# NEW YORK STATE BAR ASSOCIATION

# TAX SECTION

# Report on the Model Income Tax Convention Released by the Treasury on November 15, 2006

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**Report No. 1127**

**New York State Bar Association Tax Section**

**Report on the Model Income Tax Convention Released by the Treasury on November 15, 2006**

This report, prepared by an ad hoc committee of the Tax Section of the NYSBA,[1] comments on the United States Model Income Tax Convention of November 15, 2006, including the related notes or protocol to Article 7, relating to business profits (hereafter, the "2006 Model"), and its technical explanation (hereafter, the "Technical Explanation").[2]

We have made initial recommendations with respect to the role of the Technical Explanation in part A below; and thereafter, in Parts B, C and D, commented on what is not, and what is, included in the 2006 Model.

We recognize that our initial recommendations would if accepted require a significant effort by the Treasury Department, but we think the importance of the 2006 Model Treaty, and of its incorporation of the OECD rules into U.S. tax treaty law, justifies the effort.

We would be pleased to meet with the Treasury and discuss our comments further if that would be helpful.

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1 Consisting principally of members of the Committee on Inbound U.S. Activities of Foreign Taxpayers. The principal draftsman was Willard Taylor, with substantial contributions from Dan Altman, Kimberly Blanchard, Peter Blessing, Patrick Gallagher, James Guadiana, Charles Kingson, Richard Loengard, and John Steines. Helpful comments were received from Herb Alpert, Andrew Braiterman, Peter Canellos, Peter Connors, David Miller, Andrew Oringer, Yaron Reich, and Michael Schler.

2 United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006

## A. 2006 Model Tax Treaty

The 2006 Model replaces the model treaty issued by the Treasury in 1996. The 1996 Model had in turn followed model treaties dating back to 1977; and, unlike prior models, was accompanied by a technical explanation and statement of purpose.

Many of the provisions of the 2006 Model and the Technical Explanation are the same as in the 1996 Model, and others differ only because they reflect subsequent changes to the OECD Model treaty or its commentary[3] or in U.S. tax law.[4] But there are other places where the text of the 2006 Model or the Technical Explanation adds or subtracts, without explanation. Like the Technical Explanation of the 1996 Model, moreover, the Technical Explanation to the 2006 Model frequently omits any description of the U.S. law that is relevant to the Article under consideration; and, even where the changes in the 2006 Model or the Technical Explanation are made to reflect developments in U.S. tax law, there is frequently no reference to the underlying development.[5] And, unlike the 1996 Model, the 2006 Model is not accompanied by a statement of purpose. It is not possible to understand what is new except by a painful side-by-side comparison of the two model treaties and the respective technical explanations; or, in many cases, to understand why the changes were made. It is sometimes difficult, therefore, to put provisions of the 2006 Model in a meaningful context.

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[3] Such as the elimination the separate independent services article, *i.e.*, Article 14 of the 1996 Model, and expanded definition of real property in Article 6 (Income from Real Property).

[4] Such as amendments to Section 877, the repeal of the withholding tax on dividends paid by foreign corporations, some of the rules in further regulations issued on the source of income from services (*i.e.*, Regs. §1.861-4) and on whether income from computer software (*i.e.*, Regs. §1.861-18) is a royalty or business profits.

[5] The technical explanation of the 1996 Model noted this, stating that "The Model will be more useful if it is understood which developments have given rise to alterations in the Model, rather than leaving such judgments to be inferred from actual treaties concluded after the release of the Model."

1. Explanation of U.S. tax treaty policy and relationship between 2006 Model and current U.S. law. We have commented below on specific provisions of the 2006 Model, including items that it does not include. A fundamental question is whether practitioners and treaty partners might be better served if the Treasury were also to publish an explanation of the changes to U.S. tax treaty policy reflected in the 2006 Model, the reasons for those changes, and the relationship between the different articles of the 2006 Model and current U.S. tax law. This could be part of, or separate from, the Technical Explanation.

This recommendation is consistent with the stated purpose of U.S. model treaties -- which is to "help ... identify legal and policy differences between the two treaty partners" and thus "facilitate the negotiations" and "to provide a basic explanation of U.S. treaty policy for all interested parties, regardless of whether they are prospective treaty partners".[6] Understanding U.S. tax treaty policy is of far greater importance today than it was in 1977 when the Treasury first issued a model treaty or in 1996 when the statement of purpose was first made.

A more transparent approach to U.S. tax treaty policy may make it easier to deal with two other issues that we believe should be addressed.

2. Relevance of the 2006 Model, the Technical Explanation and treaty-specific technical explanations. First, we recommend that the Treasury state its view on the relevance of the Technical Explanation of the 2006 Model and of treaty specific technical explanations. Construing language in the 2006 Model that is often identical to that in existing treaties, the Technical Explanation makes statements as to intended meaning that may or may not be repeated in the technical explanations of specific tax treaties or protocols.[7] Moreover, not all technical explanations of essentially

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[6] See Treasury Department, Technical Explanation of the United States Model Income Tax Convention (September 20, 1996).

[7] See, *e.g.*, the discussion below of the Technical Explanation of Article 21 (Other Income) and the Technical Explanation of Article 7 (Business Profits).

identical treaty language are the same. In cases where the treaty language is substantively the same, can these statements be relied upon in interpreting treaties? The Internal Revenue Service has sometimes used the U.S. model treaties to interpret U.S. treaties;[8] and, although technical explanations are not agreed to by (or even shared with) the other contracting state, the Internal Revenue Service has invoked technical explanations of specific treaties in litigation.[9]

The technical explanations of the U.S. model treaties, like their OECD counterpart, are "ambulatory" in the sense that they reflect developments. Will changes in the explanations, and in the evolution of the meaning given to the same language in different treaties, be taken into account in the interpretation of prior treaties? For example, is the Technical Explanation's view that Article 21 (Other Income) covers guarantee and securities lending fees accurate under a treaty if the technical explanation of the specific treaty (*e.g.*, of the U.S.-Switzerland treaty or of the U.S.-Germany treaty) does not include these statements? Or suppose the treaty specific technical explanation includes items not mentioned in the Technical Explanation (such as income from covenants not to compete, which is mentioned in the U.S.-Ireland treaty or from the rental of tangible property, which is mentioned in the U.S.-Hungary treaty)? Can these be relied on? To take another example, the term, "pensions and similar remuneration," which is widely used in U.S. tax treaties, is sometimes construed by technical explanations as limited to payments from qualified plans; other times as covering payments from any plan, whether or not qualified; and in other cases not spelled out at all.[10]

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8 *E.g.*, Rev. Rul. 91-32; Rev. Rul. 86-145; and Technical Assistance Memorandum, July 30, 1999, WTA-N-112248-98, dealing with the taxability of U.S. source endorsement income of a nonresident alien performer or athlete. *See also*, Rev. Rul. 2000-59.

9 *See* Xerox Corp. v. United States, 42 F.3rd 647 (Fed Cir. 1994); and Snap-On Tools, Inc. v. United States, 26 Cl. Ct. 1045 (1992).

10 *See* the discussion of Articles 17 and 18 below.

