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TAX TREATY CONSISTENCY PRINCIPLE

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CONSISTENCY PRINCIPLE¹

This report comments on whether and to what extent there is or should be a duty of consistency (the “**Consistency Principle**”) imposed on taxpayers claiming benefits under tax treaties. This report has two goals: first, to suggest that the IRS and the Treasury provide guidance as to current law; and second, to provide suggestions for the forthcoming revisions to the Model Treaty. While some form of the Consistency Principle has long been articulated in technical explanations to U.S. tax treaties, the issue came to the fore in Revenue Ruling 84-17² (“**Ruling 84-17**”), in which the Internal Revenue Service (the “**Service**”) ruled that a foreign taxpayer could not elect to use a U.S. tax treaty to exclude certain business income from U.S. taxation while concurrently opting to apply losses from a second business (which were not attributable to a permanent establishment) to offset the taxpayer’s U.S. taxable income from a third business (which was conducted through a permanent establishment).

The Treasury expanded the scope of the Consistency Principle articulated in Ruling 84-17 in the Technical Explanation to the United States Model Income Tax Convention of November 15, 2006 (the “**2006 Model Treaty TE**”³ and the “**2006 Model Treaty**”). The 2006 Model Treaty TE states, among other things, that “[a] taxpayer may not ... choose among the provisions of the Internal Revenue Code of 1986, as amended

¹ The principal author of this Report is David R. Hardy. Substantial assistance was provided by Paul Seraganian and Jennifer Lee. Helpful comments were received from Richard Andersen, Kim Blanchard, Andy Braiterman, Peter Connors, Robert Kantowitz, Stephen Land, Yaron Reich, Richard Reinhold, Michael Schler, Stephen Shay, David Sicular, Mark Stone and Willard Taylor. This Report reflects solely the views of the Tax Section of the New York State Bar Association and not those of its Executive Committee or its House of Delegates.

² 1984-1 C. B. 308.

³ U.S. Treasury Department, Technical Explanation of U.S. Model Income Tax Convention (2006).

(the “**Code**”) ⁴ and the convention in an inconsistent manner in order to minimize tax.” ⁵ More recently in the technical explanations to the United States treaties with Poland (2013, not yet ratified), Belgium (2006) and Germany (2006 Protocol), ⁶ the Treasury has adopted this broad Consistency Principle and prescribed the mechanics for applying this principle to the treaty rules governing the attribution of business profits to a permanent establishment (sometimes referred to herein as “**PE**”). These new mechanics for attributing profits to a permanent establishment make the differences between Code rules and 2006 Model Treaty rules more pronounced, and raise important questions about how 2006 Model Treaty and Code-based methodologies for allocating income and deductions to a U.S. taxable presence are properly reconciled.

Several tax commentators have observed that this emerging Consistency Principle of uncertain scope may be in conflict with the other provisions of the Code and our treaties.⁷ In particular, Article 1, paragraph 2 of the 2006 Model Treaty provides that the provisions of such treaty will not restrict any benefit under domestic law (the “**Domestic Benefit Preservation Clause**”). To assist the Treasury as it considers updating the U.S. 2006 Model Treaty and the 2006 Model Treaty TE,⁸ this report

⁴ Hereinafter referred to as the “Code” and all sectional “§” references herein are to the Code unless otherwise indicated.

⁵ Model Treaty TE at Article 1, paragraph 2.

⁶ In contrast to the technical explanations of these treaties, the technical explanations of other recent treaties and protocols seem to prescribe a narrower Consistency Principle and less of a distinction between Code based rules and treaty based rules. *See, e.g.*, technical explanations to the U.S. treaties with France (2009 Protocol), Switzerland (2009 Protocol) and Iceland (2007).

⁷ The New York State Bar Association Report No. 1127 on the 2006 Model Treaty (April 11, 2007) (the “**2006 NYSBA Report**”); Stephen Land, *Treaty Consistency*, 66 *Tax Lawyer* 113 (2012); and Institute of International Bankers Letter to Eric Solomon (October 1, 2007).

⁸ *See* Treasury Proposed Revisions to the U.S. Model Income Tax Convention (May 20, 2015).

analyzes Ruling 84-17 and the articulation of the Consistency Principle in the 2006 Model Treaty TE. This Report then discusses the new treaty-based profit attribution rules under the Authorized OECD Approach (the “AOA”) in order to better understand the stakes of the choice between Treaty rules and Code rules, and considers the role of the Consistency Principle in attributing profits to permanent establishments under some newer U.S. income tax treaties.

I. Introduction – Ruling 84-17 and the Consistency Principle.

Broadly speaking, Ruling 84-17 concludes that it is inappropriate for a taxpayer to be able to utilize tax treaty benefits and Code benefits inconsistently for three separate businesses in the same year. In the Ruling, the taxpayer conducted a profitable business, *A*, through a permanent establishment. The taxpayer sought to elect treaty benefits to exempt income from a separate profitable business, *B*, not involving a U.S. PE from U.S. taxation while simultaneously electing Code principles and forgoing the treaty in order to use losses from yet another separate business, *C*, not attributable to a U.S. PE, to offset profits from business *A* attributable to the U.S. PE. As the 2006 NYSBA Report observed, the taxpayer’s “cherry picking” of Code and treaty benefits seems inappropriate, since the taxpayer would end up paying less tax to the United States on business *A* than the negotiated treaty benefit prescribed.⁹ The holding may be considered analogous to Section 265, which disallows deductions allocable to income exempt from taxation.¹⁰

⁹ 2006 NYSBA Report at 12-16.

¹⁰ *See also* Treas. Reg. § 1.861-8T(d)(2).

Notwithstanding the justification for the result in Ruling 84-17 on its facts, difficult issues arise when the principles underlying that ruling are exported into different factual contexts. For example, since the permanent establishment definition and the related profit attribution determinations of a treaty are typically made separately from one separate enterprise to another, one might assert that a claim of treaty benefits to override the operation of the Code should be made independently for each business. Moreover, certain broader questions exist in determining whether the invocation of treaty benefits should have the effect of displacing benefits under the Code in light of the Domestic Benefit Preservation Clause, which appears to preserve those Code benefits. As an example, in the Foreign Investors Tax Act of 1966, the United States, seeking to induce foreign capital to invest in the U.S. securities markets, enacted the securities trading safe harbor of Section 864(b) of the Code (the “**Securities Trading Safe Harbor**”).¹¹ If a foreign taxpayer conducts such securities trading in the U.S. and simultaneously conducts an independent business of manufacturing and selling goods into the United States through an independent sales agent, a broad reading of Ruling 84-17 might suggest that the taxpayer could not claim simultaneously both treaty protection for his manufacturing business and the Securities Trading Safe Harbor to exempt income from its securities trading business. This would be a puzzling result.¹²

¹¹ Public Law No. 89-809 (1966).

¹² We acknowledge that foreign taxpayers conducting businesses in the United States are often advised to form U.S. subsidiaries to conduct those activities, thereby obviating many of the consistency issues related to profit attribution to a permanent establishment under treaties. Foreign banks, however, are generally compelled by bank regulatory capital considerations to operate through U.S. branches that are permanent establishments.

In the 2006 Model Treaty TE, the Treasury appeared to describe the Consistency Principle as a very open-ended limitation on the Treaty’s preservation of domestic law benefits.¹³

“... paragraph 2 states the generally accepted relationship ... between the Convention and domestic law ... That is, no provision in the Convention may restrict any exclusion, exemption, deduction, credit or other benefit accorded by the laws of the Contracting State ... for example, if a deduction would be allowed under the ... Code ... in computing the U.S. taxable income of a resident of the other Contracting State, the deduction is also allowed to that person in computing taxable income under the Convention. Paragraph 2 also means that the Convention may not increase the tax burden on a resident of a Contracting State beyond the burden determined under domestic law... It follows that a taxpayer’s U.S. tax liability need not be determined under the Convention if the Code would produce a more favorable result. A taxpayer may not, however, choose among the provisions of the Code and the Convention in an inconsistent manner in order to minimize tax... [.]”

The 2006 Model Treaty TE does limit the Consistency Principle to some degree by stating that electing out of treaty benefits for the determination of the taxability of business profits is not considered inconsistent with electing treaty benefits to reduce the U.S. withholding tax rates on U.S. source dividend income.¹⁴ However, the scope of this broader principle of consistency is not further specified.¹⁵

¹³ Model Treaty TE at 2 and 3.

¹⁴ Presumably, dividend withholding exemptions and rate reductions would include the rates of the branch profits tax imposed by Section 884, making reduced treaty rates available to foreign corporations’ U.S. businesses otherwise electing out of the treaty protection.

¹⁵ The Consistency Principle may arise in contexts outside of the attribution of profits to a permanent establishment under Article 7 of the Model Treaty. In the technical explanation to the U.S. treaty with Italy (1999), Ruling 84-17 is cited to explain that royalties paid by a U.S. resident or a PE would be subject to U.S. withholding tax even if the royalty related to the use of intellectual property outside the U.S. *See* U.S.-Italy Treaty Technical Explanation at Article 12, paragraph 6; *but see* Senate Foreign Relations Committee Report 100-25 to the 1988 Protocol to the U.S. – France Treaty, at 14 (reaching the opposite conclusion). Such expansions of the holding of Ruling 84-17 outside the scope of profit attributions in Article 7 will not be considered here.

Another significant question lurking in the Consistency Principle is how treaty-based principles differ from Code principles with respect to the computation of taxable business profits. Under treaty principles, a branch would be treated as an independent corporation dealing with its head office (parent) on an arm's-length basis. Accordingly, branch borrowings, branch swaps and branch licenses of property from the parent corporation, normally disregarded for U.S. tax purposes, would be regarded and respected to the extent they satisfied the arm's-length standards, and business profits not attributable to a permanent establishment are excluded. On the other hand, foreign source royalties attributable to the permanent establishment could be taxable. Conversely, in determining effectively connected income ("ECI") of a U.S. trade or business under Code rules, transactions between the branch and the head office are ignored, business profits are aggregated under a limited force of attraction rule (see Section 864(c)(3)), and foreign source royalty income is excluded from business profits under Section 864(c)(4).

This report considers whether the Consistency Principle should require that the taxpayer ignore all Code rules in the attribution of profits to a permanent establishment. Are two separate regimes consistent with the basic principles of U.S. domestic tax law and of treaty interpretation? If under Article 1, paragraph 2 of the 2006 Model Treaty, the treaty provisions are not permitted to restrict any allowance or benefit under U.S. domestic tax rules, why should a taxpayer electing treaty permanent establishment profit attribution be prevented from utilizing the methodology under Treas.

Reg. § 1.882-5 for interest and capital allocation,¹⁶ the Securities Trading Safe Harbor, and the exemption of non-effectively connected investment income under Section 864(c)(4) and other Code based exemptions and benefits?

