Report No. 1313

New York State Bar Association Tax Section

REPORT ON TREATY RE-SOURCING RULES

November 24, 2014

This report (this "Report")[1] provides a general overview of the various types of resourcing rules found in U.S. income tax treaties, conveys our support for the use of a blanket resourcing rule and recommends that the Internal Revenue Service (the "Service") and the United States Department of the Treasury (the "Treasury") issue guidance clarifying the application of the sourcing rules found in certain treaties.

In general, U.S. income tax treaties[2] provide that the United States will grant a U.S. taxpayer a credit against U.S tax for taxes paid or accrued to the treaty partner in accordance with the terms of the treaty. However, the grant of a credit against U.S. tax is generally made in accordance with and subject to the law of the United States, and U.S. law includes a variety of rules and limitations relating to foreign tax credits, including rules designed to limit the foreign tax credit to taxes paid on income that is treated as foreign source.[3] Where a U.S. income tax treaty allows the treaty partner to tax income that U.S. domestic law treats as U.S. source, a U.S. taxpayer that pays income tax to the treaty partner on such income may not be able to claim a foreign tax credit unless the income is treated as foreign source under the treaty.

As described in detail below, U.S. income tax treaties have over time taken various approaches to resourcing income that a treaty partner is permitted to tax. At one end of the spectrum

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[2] The discussion in this Report is limited to sourcing provisions contained in income tax conventions. This Report does not review any gift and estate tax conventions.

[3] U.S. domestic law authorizes a foreign tax credit for foreign taxes paid, regardless of what a treaty provides. However, the authorization of the credit under Section 901 of the Internal Revenue Code of 1986, as amended (the "Code") is made subject to the rules contained in Section 904 (unless otherwise indicated, all Section references herein are to the Code). The operative provisions of Section 904 limit the foreign tax credit to the U.S. tax imposed on "foreign source income". Thus, in many instances a U.S. resident taxpayer may be unable to effectively utilize a foreign tax credit in the absence of a treaty provision that clearly allows income to be treated as "foreign source". The general simplifying premise is that the relevant item of income taxed by the treaty partner is the only foreign source income of the U.S. person. The foreign tax credit computation is, of course, more complex; and where a U.S. person has other sources of foreign income, that foreign source income may affect the ultimate amount of the credit that can be claimed.

are U.S. income tax treaties that include a "blanket resourcing rule"[4] whereby any income that a treaty partner is permitted to tax is clearly and unambiguously treated as foreign source. A second group of U.S. income tax treaties[5] include limited resourcing rules that apply in some (but not all) of the circumstances where the treaty partner is permitted to tax a U.S. taxpayer under the terms of the treaty.

A third group of U.S. income tax treaties[6] include a general resourcing rule but provide that the rule is "subject to" the domestic source rules "as apply for purposes of limiting the foreign tax credit." As described in greater detail below, it is not entirely clear whether this language is meant to refer only to the limitations imposed by Section 904 (as many practitioners expect) or to include the basic domestic source rules as well (which apply more broadly but can also have the effect of limiting the availability of a foreign tax credit). We note, however, that even if the latter reading of the "subject to" language is appropriate, an election under Section 865(h) may be available in some cases to treat the underlying income as foreign source. We believe it would be helpful for the IRS and Treasury, in connection with the issuance of any guidance that relates to the recommendations set forth below, to consider as well the meaning of the "subject to" language and the application of Section 865(h) in this context.[7]

This Report is divided into six parts: Part I describes our recommendations. Part II provides general background. Part III summarizes various provisions of the Code relating to the source of income and foreign tax credits. Part IV discusses the evolution of the sourcing provisions included in the U.S. model income tax conventions, the saving clauses found in treaties entered into

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[4] See, for example, the U.S. income tax treaties with China, United Kingdom, Canada, Germany, and Japan (discussed in Part V.A. below).

[5] See, for example, the U.S. income tax treaties with Denmark, Italy, France, Switzerland and South Africa (discussed in Part V.B. below).

[6] See, for example, the U.S. income tax treaties with Estonia, Latvia, Luxembourg, Sweden and Austria (discussed in Part V.C below) and the U.S. income tax treaties with India and Thailand (discussed in Part V.E. below).

[7] See discussion in note 76, *infra*.

by the United States and the OECD Model Convention. Part V discusses the sources rules currently found in various United States treaties. Part VI provides various examples where treaty sourcing issues and double tax concerns arise.

I. Recommendations

A. Endorsement of the Model Treaty Approach.

We strongly support the approach of the current U.S. Model Income Tax Convention, providing for a blanket re-sourcing of all income of a U.S. resident that a treaty partner is authorized to tax under a bilateral income tax treaty. We support a blanket re-sourcing rule because (i) it is most consistent with the basic objective of tax treaties, that of avoiding double taxation, (ii) it is consistent with the agreed taxation of the income, (iii) it avoids traps for the unwary, and (iv) it is likely to demand a highly disciplined approach to decisions regarding the allocation of primary taxing authority during the treaty negotiation process. We recognize, however, that there may be situations where a country is so unwilling to surrender its taxing authority over specific items of income that the Model Treaty approach may not be appropriate from the perspective of the United States.

B. Issuance of Interpretive Guidance Directed at Specific Treaties or Groups of Treaties

Many of the issues discussed in this Report could be solved through the publication of guidance (which could take the form of a revenue ruling, revenue procedure or notice) explaining how the United States will interpret certain treaties that are currently in force.[8] Such guidance could be directed at the interpretation of specific, individual treaties (or groups of identified treaties with identical or similar language)[9] where the application of the source rules for purposes of claiming a foreign tax credit is unclear and it is determined that the intent of the treaty (when combined with the

[8] We considered whether some of the issues discussed in this Report could be solved by a mutual agreement process or through Competent Authority relief. However, we expect that this may not be practical in light of the number of relevant treaties.

[9] Variations among U.S. tax treaties generally fall into patterns, based upon the time the treaties were negotiated. See Part V below.

application of the Code) is to allow the sourcing required for a foreign tax credit. For example, this guidance could address whether the language "subject to such source rules in the domestic laws of the [Contracting States] as apply for the purpose of limiting the foreign tax credit" in various treaties (see Parts V.C and V.E) is meant to refer only to the special source rules contained in Section 904 of the Code.[10]

Alternatively, for some treaties broader guidance could be issued, providing that income which the treaty allows the foreign treaty partner to tax shall be treated for Section 904 purposes as "arising from sources outside the United States" (and therefore as sourced to the relevant treaty partner country, subject to the other limitations of Section 904).

As an alternative, guidance interpreting various treaties could be issued in the form of regulations under Section 894 ("Income Affected by Treaty") or possibly under Section 904(d)(6)(C).

C. Guidance under Section 865(j)

The Treasury and the IRS could also consider issuing guidance under Section 865(j) applicable to certain source rules for personal property sales. This guidance could address the disposition of shares in a foreign company where the shares represent primarily an interest in foreign real (or "immovable") property; if the gain is taxed by a treaty partner country in accordance with the typical treaty provision (for sales of real or immovable property interests situated in a contracting state), and if the tax is applied by the treaty partner in a manner that corresponds to the tax that would be imposed on a direct sale of real estate, the guidance could provide that the gain on the stock disposition will be sourced in the same manner as gain from a sale of the underlying property would have been sourced.

[10] If considered necessary, the guidance could be limited to certain types of income or to treaties that allow the treaty partner to tax a U.S. resident on only certain types of income in a manner consistent with the current Model treaty provisions.

II. Background

In general, the country with primary taxing authority under a treaty is often thought of as the country where the income arises -- in other words, as being the country of "source." However, this allocation of primary taxing jurisdiction to a country is not always consistent with the determination of "source" imposed by the general source rules contained in the Code. While some U.S. income tax treaties (including the current U.S. Model Treaty) remedy this mismatch with a clear and unambiguous blanket resourcing rule, other U.S. income tax treaties do not.[11] As described in Part IV, variations also exist in the Model Tax Treaties that the United States has adopted over time. While the modifications and variations in language that appear in current treaties have been noted in certain Technical Explanations, there has never been a full articulation of the meaning of these differences.[12]

For example, in some treaties, the re-sourcing rules are stated to be "subject to the source rules in the domestic laws of the Contracting States as apply for purposes of limiting the foreign tax credit."[13] In other treaties, the statement in Article 23 (or its corollary) regarding the tax credit offered by the United States is stated as being provided "[i]n accordance and subject to the limitations of the law of the United States", with no further explication.[14] It is not clear if both of these clauses are equivalent provisions or what exactly the language is intended to mean. While the language could fairly be understood to subordinate the treaty re-sourcing rules to the specific source rules contained in Section 904 that apply for purposes of calculating the foreign tax credit, the

[11] One could argue, that at least in some treaties, references in the Relief from Double Taxation article to the availability of a foreign tax credit by the residence country suggest that the residence country should grant relief from double taxation on income for which it has granted primary taxing rights to the "other country" even in the absence of a blanket re-sourcing rule. It would be helpful if this were clarified by the Treasury and the IRS if it were intended.

[12] We note that there are other mismatches, such as timing mismatches, that sometimes can give rise to double tax problems. Those types of mismatches are not discussed here. Furthermore, we concentrate below on the mismatch itself and ignore the possibility that the taxpayer may have other low-taxed foreign source income against which the credit arising from the mismatch can be absorbed.