The Technical Explanation to Article 3 (General Definitions) of the Model addresses changes in law that affect the definitions in a treaty, but does not address differences between technical explanations in different treaties that use the same or similar language.[11]

3. OECD Model and other OECD documents. Second, and related to the first point, it would be useful for the Treasury to state its view of the relevance of the OECD Model Treaty and related documents to the interpretation of U.S. tax treaties. The Technical Explanation to the 2006 Model invokes the OECD Model Treaty,[12] as well as other OECD documents, such as the OECD Transfer Pricing Guidelines[13] and (by implication) the rules on the Attribution of Profits to Permanent Establishments that were released in December 2006.[14] To what extent can those OECD documents be relied on by taxpayers? The OECD Model and other documents are also "ambulatory". Will subsequent changes be taken into account in interpreting existing U.S. tax treaties? U.S. courts have relied on, or referred to, the commentary to the OECD Model treaty in interpreting income tax treaties between the U.S. and another member of the OECD,[15] as has the IRS.[16]

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11 Article 3(2) says that any term not defined in the Model shall, unless the context otherwise requires or the competent authorities otherwise agree, have the meaning which it has "at that time" under the law of the taxing state. The Technical Explanation says that the definitions are, as a consequence, "ambulatory" in the sense of reflecting changes in law subsequent to the ratification of the treaty.

12 OECD, Model Convention on Income and Capital (1992).

13 OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (July 1995).

14 OECD, Attribution of Profits to Permanent Establishments: Update on Status and Release of New Versions of Parts I, II and III (December 2006).

15 *E.g.*, Mazurek v. United States, 271 F.3rd 226(5th Cir. 2001); American Air Liquide, Inc. v. Comm'r, 116 T.C. 23 (2001); National Westminster Bank, PLC v. United States, 44 Fed. Cl. 120 (Ct.Cl. 1999); North West Life Assur. Co of Canada v. Comm'r, 107 T.C. 363 (1996); Taisei Fire & Marine Ins. Co v. Comm'r, 104 T.C.

## B. Specific Comments on the 2006 Model

Our comments on what is and is not included in the 2006 Model are set out in parts C. and D. below. The comments on what is included in the 2006 Model generally follow the order of the articles of the 2006 Model.

Our purpose in these parts of our Report is to raise questions and identify issues that we believe should be considered and not, at this point, to take positions on all of the substantive rules set out in the specific provisions of the 2006 Model on which we have commented. For example, we are at this point agnostic on whether the 2006 Model should or should not cover the excise tax imposed on insurance premiums,[17] on whether foreign pension plans should or should not be entitled under the 2006 Model to treaty benefits for investment income derived through hybrid entities,[18] or on whether the 15% rate for certain dividends paid by real estate investment trusts is or is not appropriate for inclusion in the 2006 Model.[19]

As noted, we would be pleased to comment further on any of these or other provisions of the 2006 Model if that would be helpful.

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535 (1995); and Podd v. Comm'r, T.C. Memo 1998-231 (1998), and cases cited therein.

16 *E.g.*, PLR 200048011 ("it may be helpful to look to the 1977 OECD Model Treaty and the official commentary thereto for guidance regarding the interpretation of the 1991 Treaty"); PLR 199941007 (Since Article I of the 1984 Treaty in substance parallels Article 1 of the 1977 OECD Model Tax Treaty, the 1977 OECD Commentaries to Article 1 are relevant). See also FSA 199944026; IRS CCA 199938031; FSA 200147033 and others.

17 *See* C.2 below.

18 *See* D.2 below.

19 *See* D.18 below.

C. Omissions

1. Zero withholding tax rate on certain dividends. Although an increasing number of U.S. tax treaties provide for a zero rate of withholding on parent-subsidiary dividends and dividends paid to pension funds,[20] as well a zero rate of branch profits tax, that is not a feature of the 2006 Model. We know from the statements made at conferences that the Treasury views the 2006 Model as a "starting point" for negotiations and does not wish to concede the zero rate issue, that the zero rate is available only on a "case-by-case basis", "looking at the overall balance" of the particular treaty, and that there are not many candidates left.[21] These statements offer little guidance, and we recommend that the Technical Explanation, which is silent on the matter, address the availability of the zero rate for dividends. The provisions in the recently-released treaty with Belgium that terminate the zero rate if Belgium has not satisfactorily complied with the Article 25 (Exchange of Information and Administrative Assistance) may give an indication of at least one of the issues involved, but this also could use elaboration.

Any explanation of the zero rate on parent-subsidiary dividends should also address the question of why, with the exception of the U.S.-Japan treaty, the threshold for the zero rate is ownership of 80% or more, as opposed to 50% (as in the U.S.-Japan treaty) or some other level. The explanation given for the 50% threshold in the U.S.-Japan treaty would seem to apply in any treaty negotiation.[22]

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20 *E.g.*, treaties or pending protocols with Australia, Denmark, Finland, Japan, Germany, the Netherlands, and the UK.

21 Tax Notes Today, April 13, 2005, reporting remarks by Patricia A. Brown of the Treasury Department; and Tax Notes Today, May 9, 2006, reporting remarks by Hal Hicks, International Tax Counsel, Treasury Department.

22 That "it is arguably appropriate to regard the dividend-receiving corporation as a direct investor [in a case where there is 50% or greater ownership]... rather than ... as having a remote investor-type interest" in the corporation paying the dividend.

2. Excise tax on insurance premiums. Likewise, although many U.S. tax treaties eliminate the Federal excise tax on premiums paid to insure or reinsure U.S. risks,[23] the 2006 Model does not include such a provision. The excise tax is a surrogate for U.S. income tax on the net income component of premiums paid for insurance or reinsurance and in that sense more of an income than an excise tax.[24] We think the Technical Explanation should address the question of whether the 2006 Model should or should not eliminate the excise tax (subject to the typical treaty rule which turns the elimination off if the risks covered by the premium are reinsured with a person not eligible for a treaty exemption on directly-received premiums). If the reason for the absence of such a provision is the lingering Congressional concerns about the competitive impact on U.S. insurers of eliminating the excise tax,[25] that might be spelled out.

3. Compulsory arbitration. The 2006 Model Treaty does not include an arbitration provision in Article 25 (Mutual Agreement Procedure). Since the 1989 tax treaty with Germany, the U.S. has included non-compulsory arbitration provisions in many treaties.[26] The pending protocol to the U.S.-Germany treaty and the pending U.S.-Belgium treaty provide for compulsory arbitration of certain issues if the competent authorities are unable to agree within a prescribed time frame. Similarly, a mandatory independent review process for factual disputes was included in a 2005 mutual agreement with Canada, and the OECD has now recommended the inclusion of arbitration in its

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23 Inclusion of the excise tax in the taxes covered by the treaty (*i.e.*, Article 2) means that the premiums are exempt under Article 7(1). U.S. treaties that include the excise tax in covered taxes include those with France, Germany, Hungary, Ireland, Japan, Kazakhastan, Mexico, Spain, Sweden, Switzerland, and the U.K.

24 *See* the discussion in Rev. Rul. 80-222.

25 The explanation of the U.S.-Japan treaty, which includes an exemption from the excise tax, recites the Congressional concern, expressed in connection with the Bermuda and Barbados treaties, that the exemption could put U.S. insurers at a disadvantage unless the premiums were taxed in the other country.

26 *See, e.g.*, treaties with France, Germany, Canada, Ireland, Italy, Mexico, the Netherlands, Switzerland, Kazakhstan and France.

model.[27] It would be useful for the Treasury to set out its views on mandatory and non-compulsory arbitration, its experience with arbitration under such provisions in existing U.S. tax treaties, and its evaluation of the terms of treaty arbitration provisions.