As the Treasury considers its new Model Treaty, some clarification of the scope of the Consistency Principle is advisable in order to provide the organizing principles for such a doctrine. Without some clarification on this point, the Consistency Principle could conceivably erode the protections against double taxation that the treaties attempt to extend to our trading partners. In addition, in the negotiations of U.S. treaty commitments, each side needs to be aware of domestic treaty interpretation principles that the other will employ to affect the scope of treaty protections being negotiated.

II. Summary of Recommendations.

A. No Overall Requirement of Consistency. We support the view of the 2006 Model Treaty TE that there is no overall requirement that a taxpayer apply the treaty to all items or none. For example, a taxpayer claiming the benefits of a reduced rate of withholding on dividend income is free to compute profits of a permanent establishment using Code-based rules rather than the treaty.

B. Consistency Principle Should be Limited to Preventing Inappropriate Selectivity of Treaty Benefits. While we believe that Ruling 84-17 reaches an appropriate result based on the facts that were present in that ruling, we regard the

¹⁶ Model Treaty TE actually permits taxpayers using the treaty regime to elect to use Treas. Reg. § 1.882-5 for the determination of branch capital and branch interest or, alternatively, to use a risk weighted method under AOA. *See* Model Treaty TE at Article 7, paragraph 3.

expansion of this highly fact-specific holding into the broad based Consistency Principle that is articulated in the 2006 Model Treaty TE as unnecessary and unjustified. We suggest that, in its new Model Treaty TE, the Treasury should revise its articulation of the Ruling 84-17 position to state that a taxpayer may not mix the taxation of income from a permanent establishment with losses that are not attributable to a permanent establishment in a manner contrary to the purpose of the Model Treaty to preserve the right of the United States to tax the profits of a permanent establishment (unless the taxpayer would owe less tax under the Code).

C. Treaty Elections on an Enterprise-by-Enterprise Basis. The 2006 Model Treaty determines taxability and attributes taxable income on an enterprise-by-enterprise basis.¹⁷ Assuming that the Treasury is comfortable that it has the tools to determine the separateness of enterprises, we suggest that consideration be given to clarifying in the Model Treaty TE and/or in Treas. Reg. § 1.871-12 that each separate business enterprise may separately choose to invoke the protection of a treaty (subject only to the constraint described in the preceding recommendation that a taxpayer may not mix and match such elections in a way that would thwart the purposes of the Model Treaty in a manner

¹⁷ Several provisions of the Model Treaty seem to operate under the assumption that taxability of a PE is determined on an enterprise-by-enterprise basis. See Article 7(1) of the 2006 Model Treaty, which states that the profits of “*an enterprise* of a Contracting State shall be taxable only in that state unless the enterprise carries on business...” (emphasis added); cf. Article VII(1) of the U.S. – Canada Treaty, which states that the “business profits of a *resident of a Contracting State* shall be taxable only in that state unless the resident carries on business...”, discussed *infra* at note 33. Article 7(1) of the 2006 Model Treaty then goes on to state that “the profits of the enterprise may be taxed in the other State but only so much of them as are attributable to that permanent establishment”, which turns off the limited “force of attraction” doctrine of Section 864(c)(3). This implies the profits would be calculated on an enterprise-by-enterprise basis, i.e., the U.S. source income of an enterprise that is not attributable to a permanent establishment would not be aggregated with the income of a separate enterprise that is attributable to a permanent establishment of a resident. Additionally, Article 24 of the 2006 Model Treaty provides non-discrimination protection for “nationals” in paragraph 1, and separately “taxation [of] an enterprise” in paragraph 2. There should be no need for a separate provision to address PE taxation if it is not determined on an enterprise-by-enterprise basis.

analogous to Ruling 84-17). While separating one business enterprise from another may present factual challenges, such a determination is already required by our treaties in order to separately attribute profits for each business enterprise and there are domestic law authorities to provide relevant guidance.¹⁸

D. Treaty Consistency Generally Not Required Across Taxable Years. The Model Treaty should preserve the historical position of the Service that there is no requirement that a taxpayer make the same choice to apply treaty benefits or Code benefits from one year to the next with respect to any particular U.S. line of business.¹⁹ To address any concerns that year-to-year inconsistency may erode retained taxing rights under the treaties, the Treasury may consider confirming that except as otherwise required by AOA, a taxpayer must continue the same methods of accounting from one year to the next even when switching from taxation under the Code to taxation under the treaty. In addition, the Treasury may consider requiring a restatement of or adjustment to tax attributes when carried over from one regime to the other.²⁰

E. Adoption of AOA. We support the adoption of profit attribution to a permanent establishment under the AOA methodology, which embraces the Organization for Economic Co-Operation and Development's widely disseminated transfer pricing guidelines.²¹ Certain AOA principles as adopted by the 2006 Model Treaty's adoption of

¹⁸ See Section 989(a) (relating to qualified business unit for foreign currency transactions); Treas. Reg. § 1.367(a)-2T(b)(2) and Treas. Reg. § 1.355-3(b)(2).

¹⁹ See Ruling 80-147.

²⁰ See Part IVC(1) *infra*.

²¹ Organization of Economic Co-operation and Development, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (1995, amended in 2010).

AOA, such as the prescription of an independent entity construct and the specific connection of income to a PE, are clearly and intentionally inconsistent with U.S. domestic law principles. We believe it is appropriate to treat those provisions in U.S. treaties as overriding the inconsistent provisions of U.S. law contained in Section 864(c)(2) and (3) (regarding effectively connected income).

F. The Adoption of AOA Should Preserve Code Benefits. Any consistency that may be required for tax positions governed by an article of a treaty should preserve, to the maximum extent possible, Code-based exemptions, such as the exemption of state and local bond interest and the Securities Trading Safe Harbor. Our view is informed by the Domestic Benefit Preservation Clause and general principles of harmonious construction of domestic statutes and treaties. For similar reasons, we believe that the provisions of Section 864(c)(4) which exclude certain foreign source royalties and foreign source service income from U.S. taxation are not inconsistent with AOA and should be available to taxpayers for calculating profits attributable to a permanent establishment.²²

G. Formality. The announcement of a broad Consistency Principle in the 2006 Model Treaty TE has certain deficiencies in terms of formality. While we presume that treaty partners would read the Model Treaty TE when entering into treaty

²² Cf. PLR 9651052 (holding that the Code's exclusion of foreign source bank confirmation and letters of credit acceptance service income was consistent with treaty profit attribution) discussed *infra*. Allowing AOA to displace inconsistent provisions of Section 864(c) could allow the U.S. to tax foreign source service or royalty income where such income is attributable to a PE of a taxpayer invoking the treaty benefits. We acknowledge that our view on this point differs from the views expressed by Treasury in the 2006 Model TE and Technical Explanations to the German Protocol the Belgian treaty and the proposed Polish treaty.

negotiations with the U.S. and therefore should be on notice of any articulation of the Consistency Principle in the Model Treaty TE, the Model Treaty TE lacks the formality and administrative procedural impact of a regulation. We would recommend that if and to the extent that the Treasury determines that it should expand or refine the Consistency Principle beyond the facts of Ruling 84-17, such changes should be presented as an amendment to the existing Treas. Reg. § 1.871-12 (regarding determination of tax on treaty income). We believe that such a regulatory change should have prospective effect only. Such a regulation could then guide the courts and taxpayers with respect to the intended scope of protection for treaties ratified thereafter. While Ruling 84-17 should still apply to any period prior to the issuance of such a regulation, we would also recommend that a notice or superseding ruling be issued to clarify the scope of Ruling 84-17.

III. Treaty Interpretation Principles.

Income tax treaties are designed to reduce the possibilities of double income taxation of international transactions between two nation states. Treaties thereby seek to avoid burdens that might otherwise discourage commercial interactions between trading partners and their resident taxpayers. Treaties need to convey reasonable certainty as to their scope in order for them to reliably convey the incidence of taxation to taxpayers planning transactions and to permit withholding agents to collect and remit appropriate taxes. In this regard, it is useful to review certain treaty interpretation rules that inform the process in which the Consistency Principle would operate.

A. Treaties Do Not Tax. It is important to note that treaties do not impose tax. Instead, treaties are established in order to reduce tax otherwise imposed by domestic law.²³ Thus a treaty should not increase a taxpayer's burden above that which it would experience under domestic law.

B. Code First. As a corollary, if the Treaty is a tax-relieving instrument, the domestic law provisions must be applied first to determine what that domestic tax is. Thus, under Treas. Reg. § 1.871-12(b), neither treaty income nor non-treaty income includes "income of any kind, which is exempt from tax imposed by chapter 1 of the Code." Code rules have a necessary role to play before determining treaty benefits.

C. Domestic Meanings. Article 3, paragraph 2 of the 2006 Model Treaty provides that "any term not defined therein shall, unless the context otherwise requires ... have the meaning which it has under the law of that State for the purposes of the taxes to which the Convention applies." This notion, that domestic law interpretation should fill the 2006 Model Treaty's gaps for the country to interpret its treaty rules and obligations, might be regarded as a self-evident proposition of administrability. But it also suggests that Code rules and definitions are not simply relevant for determining domestic tax that a treaty may relieve; Code definitions are incorporated in treaty interpretation except to the extent displaced by treaty definitions.

D. Mutual Understanding by Treaty Partners. Treaties result from a bi-lateral acceptance of taxing limitations between the nation states. As a negotiated agreement, like any contract, a mutual understanding of the context and meaning is fundamental to

²³ 2006 Model Treaty TE, page 2.

the two nations' acceptance and agreement to extend the benefits of the Treaty and observe their obligations under the Treaty.²⁴

E. Domestic Benefit Preservation. Article 1, paragraph 2 of the 2006 Model Treaty provides that “this convention shall not restrict in any manner any benefit now or hereafter accorded ... by the tax laws of either Contracting state” (the “**Domestic Benefit Preservation Clause**”). This language or similar language appears in all of the current U.S. tax treaties. The application of this Domestic Benefit Preservation Clause creates a broad level of protection to taxpayers that informs the interpretation of our treaties.

F. Non-Discrimination. Article 24, paragraph 2 of the 2006 Model Treaty provides: “the taxation of a permanent establishment that an enterprise of a Contracting State has in the other Contracting State shall not be less favorably levied in that State than the taxation levied on enterprises of that other State carrying on the same activities.” As the technical explanation to the proposed U.S. – Poland Treaty of 2013 observes, “not all differences in the treatment ... are ... discrimination. Rather, the non-discrimination obligations ... provide that two persons that are comparably situated must be treated similarly.” Under that view, the language broadly protects our treaty partners' expectations of comparable benefits to those extended to U.S. persons under Code rules.

²⁴ *National Westminster Bank v. U.S.*, 512 F.3d 1347 (Fed. Cir. 2008).²⁵ Convention between the Government of the United States of America and the Government of Polish People's Republic For the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income, October 8, 1974.

G. Harmonious Construction. Under normal rules of statutory construction, observed within the United States, the common law countries, civil law countries, as well as the OECD, are that provisions of a treaty and provisions of domestic law interacting with treaties must, to the fullest extent possible, be read in such a way as to harmonize their respective meaning. In this area, overriding prior provisions of law or treaty by implication is not favored. When those provisions are clearly in conflict, a court must determine which rule takes precedence. So it is that Section 7852(d) of the Code was enacted to reflect the view of Congress and the U.S. Courts that neither the Code provisions nor the treaty provisions automatically prevail over the other. Thus, where a conflict exists between Code and treaty, the later in time will prevail.