[13] See discussion below in Section V of this Report on "Version C", reviewing treaties with the following countries: Estonia, Latvia, Luxembourg, Sweden and Austria.

[14] See discussion below, Section V, Version B treaties.

language could also (at least arguably) be read to subordinate the treaty provision to all domestic source rules relevant to the foreign tax credit (*e.g.*, the basic rules in Sections 861, 862 and 865).[15]

It is difficult to discern what policy reason is at work if these provisions are to be read broadly. Tax treaties are entered into in order to protect taxpayers from double taxation; *i.e.*, taxation in both countries on the same item of income. Thus, treaties aim to "resolve competing national claims to the same tax revenue".[16] A treaty determines a taxpayer's residence and, with respect to different categories of income, assigns primary taxing rights to one country. In that same vein, treaties also typically include an obligation on the part of the residence country to offer a credit for taxes paid to the foreign treaty partner country.[17]

The treaty between the United States and India provides a good illustration. In response to the highly publicized ***Vodafone*** case,[18] India adopted broad (and retroactive) legislation proposing to tax indirect transfers of interests in assets located in India. As discussed in greater detail below, Article 13 of the U.S.-India treaty is unusual in that it broadly allows capital gains to be taxed by each contracting state in accordance with the provisions of its domestic law. If a U.S. resident were required to pay tax in India by reason of the legislation and wanted to claim a foreign tax credit in the United States for such tax, the U.S. resident would need to apply the provisions in the treaty between the United States and India. Article 25(3) of the U.S.-India Treaty provides that:

> "For the purposes of allowing relief from double taxation pursuant to this Article, income shall be deemed to arise as follows:

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[15] See Letter from Mary C. Bennett, Baker & McKenzie, to Patricia A. Brown, Deputy International Tax Counsel, Department of the Treasury, (6/2/2000), reprinted in 200 Worldwide Tax Daily 117-52 (6/16/2000). Ms. Bennett's letter stated, in reference to the "subject to" modifier clause: "There is no clear indication that Treasury ever intended this modified source rule to yield to the general source rules (e.g., sections 861 and 862) that were not limited in their purpose to the foreign tax credit limitation." See also Warren Crowdus, *The Interaction of Treaty and Code Source Rules*, Journal of International Taxation, Volume 13 (April 2002).

[16] Philip R. West and Brian R. Symington, *The Korean Position on Royalty Sourcing*, 2012 TNT 80-5, April 25, 2012.

[17] See Testimony of Barbara Angus, International Tax Counsel to the United States Department of the Treasury on Pending Tax Agreements, March 5, 2003, reprinted at: http://www.treasury.gov/press-center/press-releases/Pages/js86.aspx.

[18] *Vodafone International Holdings Ltd. v. Union of India*, Civil Appeal No. 733, see discussion, infra, pp.32-34.

> (a) income derived by a resident of a Contracting State which may be taxed in other Contracting State in accordance with this Convention (other than solely by reason of citizenship in accordance with paragraph 3 of Article 1 (General Scope)) shall be deemed to arise in that other State;
>
> (b) income derived by a resident of a Contracting State which may not be taxed in the other Contracting State in accordance with the Convention shall be deemed to arise in the first-mentioned State.
>
> *Notwithstanding the preceding sentence, the determination of the source of income for purposes of this Article shall be subject to such source rules in the domestic laws of the Contracting States as apply for the purpose of limiting the foreign tax credit.* The preceding sentence shall not apply with respect to income dealt with in Article 12 (Royalties and Fees for Included Services)…."[19]

As noted above and discussed below in Part V, the intended scope and meaning of the italicized language is not entirely clear.

As discussed in Part VI, treaty sourcing (or resourcing) issues can also arise (i) upon a sale of an interest in a company holding foreign real estate, (ii) in relation to personal services income and (iii) potentially in relation to royalties.

For example, assume a U.S. resident taxpayer holds an interest in a real property holding corporation formed under the laws of a foreign country jurisdiction ("FC") that has entered into an income tax treaty with the United States, whose assets consist primarily of real property (to use treaty terminology, "immovable property") located in the FC. Virtually all U.S. treaties in force[20] (as well as the current U.S. Model Treaty) would allow the FC treaty partner to tax gains realized on the sale of such stock by a U.S. resident; in a sense, this is a corollary to the U.S. "FIRPTA" regime. Yet, while the FC treaty partner can tax this type of gain, it is not always clear whether the operative treaty provisions properly allow the gain to be classified as "foreign source income". Those treaties

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[19] Convention for the Avoidance of Double Taxation, Sept. 12, 1989, U.S.-India, Art. 25(3), CCH U.S. Tax Treaties Vol. 4 ¶ 4203.05 [hereinafter, U.S.-India Tax Treaty] (emphasis added).

[20] With rare exceptions—*e.g.*, *see* Convention for the Avoidance of Double Taxation, June 4, 1976, U.S.-Kor., CCH Tax Treaties Vol. 4 , ¶ 5403.05 [hereinafter, U.S.-Korea Tax Treaty], which does not specifically address the sale of stock of real property holding companies, although Announcement 2001-34, 2001-1 C.B. 1087 confirmed that the United States and Korea have agreed that gains derived from the disposition of shares of certain Korean real property corporations by U.S. persons will be sourced in the situs country of the real property.

with a blanket re-sourcing rule ensure effective relief by virtue of a foreign tax credit. Other treaties present uncertainties. Differences can be observed (for example) when comparing the treaties with China, France, Sweden, and Israel.[21] The treaties with China and Israel would appear to effectively re-source the income, whereas in the case of the treaties with Sweden, France, Italy and Denmark (to name a few) there are apparent limitations on the re-sourcing of income that would not necessarily allow a foreign tax credit to be effectively claimed.

The treaty negotiation process is a negotiation between two nations. As a result, uniform results can never be assured and treaties will always raise distinct considerations. However, our expectation is that there are relatively few cases where the United States intended to permit a treaty partner to tax income of a U.S. resident but to prevent the U.S. resident from claiming a credit for these taxes by reason of the general source rules applicable under the Code.

III. Statutory Background; Source of Income and Foreign Tax Credit Provisions of the Code

The United States taxes its citizens, residents, and domestic corporations on worldwide income, wherever derived. Nonresident alien individuals and foreign corporations are taxed on certain U.S.-source fixed or determinable, annual or periodical income (even if the income is not effectively connected with a U.S. trade or business) and on income that is effectively connected with a trade or business in the United States (including, in the case of real property, gains on sales of interests in U.S. real property holding companies). The source rules of the Code attempt, in some manner, to source income according to the location of the activities that generate the income (although there are exceptions). For example, interest income paid by a corporation is generally sourced by reference to the place of incorporation of the borrower (with certain exceptions for cases

[21] In situations where there is a concern about the "source" of gain on the sale of stock, there may be cases where a taxpayer could undertake other planning, e.g., an F reorganization, followed by a sale of a "disregarded entity" predecessor of the foreign real property holding company, to mitigate this problem. Not all taxpayers, however, are in a position to obtain the advice that is needed to restructure their transactions in advance, or are in a position to control the ultimate structure of the transaction.

where a borrower does not have any U.S. trade or business or where a foreign entity derives effectively connected income).[22] Dividend income is generally sourced by reference to the place of incorporation of the payor of the dividend (with certain special rules for cases where foreign corporations earn a significant amount of income that is effectively connected with a U.S. business).[23] Rents are sourced based on the location of the relevant property,[24] and royalties are sourced based on the place where the intangible is used.[25] Services income is sourced by reference to where services are performed.[26]

In the case of gains from the disposition of property, the source rules have changed over time. Different source rules apply for inventory[27] (a discussion of these rules is outside the scope of this report) and personal property. The Section 865 source rules for personal property sales were altered by Congress in 1986.[28] Today, in the case of a United States resident, income or gain from the sale of personal property is generally U.S. source. In the case of a nonresident, such income or gain is generally non-U.S. source. There are limited exceptions to this basic residence rule, including one that applies to a U.S. citizen residing outside the United States, if a foreign tax of ten percent or more is incurred on the income.[29] In addition, Section 865(e)(2) contains special sourcing rules for sales through a fixed place of business. For example, where a U.S. resident maintains an office or fixed place of business outside the United States, to which gain on the sale of personal property is

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[22] *See* §§861(a)(1), 862(a)(1).

[23] *See* §§861(a)(2)(A) and (B), 862(a)(2).

[24] *See* §§861(a)(4), 862(a)(4).

[25] Id.

[26] *See* §§861(a)(3), 862(a)(3).

[27] *See* §§861(a)(6), 862(a)(6).

[28] Until that time, gain on personal property sales was sourced by reference to the location of the sale, generally understood to be a "title passage" rule. This approach was susceptible to manipulation, and when tax rates were reduced in 1986, Congress decided it was appropriate to change the determination to a residence-based standard.