4. Charitable, educational, religious and like organizations. Foreign entities organized for charitable, educational, religious, artistic, cultural or like purposes (hereafter, "charitable" organizations) may or may not be exempt from tax under Section 501(a), depending in many cases on whether the technical requirements of Section 501(c)(3) are met. Income of those foreign charitable organizations that do qualify under Section 501(a) is exempt from U.S. tax but, if the organization is a private foundation, will be subject to the 4% excise tax imposed by Section 4948 on gross U.S. source investment income that is not unrelated business income.[28] Income of those that do not qualify will be subject to U.S. income tax to the same extent as the income of any foreign person but will not be subject to the 4% excise tax.

U.S. tax treaties provide two rules for foreign charitable organizations.[29] First, a few treaties exempt from source country income tax the income of a charitable organization that is generally exempt from tax in the country of its organization.[30] This also exempts a qualifying foreign charitable organization from the 4% excise tax that might be imposed by Section 4948 if the foreign charitable organization qualified for

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27 OECD, Improving the Resolution of Tax Treaty Disputes (February 2007).

28 This excise tax is collected by withholding under Section 1443(b), although it is unclear how a foreign tax exempt organization can establish whether it is or is not a private foundation.

29 In addition, treaties with Mexico, Canada and Israel provide for deductibility of contributions made by residents of one state to organizations in the other. This presumably reflects the extent of cross-border contributions.

30 Treaties with Canada (Article XXI(1)), Germany (Article 27), Mexico (Article 22(1)) and the Netherlands (Article 36).

exemption under Section 501(a).[31] Second, most treaties provide, in Article 2 (Taxes Covered), that the 4% excise tax is a covered tax.[32]

The 2006 Model treaty provides (in Article 4 (Resident)) rules for determining the residence of a charitable organization[33] and (in Article 22 (Limitation on Benefits)) for the application of the limitation on benefits article.[34] Neither of the two provisions described above is included in the 2006 Model treaty, however, even though all three of the prior U.S. Model treaties did include the Section 4948 excise tax in the taxes covered by the model. It would be useful to understand why no provision of the 2006 Model addresses the substantive tax rules that apply to income of a charitable organization.

The few treaties that generally exempt foreign charitable organizations from U.S. income tax, and thus also from the 4% excise tax, are presumably premised on equivalent standards for tax exemption in the other country. As a practical matter, since U.S. source interest and royalties of a resident of the other state would in any event not be taxed under the 2006 Model, and most other items of investment income are sourced by the U.S. on a residence basis, the provision seems largely relevant for U.S. source

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31 Regs. §53.4948-1(a)(3) which provides that items of income exempt from tax under a treaty are not taken into account in determining the Section 4948 liability of a foreign private foundation. *See also*, Rev. Rul. 74-183.

32 The usual formulation is the "excise taxes ... with respect to private foundations". However, Article 10(7) of the Swedish treaty specifically provides an exemption from the excise tax for dividends; and Article 1(b) of the 2003 protocol to the U.S.-Japan treaty provides an exemption from the excise tax for royalties and other income and subjects the excise tax to the treaty rates that apply to dividends and interest.

33 Article 4(2)(b) which includes in the definition "an organization that is established and maintained in that State exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes".

34 Article 22(2)(d) provides that a qualified person includes "a person described in" Article 4(2)(b).

dividend income of a foreign charitable organization that meets the standards for tax exemption in its country of organization but does not qualify under Section 501(a). One way of addressing dividends, short of providing a complete exemption for all income of the foreign charitable organization, would be to include a zero withholding tax rate for dividends paid to a foreign charitable organization in the 2006 Model – there is a zero rate in the 2006 Model for dividends paid to pension funds.[35]

The treatment of the 4% excise tax on gross U.S. source investment income of a qualifying foreign organization is confusing. This is a narrow issue. The 4% excise tax is imposed only on a foreign charitable organization that meets the requirements of Section 501(a) and is a private foundation. It is eliminated in the few treaties, referred to above, that provide an exemption for income of a foreign charitable organization, and in other U.S. treaties does not apply to those items of investment income, such as interest, that are exempt from U.S. income tax. It makes no difference in such a case whether the excise tax is or is not covered by Article 2.[36] Thus, under the 2006 Model, the excise tax would seem to be limited to U.S. dividends and real property rents of a foreign private foundation.[37]

Suppose the treaty does provide, in Article 2 (Taxes Covered), that the excise tax is a covered tax? Inclusion in Article 2 does not as such affect the taxation of income. Would it make more sense, as suggested above, for there to be a reciprocal

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35 Article 10(3). *See also, e.g.*, the treaty with the Netherlands. On the other hand, we recognize that the Section 4948 excise tax is a corollary to the excise tax imposed on domestic private foundations under Section 4940, and that there might be valid reasons for not treating a foreign private foundation more favorably than a domestic private foundation.

36 If there is no such exemption, however, the Section 4948 tax (since it is an excise tax) would not be covered by a treaty unless the treaty specifically so provided. Rev. Rul. 84-169.

37 Rev. Rul. 76-330. Personal property rents would presumably be covered by Article 21 (Other Income).

exemption from income tax for dividends paid to foreign charitable organizations? That would eliminate the excise tax issue as well.[38]

D. Comments on What Is in the 2006 Model

Our comments on what is included in the 2006 Model and the Technical Explanation are set out below, generally in the order of the articles of the 2006 Model. The comments are not intended to be comprehensive[39] or to take positions at this point on all of the substantive issues involved in those provisions on which we have commented. We would be pleased to comment on other provisions of the 2006 Model, or to supplement our comments on those provisions that we have commented on, if that would be useful to the Treasury Department and the Internal Revenue Service.

1. Consistency. Paragraph 2 of Article 1 (General Scope) of the 2006 Model, like its predecessors, provides in substance that the 2006 Model does not subtract from the benefits to which an enterprise of the other state is entitled under the Internal Revenue Code. This gives rise to the question of "consistency" – specifically, whether a taxpayer can use the "effectively connected income" rules in the Code and the business profits article of a treaty (Article 7 of the 2006 Model) to reach different results with respect to different parts of the taxpayer's U.S. operations.

The Treasury's view, set out in Rev. Rul. 84-17, is that the permanent establishment and business profits articles of a U.S. treaty must be applied consistently. The specific holding (which is consistent with the disallowance under Section 265 of the

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38 Even with a dividend exclusion, the excise tax would continue to apply to income from real estate that is not subject to an election under Article 6(5) (Income from Real Property). Gains from real estate would presumably be taxed under Section 897 and therefore not subject to the excise tax.

39 For example, we have not commented at all on Article 8(Shipping and Air Transport), Article 13 (Gains), Article 14 (Income from Employment), Article 19 (Government Service), or Article 20 (Students and Trainees), and have not commented comprehensively on Article 22 (Limitation on Benefits).

Internal Revenue Code of expenses attributable to exempt income[40]) is that a foreign corporation which carried on two separate activities in the U.S. that were not permanent establishments, and which resulted in taxable income in one case and a taxable loss in the other, could not use the loss to reduce income from a third activity that was a permanent establishment.[41]

The Technical Explanation of Article 7 (Business Profits) gives two further applications of the consistency rule.

First, the Technical Explanation interprets the consistency rule as meaning that a foreign bank or financial institution cannot use the risk-weighting rules of Article 7 to determine its U.S. assets, and thus its deductible interest expense, unless it also uses those rules to determine its "dividend equivalent" amount under Section 884 for branch profits tax purposes. This is apparently intended to resolve an issue which the Internal Revenue Service identified in the preamble to revisions to Regs. §1.882-5 (*see* T.D. 9281 (September 25, 2006)) and said it was "continuing to consider".