IV. Ruling 84-17 and Progeny

A. Ruling 84-17. Ruling 84-17 describes a Polish corporation (the taxpayer) eligible for the benefit of a treaty with the United States, which manufactures and markets product *A* in the United States and abroad through a U.S. permanent establishment. The same taxpayer has a separate and unrelated business activity under which it manufactures product *B* in Poland and sells the product through an independent contractor in the United States and abroad, an activity that does not constitute a U.S. permanent establishment. The taxpayer has a third, separate and unrelated business activity under which it manufactures product *C* in Poland and sells through an independent contractor in the United States not representing a U.S. permanent establishment. Income from all three businesses would be effectively connected with a U.S. business and taxable under Section 864(c)(3).

For the tax year in question, the taxpayer earns profits from product *A* that are subject to tax in the United States. In that year, the taxpayer generates profits from product *B* and losses on product *C*. The taxpayer “claimed the provisions of the Convention with respect to the gain-producing activities, involving products *A* and *B*, so that the gain from the sales of product *A* was subject to United States income taxation and the gain from the sales of product *B* was exempt from U.S. income taxation.” The taxpayer sought to claim the provisions of the Code instead of the treaty with respect to its loss on product *C*, the loss from which the taxpayer would use to offset the taxable income from product *A*.

In describing the law applicable to the foregoing facts, Ruling 84-17 confirms that under Section 882, a foreign corporation engaged in a trade or business within the United States is taxable on the income that is effectively connected with the conduct of a trade or business in the United States. Section 864(c)(3) states that all income from sources within the United States other than fixed or determinable income shall be treated as effectively connected with the conduct of a U.S. trade or business. Section 894(a) of the Code requires that income, to the extent required by a treaty obligation of the United States, shall be exempt from taxation under the Code. Ruling 84-17 acknowledges that the U.S. – Poland Treaty²⁵ contains the Domestic Benefit Preservation Clause stating that the Convention shall not be construed “to restrict in any manner any deduction allowed by the laws of the United States” Ruling 84-17 explains that the Domestic Benefit Preservation Clause reflects the principle that “a

²⁵ Convention between the Government of the United States of America and the Government of Polish People’s Republic For the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income, October 8, 1974.

Convention should not increase the tax burden” on a treaty beneficiary. Ruling 84-17 then refers to the following statement from the report of the Senate Foreign Relations Committee in describing the objectives of the U.S. – Poland Treaty: “the Committee stated that ordinarily business income is not taxable in the source country ... unless the taxpayer has a fixed place of business there; if there is only a temporary or minimal presence in the country, the conventions typically provide for taxation exclusively by the residence country ...”²⁶

The crux of Ruling 84-17’s conclusion is then stated as follows:

“The intent under the Convention – that the United States will only tax business profits of a Polish enterprise that are attributable to a trade or business conducted by such enterprise in the United States – would be thwarted if losses not attributable to a permanent establishment in the United States are offset against gain attributable to a permanent establishment in the United States. Further, such an offset would require the inconsistent treatment (during a taxable year) of non-attributable gain and loss – such gain being exempt under the Convention and such loss being deductible under the Code. Accordingly, the product *c* non-attributable loss cannot be used to offset the product *a* gain attributable to the United States permanent establishment because the provisions of the Convention have been claimed with respect to product *a* and product *b* gain.”

Ruling 84-17 concludes by saying that the Domestic Benefit Preservation Clause allows the taxpayer “the option to use the provisions of the Code to determine the tax liability with respect to the sales activities for products *a*, *b*, and *c* if this results in a lower tax liability...” than under the treaty.

The conclusion of Ruling 84-17 has in general not been regarded as controversial. The U.S. Treaty negotiators have agreed to relinquish the right to tax

²⁶ Senate Report Number 94-15, 94th Congress, First Session 1 at 7 (1975), 1977-1 C. B. 425.

business profits of a foreign enterprise that are not attributable to a permanent establishment. But our treaties preserve the right to tax business profits that are attributable to a permanent establishment. Those retained taxing rights would be eroded if a taxpayer could make selective claims of treaty benefits to cause non-attributable losses to reduce attributable profits and at the same time to exclude non-attributable profits. As stated, the offset of attributable profit by non-attributable loss, while at the same time excluding non-attributable profits, would require “the inconsistent treatment” of the business profits in the taxable year. Thus, the offending inconsistency is that non-attributable profits from *B* are exempt under the treaty while non-attributable losses from *C* are utilized by electing out of the treaty. The narrow holding of the ruling is that a taxpayer, in availing itself of the protections accorded by the Treaty, like any other election, must also accept the attendant consequences of such action and election, and that by electing treaty benefits to exempt business profits from business *B*, the taxpayer cannot at the same time ignore the treaty to use the losses from business *C*, also not attributable to permanent establishment.

B. Prior Rulings. In considering the proper interpretation of Ruling 84-17, it is helpful to compare it to prior Revenue Ruling 81-78 (“**Ruling 81-78**”), which it modifies. In Ruling 81-78, the same Polish taxpayer had only two businesses: *A*, profitable through a permanent establishment, and *B*, profitable without a permanent establishment. In Ruling 81-78, the Service made the point that under Code rules, a limited force of attraction principle (the “**Residual Force of Attraction Principle**”) continues to exist in Section 864(c)(3), under which business profits of business *B* would be treated as effectively connected with the taxpayer’s U.S. trade or business if it had a

U.S. trade or business for business *A*. In contrast, Ruling 81-78 specifically states that the Residual Force of Attraction Principle does not exist under the treaties where business profits must be “attributable to a permanent establishment” (the “**Specific Connection**”). Ruling 81-78 quotes from a Joint Committee Staff memorandum interpreting the U.S. – Germany Treaty²⁷ stating that “the protocol limits the existing Convention by allowing the other country to tax only those industrial and commercial profits that are ... attributable to the permanent establishment ... Therefore, unless the income is essentially a part of or closely related to the permanent establishment, it will not be taxed by the source country.” Ruling 81-78 concludes without difficulty that the taxpayer’s profits from business *B* are exempted from taxation by the treaty if the taxpayer claims treaty benefits while profits from business *A* are subject to taxation under the treaty.

Ruling 84-17 was published following Ruling 81-78 in order to clarify the Service’s position that the taxpayer could not mix and match from Code and treaty provisions by electing the benefits of the treaty for business *A* and *B* and electing Code benefits for loss-making business *C*. The result of the additional hypothetical element in Ruling 84-17 of the loss-making, non-attributable business *C*, does have the appearance of the gaming or manipulation of an otherwise proper election to whip-saw the U.S. taxing rights. Certainly, it offends the sensibilities when deductions attributable to exempt income are allowed to reduce unrelated taxable income. Section 265, long part of the Code, expresses this principle, and the benefits that the taxpayer in Ruling 84-17, which that ruling rejects, have at least the same flavor.

²⁷ Joint Committee Staff Memorandum, 1966 – 1 C. B. 547 at 548.

A second predecessor to these rulings is Revenue Ruling 80-147 (“**Ruling 80-147**”). In Ruling 80-147, a Canadian corporation operated a business of contract carrier transporting goods between the United States and Canada. The contract carrier business had \$100 of income and \$225 of attributable expenses. The taxpayer also had \$125 of effectively connected interest income (not attributable to the permanent establishment). Ruling 80-147, referring to the Domestic Benefits Preservation Clause, stated that the Canadian taxpayer could only claim a deduction for its expenses if the income to which the expenses relate was subject to U.S. tax. Thus, if the taxpayer chose to elect treaty benefits to exclude otherwise effectively connected carrier service income from U.S. tax where such income was not attributable to the permanent establishment, it could not claim the associated expenses as a deduction. It further states that deductions attributable to treaty-exempt income would be disallowed under Section 265 of the Code and Treas. Reg. § 1.861-8(d)(2)²⁸ as allocable to tax exempt income. Ruling 80-147 then goes on to state that a taxpayer may “annually choose to remain subject to federal income tax” and can, as a result, elect Code treatment in one year and deduct related expenses from effectively connected gross income and elect the protections of the treaty in a subsequent year to exclude further income from the same business.

Revenue Ruling 79-199 (“**Ruling 79-199**”),²⁹ held that under normal rules of statutory construction requiring harmonious interpretation, the taxpayer who was permitted to utilize the foreign earned income exclusion of Code Section 911 must forgo

²⁸ Currently modified and incorporated in Regulation §1.861-8T(d)(2).

²⁹ 1979-1 C. B. 246.

the foreign tax credit for related taxes or, alternatively, include the income in taxable income and then claim the foreign tax credit under the treaty.

C. Subsequent Rulings. In a series of private letter rulings, the Service has applied Ruling 84-17 to various fact patterns. In Technical Advice Memorandum 8524004³⁰ (“**TAM 8524004**”), a Canadian taxpayer sought to elect Code treatment to its U.S.-source shopping center rental income business in order to be taxed on a net basis. But, in the very same year, the taxpayer sought to elect the treaty to exempt the gains realized from the sale of the shopping center producing such rent from U.S. income tax. TAM 8524004 concludes that “Revenue Ruling 84-17 would require the consistent treatment during the same taxable year of non-attributable income derived from a single source, *i.e.*, non-attributable rental income derived from the shopping center and non-attributable gain from the sale of the shopping center.” In accordance with Ruling 84-17, the taxpayer must use either the Convention or the Code, but not both, in determining the taxability of the rental income and gain from the same business in the same year.³¹

CCA 200612103 (November 29, 2005) (“**CCA 200612103**”) reached a similar conclusion. CCA 200612103 stated that the taxpayer would “thwart the underlying assumption of the Treaty” if it could claim that a substitute dividend payment was a dividend bringing creditable foreign tax under the treaty³² but not a dividend for

³⁰ February 12, 1985.

³¹ The TAM does not address whether the taxpayer was taxed on a net basis in prior years, which could have generated depreciation deductions that, absent the treaty, would have been recaptured on sale. *See Land, supra* note 7, at 182–87.

³² *See also* TAM 2005 09023 (November 17, 2004) (taxpayer cannot claim a foreign tax credit for tax paid on treaty excluded income); FSA 200117019 (April 27, 2001) (taxpayer claimed a cash

foreign tax credit limitation purposes under Code rules. Also, recently, in *Lehman Brothers Holdings v. United States*, 10 Civ. 6200 (S.D.N.Y. May 8, 2015), the Court, following the authorities above, ruled that the taxpayer could not claim the foreign tax credit under the UK treaty for dividend withholding in respect of dividends on shares held under securities loans while not treating the income as dividends under section 901(k) of U.S. law.