[29] S*ee* §865(g)(2).

attributed, the gain can be treated as foreign source income if an income tax equal to at least ten percent is actually paid to the foreign country.[30]

Section 865(h) makes available a special election that was adopted in order to address the "later in time" rule. (The "later in time" rule refers to Congress' ability to override the provisions of a double tax convention, particularly where it makes clear the intent to do so. Where the provisions of U.S. law and a treaty are in conflict, courts have adopted a "later in time" approach to determine which will prevail.) In relation to Section 865 and the source rules for personal property sales, Congress recognized that the change to the source rules in 1986 could create a conflict with certain existing treaties. In order to address this, Section 865(h) allows a taxpayer to elect to apply treaty source rules in order to treat gain as foreign source income, in the case of sales of stock in a foreign corporation or sales of an intangible (as defined in Section 864(d)(2)) -- but only in cases where the treaty provides a source rule for the relevant income.[31] The operative language of Section 865(h)(2) states that it applies to income "which, under a treaty obligation of the United States (applied without regard to this section) would be sourced outside the United States, and with respect to which the taxpayer chooses the benefits of this section." Section 865(d)(2) defines an intangible as any patent, copyright, secret process or formula, goodwill, trademark, trade brand, franchise, or other like property.

Special rules also apply under the Code for investments in United States real property interests by non-U.S. persons. Under the "FIRPTA" provisions of the Code, adopted by Congress in 1980, the source rules are, in a sense, modified: gain on the sale of stock in a domestic U.S. real property holding company by non-U.S. persons is treated as income that is effectively connected with a U.S. trade or business, and therefore subject to U.S. tax.[32]

[30] §865(e)(2).

[31] See S. Rep. No. 100-445, at 239 (1988), *reprinted in* 1988 U.S.C.C.A.N., 4515, 4753.

[32] See §897.

Because of the potential for double taxation that can arise whenever United States persons derive income abroad, double tax exposure has historically been addressed by allowing U.S. taxpayers to claim a credit for foreign income taxes paid. The foreign tax credit is, however, limited. The most basic and important limitation in its operation is that the foreign tax credit is allowed to reduce the imposition of U.S. tax only on foreign source income. A foreign tax credit is not effective in reducing United States tax where a person only has U.S.-source income.[33]

While an in-depth discussion of the foreign tax credit provisions of the Code is beyond the scope of this Report, a few general observations are important to bear in mind. Section 901 of the Code authorizes the allowance of a credit in lieu of a deduction for taxes paid (or deemed to have been paid under Sections 902 and 960)[34] to a foreign country. Section 904 currently limits the credit that can be taken to a cap, the cap being the U.S. tax liability on the person's foreign source taxable income.[35]

Section 904 also includes a set of additional rules that can limit the tax credit availability. Under Section 904(d), the foreign tax credit limitation rules are applied separately for "passive category income" and "general category income". "Passive category" income consists of income which is of a kind that would be foreign personal holding company income, and includes most dividends, interest, and capital gains.[36] Before 2004, there were nine baskets, but the American Jobs

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[33] See §904(a). The system of allowing a foreign tax credit to be claimed for foreign taxes paid dates to 1918; ever since 1921, the foreign tax credit was limited to the U.S. tax that would have been imposed on foreign source income. See Graetz & Grinberg, *Taxing Int'l Portfolio Income,* 56 N.Y.U. Tax Law Rev. 537 (2003).

[34] §902 of the Code allows a "deemed paid" credit for taxes paid by a foreign corporation where a domestic corporation owns 10% or more of the voting stock of such foreign corporation, by reference to the ratio of dividends received during the relevant taxable year to the foreign corporations post-1986 undistributed earnings.

[35] The limitation is expressed as a fraction; U.S. taxes (before credits), multiplied by foreign-source taxable income over total taxable income. Thus, foreign-source income is taxed at the higher of the U.S. or foreign effective rate.

[36] §904(d)(2).

Creation Act of 2004 reduced the number of baskets from nine to two (effective for tax years beginning after December 31, 2006).[37]

Section 904(d)(6) provides a further limitation, requiring taxpayers to apply the limitation rules separately for each item of income re-sourced under a treaty. Section 904(d)(6) provides in general that (i) if, without regard to any treaty obligation of the United States, any item of income would be treated as derived from sources within the United States, (ii) under a treaty obligation of the United States, such item would be treated as arising from sources outside the United States, and (iii) a taxpayer chooses the benefits of such treaty obligation, the provisions of Section 904(a), (b) and (c) shall be applied separately with respect to such item. Furthermore, Section 904(d)(6)(C) authorizes regulations "or other guidance as is necessary or appropriate to carry out the purposes of this paragraph."

Section 904(h) also contains special source rules, for situations where U.S. source income is routed through a foreign corporation. Before these rules were enacted, U.S. source income could be routed through a foreign corporation in a low-tax jurisdiction in order to artificially increase the foreign tax credit limitation of a U.S. taxpayer. Section 904(h) prevents this result, reclassifying as U.S. source certain income that is routed in this fashion. Section 904(h)(10) also includes a treaty-specific provision, to the effect that the general rules of Section 904 will respect a specific treaty re-sourcing rule where the taxpayer so elects, and that such income will be included in a separate basket for 904 limitation purposes. In order for 904(h)(10) to apply, however, the relevant treaty must provide that the income in question would "be treated as arising from sources outside the United States."

The operation of Section 904 can provide a significant limitation: if an item of income taxed by a foreign country in accordance with the terms of an income tax treaty with the United States is

[37] *See* §404, American Jobs Creation Act of 2004, Pub. L. No. 108-357.

not characterized as foreign source income, no foreign tax credit can be claimed even if a meaningful foreign tax is incurred by the U.S. resident taxpayer (assuming the taxpayer does not have other low-taxed foreign source income, putting them in an excess limitation position).[38]

The operative source rules of the Code are affected by United States treaty policy and by the agreement that is reached (with a treaty partner) when the United States enters into double tax conventions. As stated above, treaties usually contain provisions that limit the authority of the United States to impose tax. In the case of nonresidents, treaties do this by reducing or eliminating the U.S. taxes imposed. In the case of U.S. resident taxpayers, treaties generally limit the United States' taxing priority by virtue of a clause that provides (or aims to provide) foreign tax credit relief to U.S. resident taxpayers who incur a tax burden in the relevant foreign jurisdiction.

IV. Model Treaties

A. United States Model Income Tax Conventions, 1977-2006

Treaty provisions take into account the tax laws of a treaty partner, and modify the operation of United States tax law that would otherwise apply under operative provisions of the Code. The treaty negotiation process thus typically involves the United States (as well as the treaty partner) ceding certain taxing priority over specific types of income. The United States may surrender its right to tax some or all of certain income (if the income would otherwise be U.S. source under the Code), giving priority to the foreign treaty partner (for instance, the United States might agree not to impose a full 30% withholding tax on interest or dividends, but to apply a reduced or zero rate of withholding).

The American Law Institute ("ALI") undertook a study in 1991 on the International Aspects of United States Income Taxation, making certain proposals on U.S. Income Tax Treaties. The

[38] A deduction could still be claimed but the usefulness of a deduction is obviously not the same as a credit in terms of providing a full offset for foreign taxes paid. As noted above, taxpayers that are fortunate enough to have other foreign-source income in the same basket that has not borne a particularly high rate of foreign tax may be able to "cross-credit" and use the credit anyway, but that is not a reason to allow inequities and inefficiencies to persist.

ALI's study referred to the manner in which countries entering into treaties address their concerns over "source-based taxation" observing that "[i]*n practice, the bargain which emerges from the balancing of these interests invariably results in a relaxation of domestic law rules governing the source-based taxation of non-resident persons and entities*"[39] and characterizing the source rules of a treaty as a necessary measure "…*to insure that the allocation of primary taxing jurisdiction to the source country is respected by the residence country in giving double tax relief*."[40]

The ALI's in-depth study observed that, with reference to double tax problems "most of them arise because the two countries make inconsistent determinations with respect to the same taxpayer."[41] The chapter on the "Purpose of Treaties" refers to problem cases as falling into three categories: "residence-residence" (where both countries consider the same person a resident); "residence-source" (where the two countries attribute different "source" to the same item of income); and "source-source" (where both countries assert source jurisdiction to tax the same income of a taxpayer that is not a resident of either country). The issues we review below, which relate to the provisions of the "Relief of Double Taxation article", fall into the "residence-source" category of potential conflict.[42]

The discussion in Section VII below sets forth examples of "problem cases" where there is currently a gap—where the foreign country is allowed to tax income, but that same income is not 're-sourced' by virtue of the treaty as "foreign source income," leaving a taxpayer with a possible double tax burden. The most recent 2006 U.S. Model treaty (the "2006 Model Treaty") avoids this result because it has an effective blanket re-sourcing rule. However, many treaties currently in force do not

[39] ALI, Federal Income Tax Project, International Aspects of U.S. Income Taxation II, "The Purpose of Income Tax Treaties and Their Legal Consequences", at 2 [hereinafter, "ALI at"].

[40] Id., Chapter on "Residence Country Taxation", at 233.

[41] ALI at 6.

[42] ALI at 8.

reflect this approach. Furthermore, in some cases the saving clause (discussed below) can operate to allow U.S. statutory law to override a specific treaty benefit.

There have been various U.S. Model Income Tax Conventions ("U.S. Models") over time. In 1977, the Treasury Department released the first U.S. Model. As U.S. domestic law and tax treaty policy evolved over the years, the Treasury Department has released updated versions of the U.S. Model: to date, there have been four versions, released in 1977, 1981, 1996, and most recently in 2006. The different versions of the Model Treaties have adopted various versions of "Relief from Double Taxation" Articles. As noted above, the 2006 U.S. Model contains a blanket re-sourcing provision in Article 23(3).