It seems sensible to require the use of consistent methods under Article 7 to determine deductible interest expense and branch profits tax.[42] The Internal Revenue Code rules on these two issues have always moved in tandem. However, we think that the Treasury's position on this question should also be set out in a ruling (or in amended regulations under Section 884), and only illustrated, and not announced, in the Technical Explanation of the 2006 Model.

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40 *See* FSA Lexis 202 (September 7, 1995). *See also* Rev. Rul. 80-147.

41 The ruling, which involved the U.S.-Polish treaty, held that a loss from U.S. activity "c", which was not a permanent establishment, could not be used against income from U.S. activity "a", which was a permanent establishment, in a case in which the foreign corporation invoked the permanent establishment article of the treaty to exempt income from activity "b" from U.S. tax. *See also*, Rev. Ruls. 79-199, 81-78 and 80-147; and Chief Counsel Advice, POSTN-145429-05, November 29, 2005.

42 The authorization of branch profits tax in Article 10 (Dividends) cross-references business profits in Article 7.

Second, and of more importance, the Technical Explanation of Article 7 states broadly that the consistency rule means that a taxpayer which conducts different lines of business in the U.S. cannot apply a treaty to determine the income from one and the Internal Revenue Code to determine the income from another. This is a significant extension of the Rev. Rul. 84-17, which was about "cherry-picking"[43] between the Internal Revenue Code and a treaty to use a loss from one activity against income from another. It raises important questions about the relationship between the Internal Revenue Code rules for determining what income is subject to U.S. tax and the rules in U.S. tax treaties.[44] The issue is more important under the 2006 Model because of its incorporation of the OECD rules for attributing profits to a permanent establishment.

Specifically, The Technical Explanation says that (1) a taxpayer cannot use Article 7 to attribute income from a trading book and U.S. domestic rules to attribute income from its loan portfolio, and (2) a taxpayer which uses Section 864(c) to eliminate U.S. tax on foreign source royalties attributable to a permanent establishment (presumably on the basis that the royalties, although attributable to a permanent establishment, are not income described in Section 864(c)(4)(B)[45]) cannot invoke Article 7 to avoid U.S. tax on other effectively connected income.

As the royalty example notes, this application of the consistency rule requires the taxpayer to increase its taxable income by amounts not taxable under the Internal Revenue Code (i.e., the foreign source royalties) in order to take advantage of the

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43 *See* Chief Counsel Advice, POSTN-145429-05, November 29, 2005.

44 It is also broader than the interpretation given by the IRS to Rev. Rul. 84-17 in rulings such as PLR 8524004, February 12, 1985 ("the holding and rationale of [that ruling] would require the consistent treatment during the same taxable year of nonattributable income derived from a single source" – in the particular case, rental income and gain from the sale of real property.)

45 The example could use elaboration -- are the foreign source royalties not taxable under the Code because, although attributable to a permanent establishment, they are not derived in the "active conduct" of the U.S. business and therefore are not effectively connected under Section 864(c)(4)(B)?

treaty and use the permanent establishment article to exempt other income from U.S. tax. This takes "consistency" much further than Rev. Rul. 84-17.

Is it thus the view of the Treasury that if, for example, a taxpayer relies on the permanent establishment article of a treaty to eliminate tax on U.S. sales of manufactured goods, it cannot rely on the trading in securities and/or commodities safe harbors in Section 864(b)(2) to eliminate U.S. tax on gains from those activities that are attributable to a permanent establishment, notwithstanding that the activities are not related to the sales of manufactured goods? Or that the specific limitations on the U.S. taxation of foreign source income which are set out in Section 864(c)(4) or in Section 865(e)(2)(B) are not available for income that would be "attributable to" a U.S. permanent establishment if the foreign taxpayer uses a tax treaty to determine the income of a permanent establishment?

If so, it would seem that the "consistency" rule is being used to force foreign taxpayers seeking treaty benefits to surrender specific exclusions from effectively connected income that are set out in the Code and the Regulations. That seems difficult to reconcile with the policy of Article 1(2) of the 2006 Model. The Technical Explanation to that provision says that "no provision in the Convention may restrict any exclusion, exemption, deduction, credit or other benefit accorded by the tax laws of the Contracting State," and that "the Convention may not increase the tax burden on a resident of a Contracting State beyond the burden determined under domestic law."

In addition to addressing these important issues in the Technical Explanation of Article 7, consideration might also be given to further published rulings with respect to the consistency doctrine set out in Rev. Rul. 84-17. There are a number of points that might be addressed.

First, the consistency rule has so far been applied only to the application of single articles of a treaty (principally, Article 7 (Business profits)). Does it apply outside of this context? For example, we assume (and the Technical Explanation so states) that it

does not mean that a foreign corporation that "elects" not to use Article 7 for direct U.S. operations cannot use Article 10 (Dividends) for unrelated U.S. dividend income.

Second, how is the election between the Internal Revenue Code and a treaty provision made? Can it be made by the taxpayer on a year-by-year basis? Can it be changed by the taxpayer on audit? Or does paragraph 5 of Article 7 (which provides that "absent good and sufficient reason to the contrary", "the profits to be attributed to the permanent establishment shall be determined by the same method year by year") make an "election" irrevocable once a taxable year has closed?

Third, how strictly will the consistency requirement be followed? Suppose the Internal Revenue Service asserts, contrary to the foreign taxpayer's view, that not all claimed expenses are calculated on a basis that conforms to Article 7 (Business Profits) of the treaty – can this argument be used to force the taxpayer to choose between the treaty and the Internal Revenue Code?

2. Payments to fiscally transparent entities. Paragraph 6 of Article 1 (General Scope) of the 2006 Model treats income of a "fiscally transparent" entity as derived by a resident of the other state only if it is treated by that state as income of a resident, and illustrates this in the Technical Explanation of that Article as well as in the Technical Explanation of Article 10 (Dividends).

We have several comments on this.

First, in the case of income subject to tax under Section 871(a) or Section 881(a), is the 2006 Model generally intended to conform the treaty rule to Regs. §1.894-1(d), relating to payments made to fiscally transparent entities? If this is the intent, the Technical Explanation might simply state that, in so far as the U.S. is concerned, Article 1(6) incorporates the rules in Regs. § 1.894-1(d) and then go on, as discussed below, to address specifically the definition of fiscal transparency. If that is not the intent, it would

be helpful if the differences were spelled out. The Technical Explanation makes no reference to Regs. §1.894-1(d).[46]

Second, which entities are fiscally transparent? Under Regs. §1.894-1(d)(3) and, apparently, under the 2006 Model, entities that are fiscally transparent in the U.S. include partnerships, common trust funds (as defined in Section 584), grantor trusts and certain other trusts and estates, as discussed hereafter (under Treatment of trusts and estates).[47]

The Technical Explanation mentions these entities, but does not address the anticipated treatment by the other contracting state of income derived by an S corporation. An S corporation, like a partnership, is generally exempt from tax as an entity; and its shareholders, like partners, take into income their shares of its income, whether or not distributed, as though realized directly from the same source as realized by the S corporation.[48] The treatment of S corporations is important – S corporations are still (according to the most recent IRS statistics) the most commonly used form of

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46 Additionally, the language of the Technical Explanation differs in some respects from those regulations. For example, in the Technical Explanation of Article 10 (Dividends), it is said that a dividend paid to a fiscally transparent entity is eligible for treaty benefits as long as it is included in income by the owners of the entity, apparently without regard to whether its character as a dividend is changed. That would not ordinarily be the case under Regs. §1.894-1(d)(3)(ii), which generally requires that the item be treated by the other state as if "realized directly from the source from which realized by the entity".