D. Limits on Consistency. It is easy to understand why the Service and Treasury would not wish to allow taxpayers to “mix and match” treaty benefits and Code rules. The Code rules and benefits are complex in themselves. The Service might also feel that the use of Code benefits might cause the United States to lose its negotiated right to subject a foreign corporation’s attributable business profits to U.S. tax.

When Ruling 84-17 is considered in the context of the other prior rulings, a fuller picture of the offending inconsistency emerges. Rulings 81-78 and 84-17 both clearly permit the treaty to exempt one business enterprise while taxing another. From Ruling 80-147, it is clear that electing in and out of a treaty between one year and the next is not offensive. Ruling 80-147 also shows that one enterprise’s loss, if it elects out of treaty protection, may offset ECI of another enterprise so long as the loss of the first enterprise takes into account the net amount of its income and deductions.

Ruling 84-17’s statement that the taxpayer must use the treaty regime for businesses *A*, *B* and *C*, or use the Code regime for businesses *A*, *B* and *C* might be viewed

distribution, immediately recontributed for stock, was a tax-free stock dividend under the Code but sought to claim foreign tax credits under the Treaty).

as asserting that the taxpayer must make a consistent election of treaty or non-treaty treatment for all of its businesses subject to Article 7 of the 2006 Model Treaty.

However, a more nuanced view is that this statement illustrates how the taxpayer could have proceeded in a non-offensive way to utilize the non-attributable loss for business *C* – by not electing the treaty in respect of business *B*. In reaching its conclusion, Ruling 84-17 does not state that the taxpayer is required to make a single election of treaty or Code. Instead, Ruling 84-17 emphasizes the use of non-attributable loss against attributable profit, while at the same time excluding non-attributable profits, as thwarting the treaty’s purpose. As such, implicit in Ruling 84-17 is the recognition that each business enterprise may make its own treaty or Code election, unless the result is to mix and match in an impermissible way.

Furthermore, under a treaty, to be taxable, business profits of an enterprise must be specifically connected to a permanent establishment of such business enterprise; separate businesses are not aggregated to a single permanent establishment. Ruling 84-17 itself assumes that the permanent establishment definition is separately applied to business *A*, business *B* and business *C*, resulting in business *A*’s taxability in the United States while business *B* is exempt from tax under the treaty. The attribution of business profits to a PE under Article 7 of the 2006 Model Treaty is also applied on an enterprise-by-enterprise basis.³³ This may suggest that a taxpayer should be able to separately elect

³³ Article 3(1)(d) of the 2006 Model Treaty provides that, “the term ‘enterprise’ applies to the carrying of any business”. The Technical Explanation indicates that “enterprise” means any activity or set of activities that constitutes the carrying on of a business. Accordingly, just as a foreign taxpayer may be considered to enter into multiple separate and distinct “trade or business” activities under domestic law principles (*see*, for example, Treas. Reg. §1.367(a)-2T(b)(2) which defines a “trade or business” as a “specific unified group of activities that constitute (or could constitute) an independent economic enterprise carried on for profit”), we believe that the term “enterprise” should be construed as any

to “accept” or “reject” the application to Article 7 for each distinct enterprise that constitutes a PE. It could be argued that there is nothing intrinsically wrong³⁴ with affording this electivity to taxpayers, unless the combination of elections made by the taxpayer would thwart some demonstrable purpose of Article 7.

Any suggestion that in applying treaty protection for business profits, the Consistency Principle forces an “all businesses or none” election is potentially in conflict with the Domestic Benefit Preservation Clause. Ruling 84-17 and the subsequent 2006 Model Treaty TE state that the Domestic Benefit Preservation Clause allows the taxpayer to decline to use the treaty if it results in more tax than under Code rules.³⁵ However, the precise words of the Domestic Benefit Preservation Clause protect “any deduction” under domestic law, not just the relative Code benefit in the aggregate.

The 2006 Model Treaty TE agrees that the Domestic Benefit Preservation Clause protects a foreign taxpayer’s right to deduction under Code rules even if the

distinct set of activities conducted by a taxpayer (directly or through a fiscally transparent entity) that together constitute a distinct line of business.

We note that the proposition that a taxpayer may accept or reject the application of Article 7 on an enterprise-by-enterprise basis is not as clear in some U.S. Tax Treaties as it is in others. In contrast, the corresponding sentence in the U.S.—Canada Tax Treaty uses the Resident of the Contracting State (rather than an Enterprise of a Contracting State) as its main point of reference thereby blurring the distinction between the taxpayer (*i.e.* the “Resident”) and distinct lines of business that the taxpayer engages in (*i.e.* each enterprise carried on by the Resident). Specifically, the U.S.—Canada Tax Treaty provides that, “[t]he business profits of a resident of a Contracting State shall be taxable only in that State unless the resident carries on business in the other Contracting State through a permanent establishment situated therein.”

³⁴ If the taxpayer instead incorporates the separate businesses, there would be no doubt that it has the ability to separately elect treaty or Code for each business. The check-the-box regime affords the taxpayer electivity on whether to incorporate a business or to operate one or more businesses as branches. Additionally, the decision to operate through a branch is often dictated by non-tax considerations (e.g., bank regulatory capital considerations).

³⁵ See also, Ruling 80-147, 1980 1 C. B. 168.

foreign taxpayer is “computing taxable income under the Convention.”³⁶ This protection of Code-based benefits, however, is qualified in that “A taxpayer may not . . . choose among the provisions of the Code and the Convention in an inconsistent manner in order to minimize tax.” The 2006 Model Treaty TE then describes Ruling 84-17 as an example of impermissible inconsistency. This precise language previously appeared in the technical explanation to the 1996 U.S. Model Treaty.

The persistence with which the Treasury has over the years referred to refers to the Consistency Principle has not been matched by increasing detail. The consistency requirement for the treatment of any particular item for which treaty or Code rules are elected is self-evident.³⁷ As the scope of a Consistency Principle expands to the treatment of related items, consequential items or commonly-owned enterprises, the connection becomes more attenuated, and the logic of consistency less compelling.

Consistency is a concept we normally apply to Code-based elections. We do not believe that invoking the protection of a treaty is technically an election. The procedural fact that taxpayers are required to notify the Service of their claims for treaty benefits under Section 6114 does not literally make treaty invocation an election. Taxpayers make many choices that are not elections. For example, the Joint Committee Report to codification of the economic substance doctrine in Section 7701(o) notes that many fundamental elements of taxation are matters of taxpayer choice, such as debt or equity classification, reorganization instead of taxable exchange and the selection of

³⁶ Model Treaty TE, Article 1, paragraph 2.

³⁷ See, e.g. TAM 8524004 at FN 16, *supra*; Ruling 79-199 at FN 17.

entities to commence a new business.³⁸ These choices are not elections as generally understood. While these choices have consequences as to treatment of the relevant item, none of these choices require other choices to be made consistently. It is therefore difficult to justify the Consistency Principle on the basis that treaty benefits are thought to be elections, even though many sources (including this Report) informally refer to the choice to claim benefits under a treaty as an “election”.

E. Potential Scope of Consistency Principle. A number of conceivable approaches exist for the scope of the Consistency Principle indicated in Revenue Ruling 84-17. Some of these are set out below, generally in order of narrowing scope for the Consistency Principle.

1. Consistency Across Years. For completeness, we start the consideration of the scope of consistency by considering whether a taxpayer’s claim of treaty protection from some years and not others might be regarded as inconsistent and inappropriately minimizing tax.

Treasury and the Service have not sought to impose consistency across years and we think this judgment is appropriate. Ruling 80-147 specifically holds that the taxpayer is permitted annually to choose between tax under the Convention and tax under the Code Rules. Similarly, the pre-FIRPTA Netherlands treaty allowed foreign taxpayers to elect annually to treat U.S. real property rental activities as a trade or business so as to permit offsetting gross rental income with depreciation and other cash

³⁸ See Joint Committee Summary of P.L. 111-312 (2010) at footnote 345.

expenses.³⁹ This treaty-based real estate election was more flexible than the Code election under Section 882(d) that once made was irrevocable, and would persist to tax subsequent gains from the later disposition of the real property. The treaty election could be made on an annual basis allowing the taxpayer to elect out of real property business treatment in the year of sale.⁴⁰

There are practical reasons why requiring year-to-year consistency may not be workable.⁴¹ For example, at the time that the taxpayer must determine whether to make a treaty election, it may not be in a position to determine whether such election is desirable (*e.g.*, it may not know whether it will have a PE in future years or whether it will have a loss in future years). While similar uncertainties can arise for any tax election, those may be particularly acute in the treaty context where for example any reading of the Domestic Benefit Preservation Clause would seem to prevent the Treaty from increasing the taxpayer's cumulative tax liability. Additionally, treaty benefits may not be available to the taxpayer due to other factors: for example the taxpayer may not meet the limitation on benefits clause in a particular year, or the relevant treaty benefits may not otherwise be available in that year, or the treaty might not even be in effect.

However, “inconsistent” treatment from-year-to-year could in certain circumstances give rise to an erosion of the taxing rights arguably meant to be retained by

³⁹ Convention with Respect to Taxes on Income and Certain Other Taxes, Apr. 29, 1948, U.S. – Neth., art. 10, 62 Stat. 1757, as amended by Protocol, Oct. 23, 1963, art. 2, 15 U.S.T. 1900.

⁴⁰ *See also* Treas. Reg. § 1.871-12 (repeated references the taxable year suggest broad acceptance that Treaty protection is claimed on an annual basis).

⁴¹ *See Land, supra* note 7, at 173–77 (discussing and illustrating the practical difficulties in enforcing multi-year consistency).

the United States under its treaties. Consider first the following two examples based on the facts of Ruling 80-147. First, assume that a foreign taxpayer has two businesses (*A* and *B*). Business *A* is not attributable to a PE and business *B* is attributable to a PE. In year 1, business *A* generates a loss and business *B* generates income. The taxpayer does not elect benefits of the treaty and uses the loss from business *A* to offset its ECI from business *B*. In year 2, business *A* generates profits and the taxpayer elects the benefits of the treaty and excludes profits from business *A* from U.S. taxation. In this case, the taxpayer has achieved a result (albeit over two years) that is similar to the result that Ruling 84-17 denies. On the other hand, it is difficult to understand the holding of Ruling 80-147 that the choice is annual unless the taxpayer can in fact make this choice in Year 2. Now consider the following additional variation. In year 1, the loss of business *A* exceeds the profits of business *B* and taxpayer carries the loss forward to year 2. In year 2, businesses *A* and *B* are both profitable. Should it be permissible for taxpayer to exclude the business *A* profit in year 2 and at the same time use the non-PE “effectively connected” loss generated by business *A* in year 1 and carried forward to year 2 to offset its profit from business *B* in year 2. To address these concerns, the Treasury may consider requiring a restatement of or adjustment to attributes when such attributes are carried over from one regime to the other to recalculate the attributes in a manner consistent with the regime to which the attributes are being carried. Additionally, the Treasury may consider confirming that consistency in accounting methods is generally required from a Code year to a treaty year (and vice versa).⁴²

⁴² See Sections 446(e) and 481.