1. The 1977 U.S. Model

In the original 1977 U.S. Model, the Relief from Double Taxation provision in Article 23(3) contained special source rules covering particular types of income as well as a general "catch-all" re-sourcing provision in (d):

> "*For the purposes of the preceding paragraphs of this Article, the source of income or profits shall be determined in accordance with the following rules:*
>
> *(a) Dividends, as defined in paragraph 3 of Article 10 (Dividends), shall be deemed to arise in a Contracting State if paid by a company which is a resident of that State or if paragraph 5 (c) of Article 10 (Dividends) applies.*
>
> *(b) Interest, as defined in paragraph 2 of Article 11 (Interest), shall be deemed to arise in the State specified in paragraph 4 of Article 11.*
>
> *(c) Royalties, as defined in paragraph 2 of Article 12 (Royalties), shall be deemed to arise in a Contracting State to the extent that such royalties are with respect to the use of, or the right to use, rights or property within that State.*
>
> *(d) Except for income or profits referred to in subparagraphs a), b), or c), and except for income or profits taxed by the United States solely by reason of citizenship in accordance with paragraph 2 of Article 1 (Personal Scope): income or profits derived by a resident of a Contracting State which may be taxed in the other Contracting*

> *State in accordance with this Convention shall be deemed to arise in that other Contracting State.*"[43]

Paragraphs (a) through (c) reflect the special source rules, while paragraph (d) is a general re-sourcing rule for all other types of income.[44]

2. The 1981 U.S. Model

The 1981 U.S. Model took a more expansive approach to re-sourcing in the Relief from Double Taxation provision and is the most similar to the current method of re-sourcing income in the 2006 Model Treaty. The following is the relevant language from Article 23(3) of the 1981 U.S. Model:

> "*For the purposes of allowing relief from double taxation pursuant to this Article, income shall be deemed to arise exclusively as follows*
>
> *(a) income derived by a resident of a Contracting State which may be taxed in the other Contracting State in accordance with this Convention (other than solely by reason of citizenship in accordance with paragraph 2 of Article 1 (General Scope)) shall be deemed to arise in that other State;*
>
> *(b) income derived by a resident of a Contracting State which may not be taxed in the other Contracting State in accordance with the Convention shall be deemed to arise in the first-mentioned State.*
>
> *The rules of this paragraph shall not apply in determining credits against United States tax for foreign taxes other than the taxes referred to in paragraphs 1(b) and 2 of Article 2 (Taxes Covered).*" [45]

3. The 1996 U.S. Model

In the 1996 U.S. Model, the U.S. moved away from including re-sourcing of U.S. resident income in the Relief from Double Taxation provision. Instead, the provision only discusses the re-

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[43] U.S. Model Income Tax Convention of May 17, 1977, Art. 23(3), CCH U.S. Tax Treaties, Vol.1, ¶ 212.

[44] A similar Relief from Double Taxation provision incorporating both specific and general source provision can be found in the U.S.–Jamaica treaty. Not surprisingly, the U.S.–Jamaica treaty was entered into in 1980, not long before the release of the updated U.S. Model in 1981.

[45] U.S. Model Income Tax Convention of June 16, 1981, Art. 23(3), CCH Tax Treaties Vol. 1, ¶ 211. This form of Relief from Double Taxation provision appears in a number of existing treaties, but with several variations and limitations that can present uncertainties. Similar provisions can be found in the U.S. treaties with: (i) Austria (1996), (ii) Barbados (1984), (iii) Canada (1980), (iv) Finland (1989, as amended in 2008), (v) Italy (1984), (vi) Mexico (1992, modified in 2002), (vii) New Zealand (1982, as amended in 2006), and (viii) the United Kingdom (2001, with modifications).

sourcing of income of non-resident U.S. citizens.[46] Article 23(3) of the 1996 U.S. Model refers to "[w]here a U.S. citizen is a resident of [name of treaty partner country]", providing that in such cases income that would be exempt from U.S. tax under the treaty shall be sourced in the foreign country.

It is unclear why the Treasury moved away from the re-sourcing language in the 1981 U.S. Model and no real explanation is provided by the Treasury Technical Explanation. The Technical Explanation to the 1996 Model reads as follows:

> "*The United States agrees…to allow its citizens and residents a credit against U.S. tax for income taxes paid or accrued to the other Contracting State. …The credit…is allowed in accordance with the provisions and subject to the limitations of U.S. law, as that law may be amended over time, so long as the general principle of this Article, i.e., the allowance of a credit, is retained….*
>
> *As indicated, the U.S. credit under the Convention is subject to the various limitations of U.S. law (see Code sections 901-908). For example, the credit against U.S. tax is generally limited to the amount of U.S. tax due with respect to net foreign source income within the relevant foreign tax credit limitation category (see Code Section 904(a) and (d)), and the dollar amount of the credit is determined in accordance with U.S. currency translation rules (see, e.g., Code section 986). Similarly, U.S. law applies to determine carryover periods for excess credits and other inter-year adjustments. …Furthermore, nothing in the Convention prevents the limitation of the U.S. credit from being applied on a per-country basis (should internal law be changed), an overall basis, or to particular categories of income. (see, e.g., Code Section 856(h).*"[47]

Thus, there is no indication, in the general discussion of Article 23, that there was a desire to override the allocation of taxing authority in a particular treaty, or that the omission of a re-sourcing provision could have an impact on a taxpayer's ability to claim a foreign tax credit. Indeed, the explicit references in the Technical Explanation to Sections 901-908, Section 904(a) and Section 986, and their related limitation rules, could be read as an indication that these were the only "*limitations of U.S. law*" that were contemplated by the general lead-in clause. While the Technical Explanation

[46] *See* U.S. Model Income Tax Convention of September 20, 1996, Art. 23, CCH Tax Treaties Vol 1, ¶ 210.

[47] Treasury Department Technical Explanation of 1996 U.S. Model Treaty, CCH Tax Treaties Vol.1,¶ 216.

does refer to the fact that the rules of paragraph (3) were not in the 1981 Model, it does not acknowledge that prior model treaties had a more effective and general re-sourcing rule. Some commentators have posited that the U.S.'s departure from providing re-sourcing in the Relief from Double Taxation provision was driven by confusion over how to properly interpret the modified source rules adopted after the enactment of Section 904(g).[48] As observed by Warren Crowdus,"[t]he question is, what exactly are the rules that apply for purposes of limiting the foreign tax credit? The most sensible reading and approach would be to subject the Code's generally applicable source rules to the resourcing provision, and to preserve the Code's special source rules that apply exclusively (or almost exclusively) for foreign tax credit limitation purposes."[49] While the 1996 treaty does not contain an explicit re-sourcing provision, it is arguable that the underlying assumption was that the general "treaty-based credit" language implicitly incorporates a re-sourcing; otherwise, the language stating that a citizen or resident would be allowed a credit for taxes "imposed by the other contracting state" could be unilaterally negated.

4. 2006 U.S. Model

The 2006 U.S. Model adopted a blanket re-sourcing rule for all income that the U.S. allows the treaty partner to tax under the convention. The Treasury Department Technical Explanation states that the provisions of paragraph 3 of Article 23 are "intended to ensure that a U.S. resident can obtain an appropriate amount of U.S. foreign tax credit for income taxes paid to the other Contracting State when the Convention assigns to the other Contracting State primary taxing rights over an item of gross income." Article 23, "Relief from Double Taxation" reads as follows:

> "*Article 23(2): In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof), the United States shall allow a resident or citizen of the United States as a credit*

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[48] See Letter from Mary C. Bennett, supra note 15. See also Crowdus, *The Interaction of Treaty and Code Source rules,* supra note 15.

[49] See Crowdus, *The Interaction of Treaty and Code Source Rules,* supra note 15.

against the United States tax on income applicable to residents and citizens:

(a) the income tax paid or accrued to [treaty partner country] by or on behalf of such resident or citizen; and

(b) in the case of a United States company owning at least 10 percent of the voting stock of a company that is resident of [treaty partner country] and from which the United States company received dividends, the income tax paid or accrued to [treaty partner country] by or on behalf of the payer with respect to the profits out of which the dividends are paid." [50]

The reference to "in accordance with the provisions and subject to the limitations of U.S. law, as that law may be amended from time to time," is intended to ensure that the credit against U.S. tax is limited to the net foreign source income within the relevant foreign tax credit limitation category and that the dollar amount of the credit is determined in accordance with applicable currency translation rules of the Code.[51] In addition, issues such as the determination of carryover periods are determined by reference to U.S. law.

The operative re-sourcing language is contained in paragraph (3):

Article 23(3): For purposes of applying paragraph 2 of this Article, an item of gross income, as determined under the laws of the United States, derived by a resident of the United States that, under this convention, may be taxed in [treaty partner country] shall be deemed to be income from sources in [treaty partner country]." [52]

Accordingly, the Treasury Department Technical Explanation states, "if the Convention allows the other Contracting State to tax an item of gross income (as defined under U.S. law) derived by a resident of the United States, the United States will treat that item of gross income as gross income from sources within the other Contracting State for U.S. foreign tax credit purposes."[53]

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[50] U.S. Model Income Tax Convention of November 15, 2006, Art. 23, CCH Tax Treaties Vol. 1, ¶ 209 [hereinafter, the "2006 Model Treaty"].