47 Under Regs. §§1.894-1(d)(3)(ii) and (iii), fiscal transparency generally requires that (1) an interest holder take into account separately on a current basis the interest holder's respective share of the item of income paid to the entity, whether or not distributed, and (2) that the item have the same character and source in the hands of the interest holder as if the item was realized directly from the source from which realized by the entity.

48 Sections 1363(a), 1366(a) and 1366(b). Regulated investment companies and real estate investment trusts, on the other hand, would not be fiscally transparent because the pass through changes the character of the underlying income and depends on an actual distribution of the income. *See*, by implication, Rev. Rul. 2000-59.

business entity in the U.S. Since S corporation shareholders will ordinarily be U.S. citizens or residents or their estates or trusts, eligibility for treaty benefits should not be a problem, but compliance with whatever rules the other contracting state uses to implement its rules on fiscal transparency may be.

Third, assuming that no difference is intended between Regs. §1.894-1(d) and Article 1(6) in the case of income taxed under Section 871(a) or 881(a), treaty benefits will be denied to payments made to a fiscally transparent entity that is not taxed as a resident and whose owners are not currently subject to tax as residents on the payments to the entity, notwithstanding that the entity distributes its income to its owners on a current basis.[49] The denial of treaty benefits in such a case is particularly an issue for foreign pension funds that make investments through "regular" hybrid entities (fiscally transparent in the U.S. but not in the foreign state). It is a matter of indifference to the fund, and the U.S. Treasury, whether the entity is or is not transparent – put differently, there is no tax advantage to the fund, or tax detriment to the U.S., in fiscal transparency. Recognizing that the denial of treaty benefits in such a case may reach the wrong result, the U.S. has agreed with the Netherlands competent authority to treat the income of a fiscally transparent entity organized in the Netherlands as derived by a resident of the Netherlands that is a pension fund to the extent of the fund's share of such income.[50]

Should the Technical Explanation take a position and state that such an agreement is generally available under Article 1(6)? Alternatively, should this part of the Section 894 Regulations be revisited? Would it be useful for such a competent authority agreement, if available, to be extended to tax exempt investors other than pension funds and to cases where the fiscally transparent entity is organized in a third jurisdiction?

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49 Or that the income is taxed to residents under the equivalent of subpart F.

50 Internal Revenue Service, Information Release 2003-37, March 31, 2003, relating to the U.S-Netherlands treaty.

3. Treatment of trusts and estates. In so far as the U.S. is concerned, what is an "estate" or a "trust" for purposes of (1)(a) of Article 3 (General Definitions) of the 2006 Model is presumably determined under U.S. tax law and therefore excludes trusts that are classified as partnerships or as corporations under the Internal Revenue Code.

The Technical Explanation could better spell out the way the 2006 Model Treaty will apply to income of a trust or an estate and also consider whether the rules in Article 22(2)(e) are the appropriate way to determine whether such an entity is a "qualified person" or whether there should be a separate more targeted rule in Article 22 for estates and trusts.

It is our understanding of the 2006 Model that, because of the rule in Article 1(6) for income derived through a fiscally transparent entity, the rules in the 2006 Model that may apply to an estate or trust will be relevant only to income of the trust or estate that is not "required to be distributed currently".[51] Income that is required to be distributed currently will be taxed to the beneficiary currently, whether or not distributed, and will have the same character as if realized directly -- to that extent, the trust or estate should be fiscally transparent. That income will be eligible for treaty benefits only if taxed as the income of a resident beneficiary.[52]

A trust or estate is presumably not fiscally transparent with respect to other income (*i.e.*, "income [not] required to be distributed currently"), even though the trust or estate will be entitled to a deduction if in fact the income is distributed and even though its character in such a case passes through. Whether the income of an estate or trust that is not required to be distributed currently will be eligible for treaty benefits will depend, therefore, on whether the trust or estate is (1) a "resident" within the meaning of

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51 Sections 651 and 661.

52 Other treaties may, however, apply to beneficiaries who are residents of other treaty countries.

Article 4 (Residence) and (2) a "qualified person" within the meaning of Article 22 (Limitation on Benefits).

Residence will ordinarily be straight-forward.[53] But when will a trust or estate be a "qualified person" within the meaning of Article 22 (Limitation on Benefits)? As the Technical Explanation acknowledges, that article would apply only if the estate or trust is described in Article 22(2)(e), which (1) requires ownership (50% or more ownership by residents of the beneficial interests in the entity on at least half the days of the year) and (2) limited base erosion (less than 50% of the gross income is paid to nonresidents of either state as deductible payments).

The Technical Explanation says that the ownership test of Article 22(2)(e) will be applied to a trust (and presumably to an estate) based on the "actuarial" interests of the beneficiaries, but that the ownership test cannot be satisfied "if it is not possible to determine the actuarial interest of [all of] the beneficiaries in the trust" unless all "possible" beneficiaries are residents of one contracting state or the other. Thus, a trust or estate may fall out because of a contingent interest of indeterminate value owned by a nonresident of both contracting states. And, because trust or estate deductions for amounts required to be distributed and amounts in fact distributed erode the tax base (*i.e.*, are deductible from gross income), a trust or estate may fail the base erosion test on account of income which, because it is "required to be distributed currently", is not in any event eligible for treaty benefits in the hands of the trust or estate.

We question whether this result makes sense and suggest that there be a more targeted rule in Article 22 for trusts and estates. For example, an alternative might be to provide that, if a trust or estate is fiscally transparent with respect to an item of

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[53] Under Article 4(1) an estate or trust will be a U.S. resident if it is "liable to tax" in the U.S. by reason of, for example, place of organization. Notwithstanding the deduction allowed for actual distributions (as well as amounts required to be distributed), a U.S. estate or trust should be a resident if it would have been taxed on such amount in the absence of a distribution. The same rules would presumably apply in determining the residence of a foreign trust or estate. See Rev. Rul. 2000-59.

income, that item and the value of the beneficiary's interest in that item would not be taken into account in determining whether any ownership or a base erosion test is met. In addition, a trust or estate would not fail the 50% ownership test because the actuarial value of all interests cannot be determined, provided that at least half the fair market value of the interests are held by qualified residents.

4. Other income of fiscally transparent entities. The Section 894 Regulations with respect to payments to fiscally transparent entities deal only with payments of interest, dividends and other fixed or determinable, annual or periodical income (*i.e.*, income taxed under Section 871(a) or 881(a) of the Code). Article 1(6), however, applies to any "item of income, profit or gain derived through" a fiscally transparent entity, and thus seems to include income that would be taxable under Section 871(b) or Section 882. Although the Technical Explanation seems to view Article 1(6) as directed at investment income, such as interest or dividends, it does not limit Article 1(6) to items of income that would be taxed as interest, dividends or other fixed or determinable, annual or periodical income.