2. Consistency of All Treaty Provisions. Similarly, it might be thought that a taxpayer electing protection of the income tax treaty must forgo all principles of U.S. domestic law if it seeks the protection of any portion of the treaty. Such a broad interpretation of the Consistency Principle has not been adopted in any of the published positions of the Treasury. The 2006 Model Treaty TE states that if a deduction is allowed under the Code, the deduction “also is allowed to that person in computing taxable income under the Convention.” The 2006 Model Treaty TE also states that electing out of treaty protection for business profits does not prevent the same taxpayer from utilizing treaty benefits for withholding tax reductions on dividends.⁴³

U.S. internal law also indicates that the use of a treaty does not preclude reliance on Code benefits. Treas. Reg. § 1.871-12(b) states that in calculating treaty income and non-treaty income “neither term includes income of any kind which is exempt from the tax imposed by ... the Code.” This statement suggests that the Code exemptions are not inconsistent with treaty protection of other income. Indeed, it may also suggest a broader principle of the Code applying first so that the amount of the taxpayer’s income is limited by Code exemptions and exclusions before ever applying the treaty’s tax-relieving provision. Under this interpretation, the taxpayer does not need to be making consistent use of treaty or non-treaty because the Code rules, with all embedded exclusions, applies before the application of the treaty.⁴⁴

⁴³ See Model Treaty TE, Article 1, paragraph 2. We assume that the availability of reduced dividend withholding under the treaty would extend to the rate of tax on branch profits and branch interest under Section 884.

⁴⁴ For this broader conclusion that Code exclusions are consistent with the determination of profits under Article 7 of the Model Treaty, consider PLR 9651052 discussed in Section V.E, *infra*.

3. Consistency Within Each Treaty Article. The Ruling 84-17 approach to the scope of consistency might be interpreted as follows: the taxpayer in applying Article 7 of the Treaty to determine the amount of business profits subject to tax, cannot apply Article 7 to certain businesses and elect Code rules for other business profits. This approach also has certain troubling consequences. As stated above, we read Ruling 84-17 as precluding inconsistent elections where the result “thwarts the purposes of the treaty.” Would Ruling 84-17 have reached the same result without the loss making business? If business C had not existed or had been profitable, we believe that the election out of the treaty would not have been offensive, and indeed would have permitted under the principles of Ruling 80-147. Moreover, if consistency were required within each treaty article, business profits from a U.S. securities trading business that was eligible for the Securities Trading Safe Harbor under Section 864(b) represent business profits that might be taxable under Article 7 of the treaty if the taxpayer elects Article 7 protections of other businesses. We do not believe that claiming the benefits of the Securities Trading Safe Harbor, a deliberately provided Code inducement, is inappropriately inconsistent with relying on treaty protections to exempt other ECI that is not attributable to a permanent establishment.

4. Consistency Within Each Business Enterprise. The holding of Ruling 84-17 can be read to imply that consistency in the application of Article 7 of the Treaty relating to the attribution of profits to a permanent establishment is separately applied to each separate enterprise. In Ruling 84-17, each of the three separate business enterprises were described as separate and distinct from one another. The ruling had no difficulty concluding that the permanent establishment to which business A’s profits were

attributable was not sufficient to cause business *B*'s ECI to also be attributable to a permanent establishment unless *B* itself had a permanent establishment.

We also note that the factual conclusion of Ruling 84-17 that each of the three businesses were separate and distinct, while useful in framing the hypothetical question, is somewhat contrived, since actual business activities are often blurred among different divisions, and therefore, we would expect that, more often than not, taxpayers would be treated as conducting one larger enterprise rather than distinct, separate business enterprises. We acknowledge that factual issues exist for determining whether two business enterprises are separate and distinct or actually a single business. These issues are, however, inherent in Article 7's determination of profit attribution for each separate enterprise, and Section 989(a) (relating to qualified business units), Treas. Regs. § 1.367(a)-2T(b)(2) and § 1.355-3(b)(2) provide guidance.

Even if no consistency is required between separate enterprises, the question remains whether consistency is required within each such enterprise. Each of the approaches to consistency discussed in this section is relevant, whether applied to each enterprise separately, or to the taxpayer as a whole.

5. Consistency As To Related Items. In Ruling 80-147, the holding, analogous to Section 265, disallows expenses attributable to a U.S. trade or business, the income from which is excluded from the gross income under the Treaty. Section 265 does not specifically deal with credits and other allowances, which have been addressed in some of the other private letter rulings. As a broad principle of tax logic, it is generally appropriate that costs of earning gross income that is exempt from a country's taxation

should likewise be excluded from consideration. If applied to Ruling 84-17, the proposition would be that having elected treaty protection for businesses *A* and *B*, the taxpayer has consequently elected to exclude certain income from those businesses from U.S. tax. It would violate Section 265 and the scope of the tax election to allow losses from business *C*, for which the taxpayer did not make a treaty election, to reduce treaty income previously reduced through another regime. And similarly, in Ruling 79-199, if the taxpayer excludes foreign source compensation under Section 911, then the foreign tax paid on the excluded income cannot be claimed as a foreign tax credit under treaty principles.

6. Consistency Unless Compromising an Explicit Code Benefit.

Another potential circumscription of the Consistency Principle is one that would apply an overriding principle to permit clearly intended Code benefits to be realized. Thus, the Consistency Principle could be described as requiring consistency in elections of Treaty benefits for business profits under Article 7 unless the resulting taxation of such profits is clearly inconsistent with an explicit Code provision. Language of this type would allow the Service to treat the Securities Trading Safe Harbor or the U.S. exemption of tax exempt bond interest as explicit Code benefits, which the election of Treaty protections should not impair.

Limiting the Consistency Principle in this way, however, has other difficulties. Such an articulation blurs the distinction between the Domestic Benefit Preservation Clause and the Consistency Principle. Providing that the Consistency Principle incorporated all specific Code benefits would largely eliminate the Consistency Principle as an independent restriction limiting the scope of Treaty protection. But, in

Ruling 80-147, the Service stated that it viewed the Domestic Benefit Preservation Clause as simply establishing that the taxpayer should not pay higher tax under the Treaty than would be due under Code rules.

7. Consequences of the Election. Under several of the private letter rulings applying the Ruling 84-17 principle, the fact patterns could be explained as the consequence of the taxpayer's election. Thus, in Ruling 79-199, the taxpayer cannot exclude foreign earned income under Section 911 and claim a foreign tax credit for foreign taxes paid on such excluded income. An election to obtain treaty protection as to an item has consequences. This approach seems satisfying in that it could be construed as similar to Section 265 denying deductions or other attendant benefits to an item which has already been excluded from tax. The difficulty in this interpretation is that Ruling 84-17 is not dealing with one item, but with three items, assuming that each of the separate businesses is treated as independent. Accordingly, this construction of the Consistency Principle might be regarded as not sufficient to justify Ruling 84-17's holding.

8. Consistency if "Thwarting" Intention of Treaty. A narrower view would focus on the state of facts that causes Ruling 84-17 to find that the Treaty's purposes would be thwarted. In that context, a taxpayer would simultaneously reduce tax on business A through a treaty regime exemption of business B profits and the Code regime benefit of the non-attributable business C loss. That result can be seen as thwarting the purpose of the Treaty to preserve the right of the United States to tax the attributable income of A's PE. In other contexts, perhaps, it may be less clear whether an inconsistent position is thwarting a purpose of the Treaty.

F. Appropriate Consistency. As the foregoing analysis of the consistency formulation indicates, the holding of Ruling 84-17 itself is not in question. However, the broad expansion of the Consistency Principle stated in the 2006 Model Treaty TE would appear to contradict several other governing maxims of treaty interpretation and U.S. tax policy. Among these are the concept imbedded in existing U.S. regulations that treaty-based income starts after the application of Code-based exemptions. Thereafter, the treaty is to be interpreted so as not to restrict any allowance permitted under domestic law. The Domestic Benefit Preservation Clause by its terms not only protects the taxpayer's right to elect Code taxation where it is more beneficial overall than treaty-based protection. We think the words also indicate the importance of preserving all of the separately identified benefits that Congress has expressly enacted into the Code. Similarly, isn't it these same Code identified benefits that the Treaty anti-discrimination rules seek to preserve? At the same time, however, we believe that the specific facts of Ruling 84-17 illustrate a situation where the taxpayer sought a U.S. tax burden that would have been lower than intended by the U.S. Treaty negotiators and the U.S. Senate in ratifying the Treaty and the Ruling appropriately prevented that result. Future guidance and the amended Model TE should preserve this important point.

Based upon the foregoing, we would recommend an amendment to Treas. Reg. § 1.871-12(d) to provide that income attributable to a permanent establishment must be calculated to prevent the taxpayer from making inconsistent use of treaty and Code benefits with respect to different business enterprises to the extent that such inconsistent use results in the United States not being able to tax the business profits attributable to the

permanent establishment in accordance with the taxation rights it negotiated under the treaty.

G. Formality. Treaties are negotiated agreements between the treaty partners. As such, it is important that there be a meeting of the minds between the treaty partners. While the Model Treaty TE is a unilateral document prepared by the Treasury, it may help inform treaty partners that enter into negotiations with the United States of the U.S.'s position when it proposes language from the Model Treaty. However, even if an articulation of the Consistency Principle in the Model Treaty TE may provide notice to the treaty partners with respect to future treaties, it lacks formality and may not have the authoritative impact of a widely disseminated regulation or statute. Therefore, if and to the extent that the Treasury determines that it should expand or refine the Consistency Principle beyond the facts of Ruling 84-17, we would recommend that those changes be presented as an amendment to Treas. Reg. § 1.871-12.

Just as the Treasury previously promulgated Treas. Reg. § 1.871-12 pursuant to its authority under Section 7805 to prescribe “all needful rules and regulations for the enforcement of the Code”, the Treasury may similarly rely on that authority to clarify the appropriate scope of the Consistency Principle.⁴⁵ Assuming the rule of such regulation is a reasonable interpretation of the treaty, a regulation could inform the courts and the taxpayers after its promulgation. Such a regulation, however,

⁴⁵ Whether an agency regulation is within the grant of authority delegated by the Congress may be determined under the two-step test set forth in *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984).

should only have a prospective effect and should only be informative of any treaties ratified after the effective date of such a regulation.⁴⁶

With respect to periods prior to the effective date of such a regulation, we acknowledge that Ruling 84-17 remains applicable. However, we would recommend that a notice or superseding ruling be issued to limit the scope of Ruling 84-17 to its facts with respect to those periods.