[51] See Technical Explanation of the 2006 U.S. Model Income Tax Convention, CCH Tax Treaties Vol. 2, ¶ 215, p. 10,677.

[52] See 2006 Model Treaty, Art. 23.

[53] Treasury Department Technical Explanation of the 2006 U.S. Model Income Tax Convention, CCH Tax Treaties Vol. 2, ¶ 215, p. 10,678. The same section continues, referring to the special rules that may apply to a U.S.-owned foreign

B. The Saving Clause

Every income tax treaty that the United States enters into contains a "saving clause," the purpose of which is to allow the government to tax citizens and residents under the Code as if the treaty had not come into effect. The language of the saving clause is nearly identical in each instance and is often found near the beginning of a treaty.[54]

Typically, immediately following the saving clause is a paragraph which allows certain enumerated treaty provisions to override the saving clause.[55] There is variance between treaties over the specific override provisions, and over time the number of override provisions has grown. Most importantly for purposes of this discussion, the Relief from Double Taxation provision of a treaty is almost always included as one of the override provisions. Therefore, the United States generally cannot use the saving clause to tax citizens or residents if it will create a double tax in violation of the treaty's Relief from Double Taxation provision. Here again, the relevant re-sourcing language of Article 23 is determinative of the result. If a treaty contains a blanket re-sourcing provision in conjunction with its Relief from Double Taxation provision, the saving clause of that treaty can never create a double tax by reason of a source mismatch. However, if the Relief from Double Tax provision does not contain a blanket re-sourcing rule, then the saving clause allows the United States

corporation under Section 904(g)(10), and the fact that the re-sourcing rule applies to gross income, not net income; thus, the expense allocation and apportionment rules of the Code and regulations continue to apply. Treaties that contain language largely consistent with the 2006 Model Treaty include: China (1984), Tunisia (1985), the United Kingdom (2001) and Belgium (2006).

[54] The saving clause is found in Article 1, paragraph 4 in the 2006 U.S. Model Treaty. It reads, "Except to the extent provided in paragraph 5, this Convention shall not affect the taxation by a Contracting State of its residents (as determined under Article 4 (Resident)) and its citizens. Notwithstanding the other provisions of this Convention, a former citizen or former long-term resident of a Contracting State may, for the period of ten years following the loss of such status, be taxed in accordance with the laws of that Contracting State."

[55] The override provisions to the saving clause are found in Article 1, paragraph 5 in the 2006 U.S. Model Treaty, which reads, "The provisions of paragraph 4 shall not affect:

(a) the benefits conferred by a Contracting State under paragraph 2 of Article 9 (Associated Enterprises), paragraphs 1 b), 2, and 5 of Article 17 (Pensions, Social Security, Annuities, Alimony, and Child Support), paragraphs 1 and 4 of Article 18 (Pension Funds), and Articles 23 (Relief From Double Taxation), 24 (Non-Discrimination), and 25 (Mutual Agreement Procedure); and

(b) the benefits conferred by a Contracting State under paragraph 2 of Article 18 (Pension Funds), Articles 19 (Government Service), 20 (Students and Trainees), and 27 (Members of Diplomatic Missions and Consular Posts), upon individuals who are neither citizens of, nor have been admitted for permanent residence in, that State."

to assert U.S. statutory law for purposes of determining the source of income, and where U.S. statutory law treats as U.S. source an item of income that the FC treaty partner is permitted to tax, a double tax risk will exist.[56]

C. OECD Model Tax Convention

The current OECD Model Treaty offers two versions of Article 23, one, an exemption method (wherein the state of residence agrees to exempt income taxable by the other contracting state from tax) and another, a credit method (whereby the state of residence commits to reduce the tax due for taxes paid to the other contracting state on income the "other state" is allowed to tax under the treaty).[57] Because the U.S. Model adopts the credit method of relief from double taxation, the following discussion focuses on the OECD Model's credit method approach.

The OECD Model treaty language itself appears intended to effectively provide relief from double taxation, even absent express resourcing language. It states that a credit will be given to "a resident of a Contracting State [who] derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State."[58] While the OECD Model does not make explicit reference to the source rules of the contracting countries in Article 23, the commentary to Article 23 does state that "[t]he …Articles are drafted in a general way and do not give detailed rules on how the exemption or credit is to be computed, this being left to the domestic laws and practice applicable."[59] Thus, the OECD Commentary gives great deference to domestic law rules on how the residence country computes its foreign tax credit limitation, raising the question of whether this deference includes giving precedence to the resident state's domestic source rules.

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[56] The U.S.-France Treaty is one such example; see discussion below. See Part VI.B..

[57] OECD (2012), *Model Tax Convention on Income and on Capital 2010: Full Version*, Art. 23A and 23B, OECD Publishing.doi: 10.1787/9789264175181-en [hereinafter, 2010 OECD Model].

[58] 2010 OECD Model, Art. 23B.

[59] 2010 OECD Model, C(23)-11 para.32.

V. Variations in U.S. Treaties in Force

Despite the use of the U.S. Model Treaty as the starting point for treaty negotiations, many treaties in their final form do not precisely follow the U.S. Model in the Relief from Double Taxation article. The section below describes in detail variations in some relevant treaty re-sourcing provisions contained in a large sampling of treaties (25).

A. Version A Treaties: Treaties with a blanket re-sourcing approach (Examples: China, United Kingdom, Canada, Germany, Japan, and possibly Australia)[60]

A few treaties adopt the blanket re-sourcing approach found in the 2006 U.S. Model. The Treaty with China, entered into force in 1984, includes a clear statement in Article 22 that "[i]ncome derived by a resident of a Contracting State which may be taxed in the other Contracting State in accordance with this Agreement shall be deemed to arise in that other Contracting State."[61]

The U.S.-U.K treaty also essentially allows for a complete re-sourcing of the income that the United Kingdom is allowed to tax in accordance with the terms of the treaty, with one exception. The U.S.-U.K. treaty provides that the U.K. generally will not tax capital gains of U.S. residents unless the gains are "real property related" or in the case of certain gains realized by persons who had been U.K residents in the six years immediately preceding the disposition of the relevant property. (This special rule was negotiated in order to allow the U.K. to apply its domestic law to these situations). The general re-sourcing rule applies to whatever income the U.K. can tax under the treaty, with the

[60] See Convention for the Avoidance of Double Taxation, April 30, 1984, U.S.-China, Art. 22, CCH U.S. Tax Treaties Vol. 2 ¶ 2103.22 [hereinafter, U.S.-China Tax Treaty]; Convention for the Avoidance of Double Taxation, July 24, 2001, U.S.-U.K., Art. 24, CCH U.S. Tax Treaties Vol. 7 ¶ 10,901.24 [hereinafter, U.S. – U.K. Tax Treaty]; Convention for the Avoidance of Double Taxation, August 29, 1989, U.S.-Ger., Art. 23, CCH U.S. Tax Treaties Vol. 3 ¶ 3203 [hereinafter, U.S.-Ger. Tax Treaty]; Convention for the Avoidance of Double Taxation, November 6, 2003, U.S.-Japan, Art. 23, CCH U.S. Tax Treaties Vol. 4 ¶ 5201.23 [hereinafter, U.S.-Japan Tax Treaty]; Convention for the Avoidance of Double Taxation, September 26, 1980, U.S.-Can., Art. 24, CCH U.S. Tax Treaties Vol. 2 ¶ 1903.24 [hereinafter, U.S.-Can. Tax Treaty]; Convention for the Avoidance of Double Taxation, August 6, 1982, U.S.-Austl., Art. 22, CCH U.S. Tax Treaties Vol. 1 ¶ 503.45 [hereinafter, U.S.-Austl. Tax Treaty].

[61] U.S.-China Tax Treaty, Art. 22.

exception of this 6-year look-back rule of Article 13.[62] The treaty with Canada applies similar source rules.[63]

The original treaty with Germany, which was signed in 1989, did not contain a blanket re-sourcing rule and was similar to the treaties described under "Version B" in the next section. However, the 2006 Protocol to the treaty with Germany (entered into force in December 2007) amended the Relief of Double Taxation Provision (Article 23) to include a blanket re-sourcing rule.[64]

The treaty with Japan similarly applies a general re-sourcing rule to all items of income that Japan may tax under the treaty when derived by a U.S. resident.[65] The U.S.-Japan Treaty was adopted before the revised 2006 U.S. Model Treaty had been adopted, and was inconsistent with the sourcing rule contained in the earlier 1996 U.S. Model Treaty. The Technical Explanation to the U.S.-Japan Treaty contains an interesting acknowledgement:

> "*The last sentence of paragraph 2 provides a re-sourcing rule for gross income covered by paragraph 2. This provision is intended to ensure that a U.S. resident can obtain a U.S. foreign tax credit for Japanese taxes paid when the Convention assigns to Japan primary taxing rights over an item of gross income. Although the U.S. Model does not contain a re-sourcing rule, the prior Convention does contain a similar rule, as do many other U.S. treaties*."[66]

The United States-Australia tax treaty contains a modified version of the "blanket re-sourcing" approach. Unlike other treaties, which include the re-sourcing rule in the Relief from Double Taxation Article, the treaty with Australia addresses re-sourcing of income in the Miscellaneous Article, as follows:

[62] U.S.-U.K. Tax Treaty, Arts. 6, 13, and 24.

[63] U.S.-Can. Tax Treaty, Arts. 6, 13, and 24.