Is this application of the rule with respect to fiscally transparent entities intended? It is considerably broader than what was targeted by the Treasury when the Section 894 Regulations were issued, although it is not inconsistent with the as-yet-unexercised regulatory authority given to the Treasury in Section 894.[54]

For example, suppose a U.S. limited liability company performs personal services on a world-wide basis, is a partnership for U.S. tax purposes and has individual partners in foreign countries that do not view the company either as fiscally transparent or as a resident taxpayer (*i.e.*, the company is a regular hybrid as to some of its partners' countries of residence). If Article 1(6) applies to U.S. source personal services income (*i.e.*, is not limited to investment income), the effect will be to deny the benefit of the

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[54] Section 894(c)(1) relates to "reduced rate[s] of ... withholding tax", but (c)(2) authorizes regulations with respect to "any payment received by, or income attributable to any activities of, [a fiscally transparent] entity" that is a regular hybrid.

"permanent establishment" clause of the 2006 Model to those foreign partners and to subject them to U.S. tax on their distributive shares of U.S. source income, whether or not the partnership has an office or other fixed place of business in the U.S. Is this result intended?

Or suppose a treaty-eligible foreign corporation has business activities in the U.S. through an entity that is transparent in the U.S. but is not in the treaty country (*i.e.*, is a regular hybrid) and whose income is not taxed to the foreign corporation as its income (although it may be currently taxed under the foreign equivalent of subpart F). Will Article 1(6) deny the benefit of the permanent establishment provision? Will a treaty reduction in branch profits be available in respect of the dividend equivalent amount of the foreign corporation?

5. Conduit financing arrangements. In the Technical Explanation of Article 1(6) or elsewhere, the Technical Explanation should address Regs. §1.881-3, relating to conduit financing arrangements, since those Regulations both (1) deny the application of treaty benefits to payments made to a conduit entity if the entity is disregarded by the Internal Revenue Service and (2) extend treaty benefits in such a case to the deemed payments made to a financing entity that is eligible for such benefits.[55] There is no mention of the regulations in the Technical Explanation, except for a general reference in the Technical Explanation of Article 22 (Limitations on Benefits) to "the anti-abuse provisions of domestic law".[56]

6. Payments by domestic reverse hybrid entities. There is no reference in the Technical Explanation to Regs. §1.894-1(d)(2)(ii), relating to certain payments made by domestic reverse hybrids. The rule in the regulations, which converts interest payments by a U.S. corporation into dividends for purposes of both deductibility and withholding tax, is arguably inconsistent with Article 10 (Dividends) in so far as that article excludes from dividends "income from ... debt claims".[57] Alternatively, is the

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55 Regs. §1.881-3(a)(3)(ii)(C).

56 Technical Explanation p. 64.

Regulation consistent with Article 24 (Non-Discrimination), given that it is targeted at payments made to treaty partners? Consideration should be given to addressing these issues in the Technical Explanation.

7. Dual resident corporations. Article 4 (Residence) determines residence and, if a corporation is dually-resident, provides that the residence of the corporation is its place of incorporation.[58] How can this be reconciled with Sections 269B(d) and 7874(f), both of which treat certain foreign-incorporated companies as U.S. corporations, notwithstanding any contrary treaty obligation of the United States? (Under the OECD Model, the residence in the case of a conflict would be the place of effective management.[59]) The apparent conflict between the 2006 Model and the Internal Revenue Code provisions should be acknowledged by the Technical Explanation and the relationship between these Code sections and Article 4 of the 2006 Model spelled out.

8. Services rendered in an independent capacity. The 2006 Model redefines "business" in Article 3 (General Definitions) so that it now includes the performance of professional services and of other "activities of an independent character" by an individual or partnership that includes individuals.

With one exception, discussed below, this change conforms the 2006 Model to the OECD Model without, apparently, any intention to change the result the U.S. would have reached under the 1996 Model. The old separate article for independent services, *i.e.*, Article 14 of the 1996 Model, is eliminated. However, income of a resident of one state from services of an independent character that are attributable to an office or other fixed place of business in the other state continues, under Article 7 (Business

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57 We raised this issue in NYSBA Tax Section Report No. 1004, January 14, 2002, Report on Proposed Regulations under Section 894 Regarding Payments Made by Domestic Reverse Hybrid Entities.

58 If a corporation is incorporated in both states, residence will be determined by the competent authorities.

59 There is a lack of consensus among OECD countries that use this test as to how the place of effective management is determined.

Profits), to be taxed by the state of the fixed place of business.[60] Under the Technical Explanation, income for services is attributable to a fixed place of business only if for services performed in the country of the place of business.

The one change is that the "fixed base" test in Article 14 is now replaced by the permanent establishment test in Article 7, and this incorporates the definition in Article 5. Paragraphs (3) and (4) of Article 5 provide exceptions for certain fixed places of business (including a 12 month rule in Article 5(3)) that may not have been incorporated in the fixed base rule of old Article 14. This might be noted in the Technical Explanation.[61]

Article 5 of the 2006 Model, like the corresponding article of the OECD Model, excepts from the definition of a permanent establishment a building site, a construction or installation project and certain other activities if it lasts for less than 12 months. Since Article 5 now applies to personal services, should consideration be given to expanding the scope of the less than 12 months rule to include activities more conventionally associated with personal services? For example, to an office established for any narrow and specific purpose if it exists for less than 12 months?

9. Personal service partnerships. The Technical Explanation on the treatment of independent personal services, now moved to Article 7 (Business Profits), takes a different view of how Article 7 applies to partnerships providing professional services than the technical explanation of the 1996 Model. Adopting the position subsequently taken by the Internal Revenue Service in Rev. Rul. 2004-3 on Article 14 of the then U.S.-Germany treaty, the Technical Explanation of the 2006 Model provides that, whether or not a nonresident partner performs services in the state of the fixed place of business, the partner may be taxed on his or her share of the partnership's income from

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60 OECD, The Tax Treaty Treatment of Services: Proposed Commentary Changes – Public Discussion Draft, 8 December 2006.

61 In addition, tax under Article 7 is specifically limited to the "profits" of the permanent establishment, but this was the case under the 1996 Model's version of Article 14.

that state.[62] The Technical Explanation to the 1996 Model would not have taxed such a partner unless he or she had in fact performed services in the U.S.

The position taken by Rev. Rul. 2004-3 is not compelled by cases under Section 875[63], but it is consistent with an "aggregate" view of partnerships with foreign partners; and the determination of the source of partners' shares of partnership income at the partnership level is consistent with general subchapter K principles. If the partnership does no more than provide services, however, the price of Rev. Rul. 2004-3, as compared to taxation simply on the basis of the residence of the partners, is substantial administrative complexity for the partnership and its partners. It may also force otherwise unnecessary self-help, such as the use of guaranteed payments or of an entity that is classified as a corporation.

Under Rev. Rul. 2004-3, there will be U.S. tax on all of the partnership income of the U.S.-based partners, who are presumably residents or citizens, and U.S. tax on the foreign partners' shares of the partnership's U.S. source income. If every country did the same (*e.g.*, the foreign country in Rev. Rul. 2004-3 taxed the U.S. partners on their shares of the partnership's foreign income and the local partners as residents), and the foreign tax credit (or exemption) systems worked perfectly, there would be no double taxation (and the U.S. would have to give up some of the tax imposed on the U.S.-based partners). Apart from rate differences, the result would be substantially the same as if each partner's share of partnership's income had been taxed to the partner solely on the

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62 Rev. Rul. 2004-3 took the view that this conclusion followed from Section 875 of the Code, which (as interpreted by case law) would attribute the office of the partnership to each of the partners.