V. AOA Profit Attribution Under Article 7.

A. The 2006 Model and Recent U.S. Tax Treaties. In the 2006 Model Treaty TE, as well as recent U.S. tax treaties (or protocols) with Belgium, Germany, Poland (not yet ratified) and Canada, the U.S. Treasury has adopted the use of the AOA as the appropriate methodology for attributing profits to a PE under Article 7. The principal provisions of Article 7 in the 2006 Model Treaty that address the attribution of income and deductions to a PE are Article 7(2) and Article 7(3), respectively, which provide:

Article 7:

(2) Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits that it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions. For this purpose, the profits to be attributed to the

⁴⁶ Absent Congressional grant to the contrary and except in certain limited circumstances, no temporary, proposed, or final regulation shall apply to any taxable period ending before the earliest of: (1) the date on which such regulation is filed with the Federal Register, (2) in the case of any final regulation, the date on which any proposed or temporary regulation to which such final regulation relates was filed with the Federal Register; or (3) the date on which any notice substantially describing the expected contents of any temporary, proposed, or final regulation is issued to the public. Section 7805(b).

permanent establishment shall include only the profits derived from the assets used, risks assumed and activities performed by the permanent establishment.

(3) In determining the profits of a permanent establishment, there shall be allowed as deductions expenses that are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.

The Technical Explanation to Article 7 of the 2006 Model Treaty explains that:

“The language of paragraph 2, when combined with paragraph 3 dealing with the allowance of deductions for expenses, incurred for the purposes of earning the profits, incorporates the arm’s-length standard for purposes of determining the profits attributable to a permanent establishment. As noted below with respect to Article 9, the United States generally interprets the arm’s length standard in a manner consistent with the OECD Transfer Pricing Guidelines. The notes confirm that the arm’s length method of paragraphs 2 and 3 consists of applying the OECD Transfer Pricing Guidelines, but taking into account the different economic and legal circumstances of a single legal entity (as opposed to separate but associated enterprises). Thus, any of the methods used in the [OECD] Transfer Pricing Guidelines, including profits methods, may be used as appropriate and in accordance with the [OECD] Transfer Pricing Guidelines.”

Reference to the AOA is an important development in U.S. tax treaty policy in that it establishes a common conceptual baseline with treaty partners for the manner in which items of income and deduction will be attributed to a PE. This reliance on the broadly disseminated OECD TP Guidelines as a common framework for profit attribution is consonant with several overarching tax treaty objectives, such as reducing the risk of double taxation (by reducing the risk of divergent profit attribution methodologies) and promoting predictability among treaty partners and their residents. This shared baseline also presumptively reduces the potential risk of bias associated with using a particular country’s transfer pricing rules.

However, the acceptance by the Treasury of the AOA also represents the culmination of a major reorientation of the manner in which the U.S. government has approached the issue of PE profit attribution. Specifically, prior to the 2006 Model Treaty TE, it had been the consistent position of the Service that domestic “effectively connected” principles were broadly consistent with Article 7(2) and, accordingly, represented the appropriate methodology for attributing profits to a PE under Article 7. Stated differently, the Service during this time had expressed the view that there was no appreciable “daylight” between the attribution requirement under domestic ECI rules and the Article 7 profit attribution rules. So, in Revenue Ruling 78-423⁴⁷, the Service ruled that the U.S. interest allocation rules used in calculating effectively connected income of a foreign bank should be used to determine income attributable to the bank’s U.S. permanent establishment under the Japanese Treaty. In Ruling 81-78, the Service stated that “attributable to” and “effectively connected” principles overlap but are only analogous principles, noting that that the force of attraction principle does not apply in the determining profit attribution under the treaties. As noted above, the Service departed from this view in its Technical Explanation to the 2006 Model Treaty⁴⁸ (as well as the German protocol, the Belgian and the proposed Polish Treaties among others) and acknowledged the divergence between ECI principles and the AOA arm’s-length methodology for attributing profits to a PE. Thus, Article 7(2) of the 2006 Model Treaty TE states:

⁴⁷ 1978-2 C.B. 194, obsoleted by Revenue Ruling 85-7 1985-1 C.B. 188.

⁴⁸ See also, *National Westminster Bank v. U.S.*, 512 F.3d 1347 (Fed. Cir. 2008) and associated decisions.

“The “attributable to” concept of paragraph 2 provides an alternative to the analogous but somewhat different “effectively connected” concept in Code section 864(c)...In some cases, the amount of income “attributable to” a permanent establishment under Article 7 may be greater than the amount of income that would be treated as “effectively connected” to a U.S. trade or business under section 864. For example, a taxpayer that has a significant amount of foreign source royalty income attributable to a U.S. branch may find that it will pay less tax in the United States by applying section 864(c) of the Code, rather than the rules of Article 7, if the foreign source royalties are not derived in the active conduct of a trade or business and thus would not be effectively connected income.”

Accordingly, at least according to these TEs, one concomitant effect of embracing the evolving international transfer pricing norms embodied by the AOA was that doing so created the possibility for greater deviation in the U.S. tax results delivered under ECI rules, as compared to Article 7 profit attribution rules. The language of Article 7’s profit attribution diverges from U.S. domestic law in three respects: (i) the permanent establishment is considered an independent enterprise (the “**Independent Enterprise Construct**”), (ii) that the permanent establishments profits be determined based upon the application of the OECD TP Guidelines⁴⁹ to the permanent establishment based upon a functional analysis of its role (*i.e.*, the functions performed, the capital utilized and the risks assumed) instead of Section 482, and (iii) the attribution requirement of the Treaty demands Specific Connection to a permanent establishment of that business without any “force of attraction” concept present in Section 864(c)(3) of the U.S. effectively connected rules. These differences between U.S. rules and treaty rules for taxing the profits of a foreign owned business enterprise, like Ruling 84-17, create another area of potential inconsistency where taxpayers might mix Code rules and Treaty

⁴⁹ Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, O.E.C.D. (1995, amended in 2010).

rules to reduce tax in an inappropriate manner if taxpayers were afforded excessive electivity in the manner in which they opted into, or out of, treaty benefit. In response to this perceived threat, the 2006 Model Treaty TE further provides that:

In effect, paragraph 2 allows the United States to tax the lesser of two amounts of income: the amount determined by applying U.S. rules regarding the calculation of effectively connected income and the amount determined under Article 7 of the Convention. That is, a taxpayer may choose the set of rules that results in the lowest amount of taxable income, but may not mix and match ... But, as described in the Technical Explanation to Article 1(2), if it does so, [elects U.S. effectively connected income rules], it may not then use Article 7 principles to exempt other income that would be effectively connected to the U.S. trade or business. Conversely, if it uses Article 7 principles to exempt other effectively connected income that is not attributable to its U.S. permanent establishment, then it must include the foreign source royalties in its net taxable income even though such royalties would not constitute effectively connected income. In the case of financial institutions, the use of internal dealings to allocate income within an enterprise may produce results under Article 7 that are significantly different than the results under the effectively connected income rules. For example, income from inter-branch notional principal contracts may be taken into account under Article 7, notwithstanding that such transactions may be ignored for purposes of U.S. domestic law. Under the consistency rule described above, a financial institution that conducts different lines of business through its U.S. permanent establishment may not choose to apply the rules of the Code with respect to some lines of business and Article 7 of the Convention with respect to others. If it chooses to use the rules of Article 7 to allocate its income from its trading book, it may not then use U.S. domestic rules to allocate income from its loan portfolio.

While there is a legitimate role for the concept of consistency to play in constraining the ability of taxpayers to “mix and match” in the Article 7 arena, the implementation of these principles in the manner described in the 2006 Model Treaty TE may exceed the underlying concerns they address, may be unduly disruptive to the predictability that treaties are intended to promote, and may not reflect the intentions of

our treaty partners.⁵⁰ For these reasons (and as further described below), it would be desirable for Article 7 Consistency Principles to be (a) articulated more narrowly, and (b) to be announced in Treasury Regulations so as to provide greater assurance that our treaty partners are aware of the manner in which we approach the interaction of Code and Treaty principles in the Article 7 arena.

B. AOA Method. In the technical explanations of the proposed 2013 U.S. – Poland Treaty, along with other recent treaties with Germany (protocol), Belgium (2006) and the protocol with Canada⁵¹, the treaties specifically adopt the AOA as the mutually agreed appropriate method for attributing business profits to a permanent establishment. AOA is defined there as the methodology prescribed in the OECD’s 2010 Report on the Attribution of Profits to Permanent Establishments.⁵² As mentioned above, the AOA methodology differs from U.S. methodology in three essential ways: (i) the permanent establishment is treated as a functionally separate entity (the Independent Enterprise Construct), (ii) the use of OECD TP guidelines and (iii) the application of the Specific Connection principle without any residual “force of attraction” principle.

⁵⁰ We note that U.S. domestic rules do in some circumstances take interbranch transactions into effect (i.e., adopt the independent entity approach similar to the AOA), such as in the proposed global dealing regulations. *See* REG-208299-90, 63 Fed. Reg. 11177 (3/6/98), 1998-16 I.R.B. 26. The IRS has indicated in the context of the proposed global dealing regulations that it saw no reason to extend the complexities of the approach of such regulations to loan portfolios, showing that it is not “inconsistent” to blend the branch treatment in such circumstances. *See* Institute of International Bankers Letter, *supra* note 6, at 16-17.

⁵¹ We note that unlike the technical explanations to the U.S. treaties (and protocols) with Germany, Belgium and Poland, the technical explanation to the protocol with Canada appears to adopt a narrower approach to the Consistency Principle, even as it adopts the OECD TP Guidelines.

⁵² The 2010 Report incorporates and slightly revises the earlier 2008 Report. Nonetheless, the U.S. – Belgian Competent Authority Agreement of 2013 expressly adopts the ultimate report for the 2006 Treaty.

The proposed 2013 U.S. – Poland Treaty, like the 2006 Model Treaty at Article 7, paragraph 2, requires that a permanent establishment be treated as “a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions.”⁵³ This Independent Entity Construct effectively requiring that the permanent establishment be regarded as a separately incorporated entity. As a result, transactions between the permanent establishment and the head office must be regarded. Branch parent loans are regarded and branch parent swaps to transfer risk to the location with capital and expertise to absorb such risk are regarded. But if the taxpayer chooses to forgo the Treaty, under U.S. domestic ECI principles, transactions between a head office and its branch are all disregarded and there is no income or deduction to be recognized. These differences are fundamental to any reconciliation of the opposing taxing powers of two different countries.

Having separated the permanent establishment from its parent/head office, profit attribution then proceeds using a functional analysis as dictated by the OECD TP Guidelines. The OECD TP Guidelines, while different from the U.S. Transfer Pricing Regulations under Section 482, proceed based upon a functional analysis just as the U.S. rules do.⁵⁴ The OECD TP Guidelines require that entities be respected and that contracts between entities be regarded just as U.S. rules do.⁵⁵ The OECD TP Guidelines use a priority of pricing methods which largely reflect the priority of the U.S. rules, and the

⁵³ Model Treaty omits the trailing language regarding functional analysis. *See* Model Treaty, Article 7, paragraph 2.

⁵⁴ *See* Treas. Reg. §1.482-1(d)(3)(i).

⁵⁵ Compare OECD TP Guidelines (1995, amended in 2010), paragraph D.2 at 51 with Treas. Reg. § 1.482-1(d)(3)(ii).