[64] See Protocol to the 1989 United States- Germany Income Tax Treaty, Article XII, reprinted at CCH Tax Treaties Vol. 3, ¶ 3209.

[65] U.S.-Japan Tax Treaty, Art. 23.

[66] Treasury Department Technical Explanation to U.S.-Japan Tax Treaty, Art. 23, CCH U.S. Tax Treaties Vol.4, ¶ 5233.

> *"Income derived by a resident of the United States which, under this Convention, may be taxed in Australia shall for purposes of the income tax law of Australia and of this Convention be deemed to be income from sources in Australia."*[67]

The language quoted above does not explicitly state that it applies for purposes of United States law. However, the Treasury Department Technical Explanation did consider this a blanket resourcing rule: "Paragraph 1 [of Article 27] provides source rules. Income derived by a resident of the United States which, under the Convention, may be taxed by Australia, is deemed to have its source in Australia."[68]

Notably, in a 1999 private letter ruling the Service addressed the "source" of income on an item of gain realized by a U.S. corporation that was potentially taxable in a "foreign country" (which we understand to be Australia) under Article 21 of the treaty, "Items of Income Not Expressly Mentioned". [69] While one might question whether income that a treaty partner country is not *specifically* allocated primary taxing authority over should properly be considered to have been "re-sourced" under Article 27 (since the Article itself is oddly worded, and the technical explanation refers to income that under the Convention may be taxed by Australia), the Service concluded that where Australia's exercise of taxing authority was consistent with the terms of the treaty, the item of income would be re-sourced as "foreign source income."

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[67] U.S.-Austl. Tax Treaty, Art. 27.

[68] Treasury Department Technical Explanation to U.S.-Austl. Tax Treaty, Art. 27, CCH U.S. Tax Treaties Vol.1, ¶ 520.

[69] PLR 199918047 (Feb. 9, 1999).

B. <u>Version B Treaties</u>: Treaties that do not have any general re-sourcing language and only re-source income earned by a U.S. citizen who resides in the Treaty partner country (Examples: Denmark, Italy, France, Switzerland and South Africa)[70]

A number of treaties do not contain a general re-sourcing provision and apply a re-sourcing rule only for U.S. citizens who reside in the relevant foreign treaty partner jurisdiction. The 1994 U.S-France Treaty is one such example, providing as follows in Article 24, Relief from Double Taxation:

> "*Article 24 (1)(a): In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof), the United States shall allow to a citizen or a resident of the United States as a credit against the U.S. income tax: (i) the French income tax paid by or on behalf of such citizen or resident, and (ii) in the case of a United States company owning at least 10 percent of the voting power of a company that is a resident of France and from which the United States company receives dividends, the French income tax paid by or on behalf of the distributing corporation with respect to the profits out of which the dividends are paid.*
>
> *Article 24(1)(b): In the case of an individual who is both a resident of France and a citizen of the United States, (i) the United States shall allow as a credit… the French income tax paid after the credit referred to in subparagraph(a)(iii) of paragraph(2) … and (ii) income referred to in paragraph 2 and income that, but for the citizenship of the taxpayer, would be exempt from United States income tax under the Convention, shall be considered income from sources within France to the extent necessary.*"[71]

If a U.S. individual does not reside in France (or the relevant treaty country) but resides in the United States, re-sourcing is not provided for in the treaty. Thus where an item of income can be taxed by France in accordance with the Treaty and that income is classified as U.S.-source income under the Code, no relief from double tax is provided. This is because the language of the Treaty

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[70] See Convention for the Avoidance of Double Taxation, August 19, 1999, U.S.-Den., Art. 23, CCH U.S. Tax Treaties Vol. 3 ¶ 2500 [hereinafter, U.S.-Den. Tax Treaty]; Convention for the Avoidance of Double Taxation, August 25, 1999, U.S.-Italy, Art. 23, CCH U.S. Tax Treaties Vol. 4 ¶ 4803.23 [hereinafter, U.S.-It. Tax Treaty]; Convention for the Avoidance of Double Taxation, August 31, 1995, U.S.-France, Art. 24, CCH U.S. Tax Treaties Vol. 3 ¶ 300.1[hereinafter, U.S.-Fr. Tax Treaty]; Convention for the Avoidance of Double Taxation, February 17, 1997, U.S.-S. Afr., Art. 23, CCH U.S. Tax Treaties Vol. 6 ¶ 8201.23; Convention for the Avoidance of Double Taxation, October 2, 1996, U.S.-Switz., Art. 23, CCH U.S. Tax Treaties Vol. 6 ¶ 9101.23.

[71] U.S.-Fr. Tax Treaty, Art. 24.

qualifies the obligation of the United States to offer a tax credit; it is made available only "[i]n accordance with and subject to the limitations of the law of the United States". The Technical Explanation to the U.S.-France treaty notes that:

"Thus, although the Convention provides for a foreign tax credit, the terms of the credit are determined by the provisions of the U.S. statutory credit at the time a credit is given. The limitations of U.S. law generally limit the credit against U.S. tax to the amount of U.S. tax due with respect to net foreign source income within the relevant foreign tax credit limitation category (see Code section 904(a))."[72]

Essentially the same language as that cited above can be found in the treaties with Denmark (signed in 1999 and entered into force on March 31, 2000); and Italy (signed in 1999 and entered into force on December 16, 2009).[73]

C. **Version C Treaties: Treaties that have a general re-sourcing rule, where the relevant rule is "subject to the source rules in the domestic law of a treaty party as apply for purposes of limiting the foreign tax credit" (Examples: Estonia, Latvia, Luxembourg, Sweden, and Austria)**[74]

Another variation from the U.S. Model Treaty's re-sourcing language is a group of treaties that contain a general re-sourcing rule but provide that it is "subject to such source rules in the domestic law" of the treaty party "as apply for purposes of limiting the foreign tax credit…." By way of example, the U.S. - Estonia Tax Treaty provides that:

> "*23(1). In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof), the United States shall allow to a resident or citizen of the United States as a credit against the United States tax on income: (a) the Estonian tax paid by or on behalf of such resident or citizen; and (b) in the case of a United States company owning at least 10 percent of the voting stock of a company*

[72] Treasury Department Technical Explanation to U.S.-France Tax Treaty, Art. 24, CCH U.S. Tax Treaties Vol.3, ¶ 3060.

[73] U.S.-Den. Tax Treaty, Art. 23; U.S.-It. Tax Treaty, Art. 23.

[74] Convention for the Avoidance of Double Taxation, January 15, 1998, U.S.-Est., Art. 23, CCH U.S. Tax Treaties Vol. 3 ¶ 2801.24 [hereinafter, U.S.-Est. Tax Treaty)]; Convention for the Avoidance of Double Taxation, January 15, 1998, U.S.-Lat., Art. 24, CCH U.S. Tax Treaties Vol. 5 ¶ 5551; Convention for the Avoidance of Double Taxation, April 3, 1996, U.S.-Lux., Art. 24, CCH U.S. Tax Treaties Vol. 5 ¶ 5701; Convention for the Avoidance of Double Taxation, September 1, 1994, U.S.-Swed., Art. 23, CCH U.S. Tax Treaties Vol. 6 ¶ 8801.24; Convention for the Avoidance of Double Taxation, May 30, 1996, U.S.-Austria, Art. 22, CCH U.S. Tax Treaties Vol. 1 ¶ 703.22.

> *which is a resident of Estonia and from which the United States company receives dividends, the Estonian tax paid by or on behalf of the distributing company with respect to the profits out of which the dividends are paid.*
>
> *(…)*
>
> *23(3) For the purposes of allowing relief from double taxation pursuant to this Article,* ***and subject to such source rules in the domestic laws of the Contracting States as apply for purposes of limiting the foreign tax credit,*** *income derived by a resident of a Contracting State which may be taxed in the other Contracting State in accordance with this Convention (other than solely by reason of citizenship in accordance with paragraph 4 of Article 1 (General Scope)) shall be deemed to arise in that other State*." [75]

While the precise meaning of the "subject to" language is not entirely clear, a natural interpretation of the overall provision would be that income of a U.S. taxpayer which Estonia taxes in accordance with the treaty will generally be treated as a foreign source income for purposes of applying the U.S. foreign tax credit rules, but the limitations under Section 904 will continue to apply to any such taxes.[76]

The treaty with Estonia was signed in January 1998 and entered into force on December 30, 1999. In the Joint Committee Explanation of the Treaty, Article 23 is described by the Joint Committee on Taxation as follows:

> "*Part of the double tax problem is dealt with in other articles of the proposed treaty that limit the right of a source country to tax income. This article [Article 23] provides further relief where both Estonia and the United States otherwise still tax the same item of income. This article is not subject to the saving clause, so that the country of*

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[75] U.S.-Est. Tax Treaty, Art. 23.

[76] We note that Section 865(h) permits a taxpayer to make an election to treat certain gain as foreign source if (among other things) it would be sourced outside of the United States "under a treaty obligation of the United States (applied without regard to [Section 865])…." As a result, even if the "subject to" language were interpreted broadly, an election may be available in some cases to treat gain as foreign source. The application of Section 865(h) to the Version C treaties is somewhat confusing since (i) Section 865(h) requires that the underlying gain be treated as foreign source under the treaty and (ii) in the version C treaties, the source rules are (under a broad reading) "subject" to the domestic rules. However, Section 865(h) provides that the determination of whether a treaty treats the income as foreign source is made "without regard to" Section 865. This could be read to turn off the "subject to" language for purposes of applying Section 865(h) even if the "subject to" language were given a broad interpretation. Similar principles would apply in the Version E treaties.