63 *E.g.*, by Donroy, Ltd. v. United States, 301 F.2d 200 (9th Cir. 1962)(Canada limited partner had a U.S. permanent establishment on account of the partnership's activities).

basis of residence, and the complexity of multiple returns would be avoided. Is this an alternative that should be considered?[64] Are there others?[65]

10. Real property. Article 6 (Income from Real Property) permits the country in which real property is situated to tax income from real property, and the Technical Explanation says (as it did with respect to the 1996 Model) that for this purpose "real property", in the case of the U.S., is defined by Regs. §1.897-1(b). In addition to real property, Article 6 of the 2006 Model, unlike Article 6 of the 1996 Model, now includes income from "property accessory to real property", "rights to which the provisions of general law respecting landed property apply", and a "usufruct of real property". These additions conform Article 6 to the current OECD Model. It would be useful if the Technical Explanation related these changes to the definition in Regs. §1.897-1(b) — *i.e.*, stated whether they add to that definition or not.

11. Definition of a permanent establishment. Apart from banks and some insurance companies, most foreign corporations conduct U.S. operations through subsidiaries, and, in our experience, assume that this limits the U.S. tax to the taxable income of the subsidiary (taking into account any transfer pricing adjustments) and any withholding taxes on U.S. source dividends, royalties and like income. It is thus important to have clarity on the circumstances in which this tax assumption may be wrong and a U.S. subsidiary may cause its foreign parent to have a U.S. permanent establishment.

Article 5 (Permanent Establishment) of the 2006 Model provides in paragraph 7 that "control" of one corporation by another "shall not be taken into account" in determining whether either has a permanent establishment in the state of the other. This language, incorporated in Article 5(7) of the recently-proposed U.S. treaty with

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64 *See* Reinhold, Some Things that Multinational Tax Treaties Might Usefully Do, 57 Tax Law. 661 (2004).

65 *See* Blanchard, The Unresolved Tax Status of Multinational Service Partnerships and Their Partners, 56 Tax Law. 779 (2003).

Belgium, is arguably a broader rejection of the subsidiary-as-a-permanent-establishment-of-its-parent worry than the corresponding language of the 1996 Model ("shall not constitute either entity a permanent establishment of the other") or the 2004 OECD Model ("shall not of itself constitute either company" a permanent establishment of the other).

The Technical Explanation says nothing about the differences and, if the changed language is intended (as we think it may be) to clarify that the existence of control that results from ownership of equity is irrelevant to whether a subsidiary is a permanent establishment of its parent, we would recommend that it be stated in that way. Ownership, and the resulting control, of a corporation should not be relevant to the question of whether the corporation is a permanent establishment of its owner (or the owner is a permanent establishment of the subsidiary). The simple use of the words "controls" and "controlled by" in Article 5 may be interpreted as going further, however, and the Technical Explanation might usefully address this. In general, the degree to which a parent *exercises* control over the activities of a subsidiary *is* relevant to the question of whether the subsidiary has the economic and legal independence necessary to be an independent agent — the Technical Explanation itself says that the exercise of "comprehensive control" may mean that a subsidiary is not legally independent.

The question of whether a subsidiary is a permanent establishment of its parent generally involves the question of whether the subsidiary is an agent and, if it is, not an "independent" agent.[66] The Technical Explanation says that "independence" requires "legal" and "economic" independence and that the agent be acting in the ordinary course of its business.[67] In addition to clarifying the ownership/control point in

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66 *See* Tasei Fire & Marine Ins. Co. v. Comm'r, 104 T.C. 535 (1995), which however did not involve a subsidiary.

67 The Technical Explanation goes on to say that independence is a "factual determination", that the extent to which the agent operates "on the basis of instructions" from the principal is relevant, that economic independence looks to whether the agent "bears business risk", which is "primarily" a question of "risk of loss", and that another relevant fact is whether the agent acts "exclusively or nearly exclusively" for the principal.

Article 5(7), it might be useful for the Technical Explanation of that Article to address further what these terms mean and provide examples of cases in which there is or is not "legal" or "economic" independence. The issue of "legal" and "economic" independence was litigated in Tasei Fire & Marine Ins. Co. v. Comm'r, 104 T.C. 535 (1995); and, while the Internal Revenue Service has acquiesced in the Tax Court's decision in that case,[68] it is not clear what the basis for its disagreement was in the first place.

Like the OECD Model, the definition of a permanent establishment in the 2006 Model includes a "place of management". This term (like the "place of effective management" used by the OECD Model to resolve the residence of dual resident corporations) has no specific meaning under U.S. tax law, and the Technical Explanation of the 2006 Model might consider addressing this point.

12. Definition of business profits. The Technical Explanation of Article 7 (Business Profits) says that business income includes income from notional principal contracts and other "financial instruments" but only if derived by a dealer or otherwise in a trade or business. Income from such instruments that is not covered by Article 7 is dealt with in Article 21 (Other Income).[69] These comments seem to pre-date the adoption of the rules in Regs. §§1.863-7 and 1.988-4[70] and the enactment of Section 865, which generally source income from notional principal contracts and gains from sales on the basis of residence. Under the regulations, foreign exchange gain and income from notional principal contracts of a foreign person will be foreign source, and thus not subject to U.S. tax, unless attributable under Section 863(c) principles to a U.S. trade or business. The same rule applies generally to gain from dispositions of derivatives -- for example, from the expiration of an option. Given these rules, the discussion of notional

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68 1995-2 C.B. 1.

69 *See also* the Technical Explanation to Article 21, which says that Article 21 will cover income from notional principal contracts and other "derivatives" if not derived by a dealer or used to hedge business risks.

70 And may be derived from Rev. Rul. 87-5, which construed the U.S.-Netherlands treaty to include swap income of a Dutch bank in its industrial and commercial profits.

principal contracts in this part of the Technical Explanation of Articles 7 and 21 seems in large part to be unnecessary — and thus is confusing.

13. Attribution of business profits to a permanent establishment or fixed base. There is no international consensus on how profits should be attributed to a permanent establishment,[71] and the OECD is currently working on a revision to Article 7 to address this issue. The "authorized OECD approach" is that a permanent establishment should be treated as "functionally" a separate entity -- as a "legally distinct and separate enterprise" -- and its profits determined by arm's length pricing with other parts of the same legal enterprise, based on the assets used, risks assumed and activities of the permanent establishment.[72] The OECD report sets out special considerations that may be involved for banks and for the global trading of financial instruments and will, shortly, also do so for insurance.

Absent a tax treaty, the Internal Revenue Code rules for attributing income and expense are different — revenue and expense from inter-branch transactions are generally not recognized, some kinds of income are attributed (under the "material factor" tests in Section 864(c)(2)(B) and 865(c)(B)) to a U.S. trade or business on an all-or-nothing basis, and the determination of income on the basis of source (other than residence-based sourcing, which ordinarily uses an "attributable" to a U.S. place of business standard) may mean that the income attributed to a U.S. permanent establishment far exceeds what would be taxable under any arm's length principles. This may be because of the U.S. rules on the source of income,[73] or because under the

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71 *See* International Fiscal Association, 2006 Amsterdam Congress, Subject II, "The attribution of profits to permanent establishments".

72 *See* OECD, Report on The Attribution of Profits to Permanent Establishments (December 21, 2006).