OECD TP Guidelines contemplate a range of acceptable outcomes just like the U.S. rules.⁵⁶ While the OECD TP Guidelines are different, they proceed toward similar results using similar methodology to the U.S. rules. The Profit Attribution Report states: “The authorised OECD approach does not dictate the specifics or mechanics of domestic law, but only sets a limit on the amount of attributable profit that may be taxed in the host country of the PE. Accordingly, the profits to be attributed to a PE are the profits that the PE would have earned at arm’s length ... determined by applying the Guidelines by analogy...”⁵⁷ This language suggests that the AOA is not meant to displace domestic law but only to create limitations on domestic law.

The third manner in which the AOA methodology diverges from domestic law principles is in the requirement of Specific Connection for treaty profit attribution. Under Section 864(c)(3) of the Code, if a foreign taxpayer conducts a trade or business in the United States, then “all income ... from sources within the United States (other than income ... to which paragraph 2 applies) [fixed and determinable income from assets not used in a trade or business] shall be treated as effectively connected with the conduct of a trade or business within the United States.” (Referred to as the limited “force of attraction” doctrine.) By contrast, Article VII paragraph 1 of the 2006 Model Treaty provides “the profits of the enterprise may be taxed in the other state but only so much of them as our attributable to that permanent establishment” (*i.e.*, Specific Connection).

⁵⁶ See OECD TP Guidelines (1995, amended in 2010), at 59 *et. seq.*

⁵⁷ Profit Attribution Report at 13, paragraph 9.

As the 2006 Model Treaty TE describes: “the ‘attributable to’ concept in paragraph 2 provides an alternative to the analogous but somewhat different ‘effectively connected’ concept in Code Section 864(c).” As the Treasury has acknowledged, the “attributable to” concept of our treaties requires Specific Connection of the business enterprise profits to a permanent establishment and is not satisfied merely because the taxpayer has a permanent establishment in the United States to which the particular business profits do not relate. Thus, in respect of profit attribution generally, the Code based ECI principles are broader in some respects than the Treaty attribution principles. And Code rules could therefore consider other business profits not attributable to a U.S. PE as subject to U.S. tax. While the Specific Connection rules of the treaty narrow the ambit of taxation in this regard, the treaties do not contain other explicit Code exceptions and exclusions from taxability. Thus, under Section 864(c), the U.S. ECI rules generally exclude foreign source income with certain exceptions. The U.S. Code also provides other exemptions, such as the exclusion for municipal bond interest under Section 103, the Security Trading Safe Harbor, and the exemption for international carrier income provided in Section 883, for example.

In the technical explanations to the recent U.S. treaties as well as the 2006 Model Treaty TE, the Treasury regularly explains that in their view of the separate regimes, the Code based rules may be at times more restrictive and at times more inclusive. Where a foreign taxpayer with a U.S. permanent establishment has significant foreign source royalty income, that income might be excluded from U.S. taxability under Section 864(c)(2) of the Code if the taxpayer elects not to apply the treaty; but the foreign source royalty income might be attributable to the U.S. permanent establishment under

the treaty in the view of the Treasury. The suggestion that foreign source royalty income which might be excluded from taxability under U.S. ECI concepts might nonetheless be attributable is helpful in explaining the differences between what the United States can tax under the treaty (attributable profits) and what the Code does tax (ECI). This particular example is somewhat unusual in that a U.S. permanent establishment of a foreign taxpayer would typically be capitalized with assets necessary to the U.S. business and not with unrelated assets generating passive income that need not be subjected to U.S. tax. But cases of this sort do arise, for example, where a U.S. branch of a foreign bank makes a loan to an overseas affiliate.

C. Polish – Belgian – German Treaties. Page 21 of the technical explanation of the proposed 2013 U.S. – Poland Treaty incorporates the standard U.S. discussion of the attribution of profits under paragraph 2 of Article 7 from the 2006 Model Treaty TE. It repeats that attribution to a permanent establishment is an alternative to Code based effectively connected analysis, that may be more or less favorable to taxpayer. The technical explanation of the proposed 2013 U.S. – Poland Treaty continues on page 22 with the following statement explaining the taxpayer’s choice:

“if the foreign corporation chooses to apply Code Section 864(c) to determine its effectively connected income, it may not also use Article 7 principles to reduce its third party royalty income by inter branch royalty expense, since doing so would be inconsistent with either the principles of the Code or the Convention. Conversely, if the taxpayer opts to use Article 7 to calculate the amount of business profits attributable to its U.S. permanent establishment, it must include all foreign-source income, from third party and inter-branch income in its business profits whether or not such income would be effectively connected income under the Code, if attributable to the functions performed, assets used or risks assumed by the permanent establishment. Then, as stated above, the foreign corporation may elect to be taxed on the lower of the two amounts. Article 7 can only

be used to reduce the amount of tax that would have otherwise been calculated using Code Section 864(c) principles.”

Similarly, under each the U.S. – Belgium Treaty and the German protocol, the technical explanations, ratified in 2006 (the “**Belgium Treaty TE**” and the “**German Protocol TE**”), provide that the taxpayer has the choice of proceeding under Article VII profit attribution or under the domestic law principle of 864(c). “A taxpayer may choose the set of rules that results in the lowest amount of taxable income, but may not mix and match.” In these explanations, each the Belgium Treaty TE and the German Protocol TE refers to the Domestic Benefit Preservation Clause of Article I, paragraph 2 but describes the choice between treaty attribution and Code attribution as mutually exclusive. In a particular example, the Belgium Treaty TE and the German Protocol TE add in the case of financial institutions, “the use of internal dealings to allocate income within an enterprise” (inter-branch notional principal contracts) could be used under Article VII profit attribution principles but not under U.S. effectively income principles.⁵⁸

D. Harmonious Construction. In construing the relationship between the AOA methodology and the U.S.-based effectively connected income methodology, the Treasury describes the two approaches as alternative methodologies from which the taxpayer is permitted to choose the set of rules that result in the lowest amount of taxable income. In this construction, the Treasury assumes that the AOA constitutes an alternative methodology that is distinct from ECI principles and, as a corollary, the AOA methodology displaces or overrides certain aspects of U.S. statutory law that would otherwise operate to effectively connect income and deductions to a U.S. trade or

⁵⁸ See Belgium Treaty TE at Article 7, paragraph 2; German Protocol TE at Article III.

business. Thus, under Article 7(2) of the 2006 Model Treaty TE, a taxpayer electing to attribute profits to a permanent establishment under the Treaty AOA method is not permitted to utilize section 864(c) rules that treat foreign source royalty income as not effectively connected with a U.S. trade or business. This example brings to the surface the vital question of how ECI rules and various other Code rules that ultimately feed into the determination of the taxable income of a U.S. branch are intended to interact with the profit attribution principles under U.S. tax treaties. In considering this issue, we believe it is important to take into account general principles of construction applicable to the interaction between U.S. treaty obligations and U.S. laws.

Ruling 79-199⁵⁹ sets forth these principles of construction. In the ruling, the Service considered whether a foreign tax imposed on income excluded from U.S. taxability under Section 911 (foreign earned income exclusion) could nonetheless be creditable to the U.S. taxpayer paying such tax under the relevant tax treaty. The Service stated “because treaties and acts of Congress are given equal weight by the Constitution as domestic law, Congress has the authority to overrule the effect of a treaty by subsequent legislation. When an act of Congress and a treaty relate to the same subject, the courts will endeavor to construe them so as to give effect to both, if that can be done without violating the language of either. The courts do not favor repudiation of an earlier treaty by implication and require clear indications that Congress, in enacting subsequent inconsistent legislation, meant to supersede the earlier treaty.”⁶⁰

⁵⁹ 1979-1 C.B. 246.

⁶⁰ Citing, *Head Money Cases*, 112 U.S. 580 (1884); *U.S. vs. Payne*, 264 U.S. 446 (1924); and *Menominee Tribe vs. U.S.*, 391 U.S. 404 (1957).

These principles of harmonious construction apply with equal force to protect both a treaty and a statute against repudiation by implication.⁶¹ So in *Whitney vs. Robertson*, 124 U.S. 190, 194 (1888), the Supreme Court stated, “By the Constitution a treaty is placed on the same footing, and made of like obligation, with an act of legislation. Both are declared by that instrument to be the supreme law of the land, and no superior efficacy is given to either over the other. When the two relate to the same subject, the courts will endeavor to construe them so as to give effect to both, if that can be done without violating the language of either; but if the two are inconsistent, the one last in time will control over the other.”⁶² This analysis was codified in Section 7852(d).

There is no question that the United States has full power and authority in its tax treaties to define the terminology and to create rules in a treaty that are inconsistent with U.S. domestic principles. Where this inconsistency is not obvious, however, the foregoing authorities suggest caution in interpreting the provisions of a treaty or a statute as overriding or repudiating the provisions of the other. As noted above, the Treasury has previously accepted the proposition that treaty-based profit attribution differs from the U.S. effectively connected income principles by virtue of the Independent Enterprise Construct as well as the Specific Connection requirement and we regard these differences as reasonable and appropriate. However, the 2006 Model Treaty TE expands the conceptual gap between Code-based and Treaty-based profit attribution by positing that the application of treaty based profits attribution would necessarily occur under a

⁶¹ See, e.g., *North West Life Assurance Company of Canada vs. Comm’r*, 107 T.C. 363 (1996) (where a treaty contradicted a U.S. statute enacted prior to such treaty the treaty over rode the U.S. statute).

⁶² Quoted with approval in *Kappus vs. Comm’r*, 589 F.3d 1040 (D.C. Cir. 2003) (finding that subsequent protocol to the U.S.–Canada Treaty did not overrule the U.S. foreign tax credit limitation); and *Jamieson vs. Commission*, 95 T.C.M. 1430 (2008).

methodology that displaces various clearly articulated legislative purposes embedded in U.S. statutory law. While we acknowledge that it is possible for a treaty to displace Code principles as a policy matter, we believe that, in the interests of transparency and predictability, it should do so explicitly through the language of the Treaty itself, not implicitly through a unilateral technical explanation. Furthermore, except to the extent of the Independent Enterprise Construct and the Specific Connection requirement, we do not perceive there to be a self-evident conflict that would prevent the co-existence of Code-based and Treaty-based profit attribution principles. Accordingly, we would regard an approach that applies Treaty-based profit attribution after having determined ECI under the Code (adjusting only for the Independent Enterprise Construct as well as the Specific Connection requirement) as more consistent with the judicial principles of harmonious construction described above. This approach would also, in our view, be most consonant with Domestic Benefit Preservation Clause. While Treasury may not conceive of the approach articulated in the 2006 Model Treaty TE as implicitly repudiating domestic law benefits, it would be useful for the Treasury to articulate precisely why it regards AOA as inconsistent with specific principles of U.S. tax law, other than the Independent Entity Construct and the Specific Connection requirement.