> *citizenship or residence will waive its overriding taxing jurisdiction to the extent that this article applies.*
>
> *The proposed treaty generally provides that the United States will allow a U.S. citizen or resident a foreign tax credit for the income taxes imposed by Estonia. … For purposes of allowing relief from double taxation under this article, the proposed treaty provides a source rule for determining the country in which an item of income is deemed to have arisen. Under this rule, income derived by a resident of one of the countries that may be taxed in the other country in accordance with the … treaty (other than solely by reason of citizenship) is treated as arising in that other country. However, the preceding rule does not override the source rules of the domestic laws of the countries that are applicable for purposes of limiting the foreign tax credit.*" [77]

The Treasury Department Technical Explanation to the treaty with Estonia states: "As indicated, the U.S. credit under the Convention is subject to the various limitations of U.S. law (see Code sections 901 - 908)."[78] While the Joint Committee and Treasury Department explanations reiterate the reference to "source rules… that are applicable for purposes of limiting the foreign tax credit", there is no indication in either of the two explanations that this language meant all general source rules contained in the Code would override the treaty allocation of taxing rights, or impede a foreign tax credit from being claimed. A more logical reading would suggest that "subject to the source rules" was intended to refer only to the different baskets of income that apply under Section 904 of the Code.[79]

In the Technical Explanation that accompanied the 1996 Luxembourg treaty, however, a sentence appears, stating that if the treaty source rules and the Code source rules are inconsistent, an election under Section 904(g)(10) would be unavailable (thus, reading a general "source override"

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[77] Joint Committee on Taxation Explanation of Proposed Income Tax Treaty Between the United States and the Republic of Estonia, October 8, 1999, CCH U.S. Tax Treaties Vol.3 ¶ 2811.

[78] Treasury Department Technical Explanation of U.S.-Est. Tax Treaty, CCH U.S. Tax Treaties Vol.3, ¶ 2812.

[79] The following treaties contain language such as this: Convention for the Avoidance of Double Taxation, January 15, 1998, U.S.-Lat., Art. 24, CCH U.S. Tax Treaties Vol. 5 ¶ 5501; Convention for the Avoidance of Double Taxation, January 15, 1998, U.S.-Lith., Art. 23, CCH U.S. Tax Treaties Vol. 5 ¶ 5551; Convention for the Avoidance of Double Taxation, April 3, 1996, U.S.-Lux., Art. 25, CCH U.S. Tax Treaties Vol. 5 ¶ 5701; Convention for the Avoidance of Double Taxation, September 1, 1994, U.S.-Swed., Art. 23, CCH U.S. Tax Treaties Vol. 6 ¶ 8801.24; Convention for the Avoidance of Double Taxation, May 30, 1996, U.S.-Austria, Art. 22, CCH U.S. Tax Treaties Vol. 1 ¶ 703.22.

into the clause)[80]; this statement could reflect a broad reading of the "subject to" clause. This particular Technical Explanation is an unusual example and is inconsistent with the technical explanations to other treaties in this category. As noted earlier in the Report,[81] however, commentators have articulated the position that the "subject to" clause included in these Version C treaties should not be interpreted as allowing all general source of income rules in the Code (which are of general application and are not primarily directed towards limiting the availability of a foreign tax credit) to override the treaty-specific determination of "source" (by reference to the allocation of primary taxing authority).

D. Version D Treaties: Treaties that pre-date the 1977 Model Treaty and contain an outdated situs-based test for sourcing sales of personal property (Examples: Korea, Israel, Norway, Cyprus, Indonesia, Morocco, and Egypt)[82]

A number of treaties do not conform to any of the U.S. Models because they were entered into before any U.S. Model had been adopted. These treaties consistently approach the question of source on an item-by-item basis, in a separate article entitled "source" (generally, Article 6). The approach seems to reflect an intent to source income in a manner consistent with the way in which it would be taxed under the treaty, but the treaties themselves do not specifically so state.

These treaties generally contain a separate article with source rules of general applicability (relevant for purposes of determining which country has primary taxing jurisdiction). With respect to personal property sales, these treaties provide that such property will be sourced by reference to

80 *See Bennett*, supra note 15. Ms. Bennett states that this "ignores the fact that, for purposes of determining whether there is a potential conflict between the Code source rule and the modified treaty source rule, section 904(g)(10)(A)(i) requires reference to the U.S. source treatment that results from section 904(g)(1), and section 904(g)(10)(A)(ii) requires the modified treaty source rule to be applied as if section 904(g)(1) did not exist."

81 *See* note 15 *supra*.

82 See U.S.-Kor., Art. 6; Convention for the Avoidance of Double Taxation, November 20, 1975, U.S.-Isr, Art. 4, CCH U.S. Tax Treaties Vol. 4 ¶ 4603.09; Convention for the Avoidance of Double Taxation, December 3, 1971, U.S.-Nor., Art. 24, CCH U.S. Tax Treaties Vol. 5 ¶ 7003.51; Convention for the Avoidance of Double Taxation, March 19, 1984, U.S.-Cyprus, Art. 6, CCH U.S. Tax Treaties Vol. 2 ¶ 2303.07; Convention for the Avoidance of Double Taxation, July 11, 1988, U.S.-Indon., Art. 7, CCH U.S. Tax Treaties Vol. 4 ¶ 4303.15; Convention for the Avoidance of Double Taxation, August 1, 1977, U.S.-Morocco, Art. 5, CCH U.S. Tax Treaties Vol. 5 ¶ 6050.43; Convention for the Avoidance of Double Taxation, August 24, 1980, U.S.-Egypt, Art. 4, CCH U.S. Tax Treaties Vol. 3 ¶ 2703.

where the sale occurs (an approach consistent with the title-passage rule that applied under U.S. statutory law at the time).

E. <u>Version E Treaties</u>: Treaties with India and Thailand[83]

As discussed above, India now taxes non-residents, under its domestic law, on income which "accrues or arises or is deemed to accrue or arise in India."[84] With regard to capital assets, a non-resident's income is deemed to accrue or arise in India upon the transfer of a capital asset "situated in India".[85]

The treaty with India was signed in 1989 and entered into force in 1990. The treaty in some respects follows the style of the general resourcing rule found in 1981 U.S. Model, but contains a limitation (similar to the one found in the Version C treaties) that the provision is subject to the domestic source rules of each contracting state for purposes of limiting the foreign tax credit. Article 25 of the U.S.-India treaty refers to the United States allowing a citizen or resident a credit in accordance with and subject to the limitations of U.S. law. Article 25, paragraph 3, reads as follows:

> "*For the purposes of allowing relief from double taxation pursuant to this Article, income shall be deemed to arise as follows:*
>
> *(a) income derived by a resident of a Contracting State which may be taxed in the other Contracting State in accordance with this convention (other than solely by reason of citizenship in accordance with paragraph 3 of Article 1 (General Scope)) shall be deemed to arise in that other state;*
>
> *(b) income derived by a resident of a Contracting State which may not be taxed in the other Contracting State in accordance with the Convention shall be deemed to arise in the first-mentioned State.*
>
> ***Notwithstanding the preceding sentence, the determination of the source of income for purposes of this Article shall be subject to such source rules in the domestic laws of the Contracting States as apply for the purpose of limiting the foreign tax credit.*** *The preceding*

83 U.S.-India Tax Treaty, Art. 25; Convention for the Avoidance of Double Taxation, November 26, 1996, U.S.-Thailand, Art. 25, Tax Treaties (CCH) Vol. 6 ¶ 9403.25.

84 Sec. 9(1), Income-Tax Act, 1961 as amended by Finance Act 2012.

85 Id.

> *sentence shall not apply with respect to income dealt with in Article 12 (Royalties and Fees for Included Services).*"[86]

The Treasury Department's Technical Explanation to the treaty refers to Article 25(3) and acknowledges the limitation of the treaty in terms of re-sourcing income as follows:

> "*Paragraph 3 provides rules for determining the source of income for purposes of the treaty foreign tax credit. The general rule is (1) that income of a resident of a Contracting State is deemed to arise in the other Contracting State, if that other State is given the right to tax that income by the Convention, so long as that taxing right is not solely on the basis of citizenship…*
>
> *If, however, the rules in the laws of a Contracting State for the determination of source of income for foreign tax credit purposes differ from the general rule stated above, the statutory rule will apply. This granting of precedence of statutory source rules over the treaty source rule, however, does not apply to determining the source for credit purposes of royalties and fees for included services dealt with in Article 12.*"[87]

The U.S.-Thailand Tax Treaty is consistent with the India treaty provisions described above.

Like the Version C Treaties discussed above, a natural interpretation of the "[n]otwithstanding" qualification is that it applies only to the specific source rules contained in Section 904 of the Code but not to the more general source rules of the Code. However, the fact that this qualification is followed by a statement that "[t]he preceding sentence shall not apply with respect to income dealt with in Article 12" could make this conclusion more difficult to reach than in the case of the Version C treaties. Moreover, the ALI study on International Aspects of U.S. Income Tax, in its chapter on Residence Country Taxation states that:

> "*Article 23, paragraph 3 of the treaty with India contains the usual language but then goes on to provide that Code source rules nonetheless apply for treaty credit purposes, except for special treaty rules relating to royalties. While the purpose of this language is not clear, it appears to mean that the United States will not give double tax relief for Indian taxes which are based on the application of the treaty. This is somewhat inconsistent with the principles stated in the text; it may simply be a case where the source country was unwilling*

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[86] U.S.-India Tax Treaty, Art. 25(3).

[87] Treasury Dept. Technical Explanation of the U.S.-India Treaty, reprinted at CCH U.S. Tax Treaties Vol.5, ¶ 4250.

> *to give up taxing jurisdiction and the residence country unwilling to give double tax relief, leaving a resulting area of unrelieved double taxation."*[88]

However, we question this interpretation as it would (like a broad reading of the subject to language in the case of the Version C treaties) completely negate the re-sourcing contemplated by Article 25(3)(a) of the India Treaty.[89]

VI. Examples of Treaty Sourcing Issues

A. Capital gains on sales of shares in companies, or interests in partnerships, whose assets consist mainly of real property located in the relevant foreign country.

Most treaties in force (and all of the treaties we discussed above)[90] allow the U.S. treaty partner to impose tax on gains attributable to sales or dispositions of "shares or similar rights in a company the assets of which consist of at least 50 percent of real property situated in" the relevant foreign country or derive at least 50 percent of their value, directly or indirectly, from real property situated in such country.[91] When this gain is not clearly re-sourced under the treaty, a question arises regarding the source of the gain for U.S. tax purposes. If, in the hands of a U.S. resident, the gain remains U.S. source income by virtue of the provisions of Section 865 of the Code (as would appear to be the case), the U.S. resident would not be able to claim a foreign tax credit and double taxation of the income could result.

Application of the U.S. sourcing rules may be impacted where the relevant treaty contains a definition of the term "real property" that cross-references relevant local law. For example, Article 6 of the treaty with Italy refers to the fact that "the term 'immovable property' shall have the meaning

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[88] ALI, "Residence Country Taxation", at 233.

[89] See also a discussion of Section 865(h) in note 76, supra.

[90] The treaty with Korea did not originally allow Korea to impose such a tax but a later announcement was made that the U.S. government had entered into an agreement with Korea to this effect. See Announcement 2001-34, 2001, CB 1087, April 3, 2001.

[91] See, e.g., U.S.-Fr. Tax Treaty, Art. 13 (2)(b).

that it has under the law of the Contracting State in which the property in question is situated."[92] If a treaty reads in this manner, and if the gain on the sale of the foreign company's shares in the case of a relevant jurisdiction is taxed by the foreign country because the shares are, under local law, treated as "real property," one might consider whether a U.S. resident could attempt to apply the treaty in a manner that requires the United States to similarly treat this gain as arising from a sale of real property, and possibly treat the gain as income from sources outside the United States under Section 862(a)(5). This might appear to be a reasonable approach theoretically, but it is by no means assured. And, if this is not the case under local law (in other words, if the law of the foreign country would not characterize the gain on a sale of such shares as real property gain), then the gain would be U.S. source income in the hands of a U.S. resident and the U.S. resident may not have relief from double taxation.[93]

B. Income from Personal Services

Issues can also arise under treaties that do not have a blanket re-sourcing rule where a U.S. citizen resides overseas and performs occasional dependent personal services for a non-U.S. employer within the United States. Treaties generally allow the United States to tax U.S. citizens by virtue of the operation of the saving clause in this type of situation, even if the primary taxing authority is granted to the country of residence under the treaty. Thus, (a) a U.S. citizen residing overseas may be subject to worldwide taxation by the foreign country of residence on his or her income for dependent personal services in that foreign country, and may also come into the United States to perform occasional services here; (b) the United States can similarly exercise its taxing

[92] See U.S.-Italy Tax Treaty, Art. 6(2); see also, e.g., U.S.-Fr. Tax Treaty, Art. 6(2).

[93] Moreover, some treaty partners are permitted to tax certain capital gains of a U.S. resident even where the gain is not attributable to "immovable property" (see, e.g. the U.S-Spain treaty, article 13, which allows Spain to impose a tax on capital gains where a U.S. resident owns or used to own at least 25% of the stock of the company). However, the special provision in the treaty with Spain incorporates its own special source rule (under the U.S.-Spain treaty, such gain is deemed to arise in the other state to the extent necessary to avoid double taxation). See Convention for the Avoidance of Double Taxation, February 22, 1990, U.S.-Spain, Art. 13, CCH U.S. Tax Treaties Vol. 6 ¶ 8403.27 [hereinafter, U.S.-Spain Tax Treaty]. We mention this example because it demonstrates the principle the Report is supporting; i.e., where a treaty partner is given priority taxing authority over an item of income, a credit should be available, particularly if the tax was contemplated at the time the treaty was negotiated.

authority on the U.S. citizen's worldwide income, as confirmed by the saving clause of the treaty; (c) the saving clause of the treaty does not override the Relief from Double Taxation article; however, it does override other provisions of the treaty dealing with the taxing authority of a country in the case of income for personal services. This precise fact pattern was addressed by the Tax Court in *Filler v. Commissioner.*[94]

In *Filler*, a U.S. citizen resided in France. The individual, who was employed by IBM-Europe, made business trips to the United States for a few days at a time during 1972 and 1973. As a French resident, Filler paid income tax to France on his total amount of compensation earned during 1972 and 1973, including the portion attributable to his services in the United States. The United States also taxed Filler (since he was a U.S. citizen) and disallowed his claim for a foreign tax credit on the income attributable to the days worked in the United States, because this income was U.S.-source income under the Code.

The substantive provisions of the treaty with France provide in Article 15 that in the case of personal services income, only the county of residence shall tax the income if: (a) the recipient is present in the other state for periods not exceeding in the aggregate 183 days in any 12-month period; (b) the employer is not a resident of the United States; and (c) the wages/salary are not borne by a permanent establishment or fixed place of business in the United States.[95]

Therefore, under Article 15 of the treaty, only France could tax Filler on the income earned because Filler was in the United States for fewer than 183 days that year. However, the Tax Court stated that Article 15 does not stand alone, drawing attention to the fact that there is also the saving clause of the treaty to be considered. The savings clause (currently in Article 29(2) of the U.S.-France Tax Treaty) allows the U.S. to tax its citizens and residents as if the treaty had not come into effect. While the saving clause cannot override the Relief from Double Taxation provision, it can

[94] *Filler v. Commissioner*, 74 T.C. 406 (1980).

[95] U.S.-Fr. Tax Treaty, Art. 15.

override Article 15. The Tax Court concluded that a fair reading of the treaty is that France should offer the credit, not the United States. The U.S. is required to provide a credit only for “the appropriate amount” of French tax and it is understood that the related Code sections on “source of income” would be applicable.[96]

Yet another case of double taxation on personal services income can arise when multinational partnerships, including service partnerships, earn income that is taxed by both the United States (when received or allocated to the partners) and by a treaty partner. Coincidentally, one example of this situation appears in Article 14 of the U.S.-France treaty. Specifically, Article 14(4) of the U.S.-France treaty provides that the exemption from French tax granted under Article 24 of the treaty shall not exceed more than 50 percent of the earned income from a partnership accruing to a U.S. citizen residing in France. Thus, any U.S. income in excess of this 50 percent cap can be taxed by both France and the U.S. While France is allowed to impose this tax under the treaty, nothing in the treaty requires the United States to re-source the income and treat it as foreign source.[97]

C. Royalties Earned by U.S. Residents from Persons in Treaty Partner Countries

Commentators have identified the difficulty with identifying the “source” of royalty income, as well as the proper character of that income (especially when there is a group of rights in the relevant contractual provisions covered by the license).[98] While many treaties avoid the issue of source and double taxation because they exempt royalty payments made to residents of the other contracting state from withholding altogether, some treaties do currently allow withholding taxes to be imposed upon payments of royalties to U.S. residents. For example, treaties with Australia,

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[96] In this case the taxpayer had actually sought relief from the French tax authorities by way of a credit and it had been denied. The Tax court stated that he could re-present his case to the French taxing authorities, and, if denied, then he could go to the French competent authority to “initiate international administrative procedures under article 25.”

[97] See Blanchard, Multinational Service Partnerships, 56 Tax Lawyer No. 4, at 785

[98] West & Symington, supra note 16. See also Andersen, 11.02(1)(b)(iii).

Bulgaria, Italy, Korea and Spain all currently allow for withholding tax to be imposed. These treaties generally refer to royalties that "arise" in a contracting state, and describe royalties as "arising" in a particular place by reference to the payor.[99]

Where the treaty does not effectively re-source the royalty income in question as foreign source income, double tax exposure can arise if the royalties are being paid by a foreign person for use of licensed property in the United States because, in such a case, the United States would treat the income as U.S. source even though primary taxing right is ceded to the treaty partner.

[99] U.S.-Austl. Tax Treaty, Art. 12; Convention for the Avoidance of Double Taxation, February 23, 2007, U.S.-Bulg., Art. 12, CCH U.S. Tax Treaties Vol. 2 ¶ 1803.25; U.S.-Kor. Tax Treaty, Art. 14; U.S.-Spain Tax Treaty, Art.12; U.S.-It. Tax Treaty, Art. 12.