In addition to the Domestic Benefit Preservation Clause, the non-discrimination provision of Article 24 of the 2006 Model Treaty states that “the taxation on a permanent establishment that an enterprise of a contracting state has in the other contracting state should not be less favorably levied in that other state than the taxation

levied on enterprises of that other state in carrying in the same activities.”⁶³ Article 24, paragraph 2 of the 2006 Model Treaty TE provides an interpretation, stating that it would not be a violation of paragraph 2 to determine income and expenses have been attributed to a permanent establishment in conformity of the principles of Article VII (business profits). Thus, the suggestion is that attribution under the AOA may clearly be different than U.S. domestic taxation principles but that the difference is not discriminatory. To this, one must acknowledge that profit attribution under the Independent Entity Construct and the Specific Connection rule is required and not discriminatory.⁶⁴

E. AOA Displacement. The Treasury’s formulation of the AOA profit attribution rule makes clear that, in its view, various provisions of U.S. law are displaced by the profit attribution methodology under the Treaty. The Treasury has not been specific about precisely which provisions of U.S. domestic law are displaced and why such displacement is justified, particularly in light of important countervailing considerations such as the principles of harmonious treaty construction and the Domestic Benefit Preservation Clause. Thus, for example, in Treas. Reg. § 1.871-12, it is stated that an exemption applicable to municipal bond interest would apply to any person in calculating treaty income or non-treaty income. While that conclusion seems perfectly sensible, one can easily conceive of the U.S. branch of a foreign bank holding municipal

⁶³ U.S. Model Treaty Article 24, paragraph 2.

⁶⁴ Having said that, the U.S. branch of a foreign bank that holds U.S. municipal securities in its U.S. branch business might be thought of as having U.S. source interest which is attributable to a permanent establishment notwithstanding that interest on municipal securities is excluded from income under U.S. rules. This conclusion is denied in Treas. Reg. § 1.871-12. Additionally, we note that the mere fact that the taxpayer can avoid taxation of profits attributable to a PE by electing benefits of the Code should not mean that the non-discrimination provision is not or should not be applicable. The non-discrimination provision is meant to be available to taxpayers electing benefits of the treaty, not taxpayers electing to be taxed under the Code.

obligations as a portion of its branch assets. Why does Treasury Regulation § 1.871-12 conclude that income on such municipal bonds would continue to be exempt in its hands if the bank invoked treaty-based profit attribution? Similarly, the Securities Trading Safe Harbor of Section 864(b)(2) excludes securities trading from the definition of trade or business for U.S. taxation purposes. If however, an election by a foreign owned U.S. business enterprise of treaty protection for its U.S. branch precludes the use of U.S. Code principles for other business profits of the same enterprise, then the Securities Trading Safe Harbor would not be available. Such a result would seem to override a clear legislative intention to exempt such profits, which would be a surprising result. Moreover, it is not clear why retaining the benefit of the Securities Trading Safe Harbor would be viewed as inappropriately inconsistent with its otherwise electing treaty benefits.

The scope of treaty displacement pursuant to the Consistency Principle needs articulation and clarification. In the context of the 2006 Model Treaty TE discussion pertaining to Article 1, paragraph 2, the Treasury states that any deduction available to a foreign taxpayer under U.S. Code principles would equally be available to the business enterprise of that foreign corporation in calculating its income attributable to its permanent establishment under the treaty and that, “a right to tax given by the Convention cannot be exercised unless that right also exists under internal law.” On the other hand, the 2006 Model Treaty TE states that, “[a] taxpayer may not, however, choose among the provisions of the Code and the Convention in an inconsistent manner in order to minimize tax”. But, if treaty-based profit attribution is to displace certain elements of the Code-based determination of branch income, how is one to determine

which U.S. tax law based benefits are consistent with the treaty election and the AOA methodology and which are not? Under the Code, various provisions, whether they fall under the rubric of an exemption, a profit attribution rule, a timing rule, a non-recognition rule, or income exclusion rule, all operate to effectively reduce taxable income or exclude items of income from consideration, all of which have the effect of reducing tax. These Code benefits may be characterized in many different ways depending on the placement in the Code and the nature of the provision. For example, transactions between a parent and its branch or permanent establishment would be disregarded for U.S. tax purpose and not be cognizable at all; whereas the receipt of municipal bond interest might be exempt from income. Other accessions to wealth might be treated as excluded income, non-recognition income, foreign source income or not ECI, as the case may be.⁶⁵ In addition, provisions of deductions and/or credits likewise have the same ultimate effect of reducing tax. Against this backdrop, how does a taxpayer or a court determine which of these U.S. tax law based benefits is displaced by the election to apply Article 7 of a U.S. Tax Treaty and which remain available?

The question of which Code benefits are displaced by a treaty election is a question that the Service itself has considered previously. In Private Letter Ruling 9651052 (“**PLR 9651052**”),⁶⁶ the Service was asked to consider whether the income of a foreign bank’s U.S. branch should include foreign source income from Letter of Credit confirmation services and acceptances of foreign bank letters of credit. That ruling

⁶⁵ See Treas. Reg. §1.861-8T(d)(2)(ii) (treaty income that is “exempt, excluded, or eliminated” as equivalent).

⁶⁶ June 19, 1996. Private Letter Rulings are not considered to have precedential authority.

considered the Domestic Benefits Preservation Clause and imported its meaning into the relevant treaties. The ruling concluded “the Code imposes tax on only those categories of a foreign corporation’s foreign source income described in Section 864(c)(4)(B) and (C). Under paragraph 2 of Article 1, the treaty cannot extend the reach of the U.S.’s taxing jurisdiction to categories of foreign source income not taxable under Code. Accordingly, under the Treaty, the United States taxing jurisdiction runs only to that foreign source income which is described in section 864(c)(4)(B) and (C) attributable to the foreign corporation’s U.S. permanent establishment.” PLR 9651052, while not authoritative, adopts a conceptual framework for interpreting the Domestic Benefit Preservation Clause that is clearly in conflict with the broader framework announced in the 2006 Model Treaty TE.

Under the provisions of the 2006 Model Treaty, profits attribution must clearly displace U.S. Code principles inconsistent with the Independent Entity Construct and the Specific Connection rules. Beyond that, it seems quite difficult to construct clear and coherent principles as to which of the U.S. domestic law benefits treaties would displace. For example, if one adopts the precept of the 2006 Model Treaty TE that the “attributable to” concept of Article 7 is “an alternative to the analogous but somewhat different ‘effectively connected’ concept in Code section 864(c)” one necessarily needs to deal with difficult questions as to why the Article 7 displacement should be limited to rules that happen to be situated in Section 864(c). Is the Securities Trading Safe Harbor rule, which happens to employ the mechanic of deeming certain activities not to be a trade or business (but which otherwise has the same ultimate economic effect as a rule that would treat income attributable to such activities as not being “effectively

connected”) more worthy of preservation than a rule excluding foreign source royalty income located in 864(c) and, if so, why? It does not seem appropriate to have the availability of a Code-based benefit turn on the relatively formal distinction of whether the benefit is formulated as an “effective connection” rule. Such an approach also seems inconsistent with prior guidance related to the interaction of Code and Treaty based rules (see Treas. Reg. §1.871-12 and PLR 9651012, each discussed above). Without regard to these instances of inconsistent prior guidance, the notion that AOA displaces specific Code benefits might well offend the Domestic Benefit Preservation Clause and the non-discrimination clause. But more than this, the position that the election of treaty protections and the AOA methodology displaces clearly articulated Congressional policy judgments should be supported by express language and not simply by implication.

F. Framework for Implementing a Consistency Requirement in Article 7. In our view, the language used by the 2006 Model Treaty TE to embed consistency principles into Article 7 extends beyond its appropriate scope. We believe that, to operate more effectively, the Consistency Principle in Article 7 should be articulated in a manner that is more harmonious with other domestic and treaty considerations. More specifically, we believe that any consistency based constraint imposed in the Article 7 context should be shaped by, and balanced with, the following considerations:

1. AOA Consistency. We believe that a decision by a taxpayer to invoke the benefits of Article 7 of a U.S. tax treaty with respect to a PE should not adjust the Code-based determination of ECI in respect of such PE, other than adjustments attributable to (i) overriding Section 864(c)(3) (the Specific Connection Requirement), and (ii) implementation of the Independent Enterprise Construct. Beyond this, we do not

believe consistency requires that the application of AOA principles pursuant to Article 7 further displace the computation of the PE's taxable income under ECI principles.⁶⁷

2. Article 7 Should Apply on an Enterprise-by-Enterprise Basis. As the attribution of business profits to a PE under Article 7 applies on an enterprise-by-enterprise basis, we think that a taxpayer should be able to separately elect to “accept” or “reject” the application to Article 7 for each distinct enterprise conducted by the taxpayer which constitutes a PE. We believe that the technical explanation to treaties should acknowledge that there is nothing intrinsically wrong with affording this electivity to

⁶⁷ The recent U.S. Treaties with Poland and Belgium, adopting AOA as the profit attribution method, have responded to a perceived risk of inconsistent treatment between the two tax authorities of attributable profits by adding an explicit corresponding adjustment mechanism. Under the U.S. – Poland Treaty, paragraph 3 to Article VII states: “Where...a Contracting State adjusts the profits that are attributable to a permanent establishment of an enterprise...the other Contracting State shall,...to eliminate double taxation, make an appropriate adjustment if it agrees with the adjustments made in the first-mentioned state; if the other Contracting State does not so agree, the Contracting States shall eliminate any double taxation resulting therefrom by mutual agreement.” *See also* the U.S. – Belgium Treaty of 2006, a Competent Authority Agreement of 2013. Because profit attribution under OECD TP Guidelines will itself prescribe results within an arm's-length range, we do not regard the use of AOA as likely to eliminate disagreements between the two taxing states as to profit attribution to a PE. Nearly identical, corresponding profit attribution adjustment language appears in paragraph 2 of Article 9 of the U.S. – Poland Treaty relating to arm's-length pricing between associated enterprises but without adopting any new implementing procedures.

We would not expect that the AOA corresponding adjustment would proceed more quickly than normal treaty benefit controversy resolution. Treasury may wish to consider whether a special AOA corresponding adjustment would be more sensible than relying upon the existing Mutual Agreement Procedure established in Article 26 of the 2006 Model Treasury. *See* Notice 2013-78, I.R.B. 2013-50, 633.

Also, where the U.S. corporation has a permanent establishment in a foreign country, any increase in taxable income of the permanent establishment by the source jurisdiction would only result in any increase in foreign tax credits available in the United States. The explanation in the Belgium 2013 Competent Authority Agreement states that such foreign tax credit adjustments would be subject to domestic law limitations (e.g., the U.S. foreign credit limitation under Section 904) like other double tax mitigation procedures. The language then says that “where a taxpayer can demonstrate to the U.S. competent authority that such double taxation has been unrelieved after application of mechanisms under U.S. law such as the utilization of foreign tax credit limitation created by other transactions, the United States will relieve such additional double taxation.” We are not aware of why normal MAP adjustments give rise to U.S. foreign tax credit relief fully subject to U.S. domestic law limitations but the AOA corresponding adjustment does not.

taxpayers, provided that the combination of elections made by the taxpayer does not thwart some demonstrable purpose of Article 7, such as in Ruling 84-17.