73 Consider an example in the OECD materials on attribution of profits which (adapting the example to the U.S.) involved a foreign corporation that passed title in the U.S. to inventory sold to U.S. customers and, because it had a U.S. subsidiary whose personnel managed inventory risks, was held to have a U.S. permanent establishment. Under the Internal Revenue Code, 50% of the gross income from the sales would have been U.S. source income, assuming that the

"material factor" tests in Sections 864(c)(4) and (5) all of the income from an activity may be attributed to a U.S. trade or business, notwithstanding the material involvement of non-U.S. people in the activity.[74] The source of income and material factor rules are the backdrop to the Internal Revenue Service's advance pricing agreement program, in so far as it applies to global trading of financing instruments; and also to the proposed global trading regulations.[75]

While sometimes over inclusive, the effectively connected rules in the Code and regulations may also understate the income that would be "attributable" to a permanent establishment, as the Technical Explanation acknowledges in the example dealing with foreign source royalties.[76]

The first part of paragraph 2 of Article 7 (Business Profits) is the same in the 2006 Model as in the 1996 Model, in each case referring to the profits that the permanent establishment "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".

The Technical Explanation of the 1996 Model adds very little to this, except to emphasize that the separate entity language of Article 7(2) "incorporates the arm's length standard for purposes of determining" attributed profits. In other places,

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inventory had been produced by the foreign corporation outside of the U.S. and that no independent factory price could be established (*see* Regs. §1.863-3); under the OECD materials, the question is what the subsidiary would have earned on an arm's length basis for the inventory management. The results could be radically different.

74 For example, loans made by a foreign bank in cases where the activities (solicitation, negotiation, credit evaluation, etc.) are divided among two or more jurisdictions).

75 Prop. Regs. §1.482-8, Reg-208299-90, March 6, 1998.

76 U.S. rules that limit what is effectively connected to less than what may be attributable include the rules in Section 864(b)(2), Section 864(c)(4), Section 865 and Regs. §§1.864-4(c)(5)(ii)(b)(3) and 1.864-4(c)(2)(iii).

however, that technical explanation seems to make it clear that revenue and expense from interbranch transactions are not taken into account, and that what is "attributable" under Article 7(2) is substantially consistent with what would be regarded as "effectively connected" under Section 864(c) of the Code.[77]

The 2006 Model treaty goes much further towards the "authorized OECD approach", however, by then providing new rules, as follows:

First, under a new second sentence of paragraph 2 of Article 7, only profits derived from the assets used, risks assumed and activities performed by the permanent establishment may be attributed to the permanent establishment and, under the notes or protocol, the attribution must be made under the OECD Transfer Pricing Guidelines. This seems to be a major alteration of the U.S. rules that would apply in the absence of a treaty and, less certainly, under the 1996 Model, since it would regard the permanent establishment as a "functional" and "legal" separate entity and adopt a transfer pricing model for determining the profits attributable to the permanent establishment. This cuts both ways, both reducing and increasing the income that would, absent a treaty, be attributed to a U.S. trade or business.

Second, under the Technical Explanation, "internal dealings" — *e.g.*, inter-branch notional principal contracts — may be used to allocate income within an enterprise, at least in the case of a financial institution.

Third, in the case of a financial institution other than an insurance company, interest expense attributable to a permanent establishment may at the taxpayer's election be determined by risk weighting assets. This is consistent with a

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[77] Stating, for example, that attributable is "analogous but not entirely equivalent to" Section 864(c), with the difference apparently being that Section 7(2) includes foreign as well as U.S. source income; and that attributable is "consistent with the 'asset-use' and 'business activities' test of" Section 864(c)(2). See also the technical explanations of the U.S. treaties with Ireland and Switzerland.

number of recent treaties or pending protocols,[78] but has not so far been a standard feature of U.S. tax treaties.

Each of these three points, however, could use more elaboration and illustration by examples. The OECD Transfer Pricing Guidelines are well over 100 pages long, and the recent OECD report on the attribution of profits includes more than 100 pages just on banks and global trading. Is all of this imported into U.S. treaty law without reservation? Are the new rules, once set out in a treaty, self-executing and, if not, how will they be implemented? In connection with Notice 2005-53, we urged the Internal Revenue Service to develop rules for risk-weighting assets in determining the deductible interest expense (and branch tax liability) of U.S. branches of foreign banks.[79] Risk-weighting is already contemplated by a number of existing and pending treaties and, absent guidance, taxpayers will turn to self-help.

Fourth, the notes or simultaneous protocol would apparently — this is nowhere said in the Technical Explanation — affirm and make generally applicable the decision in Northwest Life Assurance Co. of Canada v. Comm'r, 107 T.C. 363 (1966), which held that the business profits article of the U.S.-Canada tax treaty trumped the formulary determination of investment income, by providing that U.S. tax on the investment income of the permanent establishment of an insurance company is on "the portion of [an] insurance company's overall investment income from reserves and surplus that supports the risks assumed by the permanent establishment".

Finally, deductible expenses, other than interest, are generally determined by allocation and apportionment under regulations (*i.e.*, Regs. §1.861-8) that stress the factual connection between the expense and the income. The Technical Explanation of Article 7 suggests, however, in the only example it provides with respect to expenses,

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78 *E.g.*, with Germany, Japan and the U.K.

79 *See* NYSBA Tax Section, Letter Re: Notice 2005-53, September 22, 2005. That letter also recommended that risk-weighting be allowed outside of treaties by competent authority proceedings.

that it may be necessary (or at least highly relevant) for a taxpayer that allocates and apportions expenses of the enterprise among branches to have a written policy and make interbranch charges in order to allocate home office expenses among branches.[80] If this is intended to require such policies and/or inter-branch formal charges, the requirement should be spelled out further. There is no such requirement under current U.S. law or under most U.S. tax treaties.

14. Notes and/or protocol. The 2006 Model contemplates that Article 7(2) will be supplemented by notes or by a simultaneous protocol to the treaty. There is no explanation for the separate notes or protocol. Are these available only to selected treaty partners? If so, why? Or is the purpose simply to conform the text of Article 7 more closely to what is in the text of the corresponding OECD Model Article? This might usefully be clarified.

15. Associated enterprises. The accompanying protocol/notes to Article 7 (Business Profits) of the 2006 Model applies the principles of the OECD Transfer Pricing Guidelines to the attribution of income to a permanent establishment, but do not expressly apply these principles to the determination of income under Article 9 (Associated Enterprises) in situations involving transfer pricing adjustments. It would be useful to know whether this was intentional and, if it was, what the policy is behind the different application of the OECD Guidelines to these two similar situations.

In the case of intangibles, the OECD Guidelines and the regulations under Section 482 differ in at least one important respect. While the U.S. rules on intangibles generally focus on whether the taxpayer reflects arm's length results on its returns (the

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80 *See* the Technical Explanation, p. 24, stating in part that "the method to be used in calculating" deductions for "payments made to [the] head office or another branch" will depend on the terms of the arrangements between the branches and head office. For example, the enterprise could have a policy, expressed "in writing" for the joint use of internal lawyers or "[a]lternatively, the head office could agree to employ [internal] lawyers at its own risk and to charge an arm's length price for legal services...."

"commensurate with income" rule), the OECD Guidelines focus on the arm's length price as of the time the transfer occurred.[81]

16. Dividends – definition. For withholding tax and all treaty purposes, dividends include substitute payments of dividends in securities lending and "repo" transactions.[82] The Technical Explanation to Article 10 (Dividends) might state this, and also make the point, noted in D.6. above, that certain interest payments by domestic reverse hybrids are treated as dividends by Regs. §1.894-1(d)(2)(ii).

17. Dividends paid to fiscally transparent entities. As in the 1996 Model, the ownership thresholds for reduced rates of withholding on dividends in the 2006 Model depend on who the shareholder is (a corporation, an individual or a pension plan), the extent of the shareholder's ownership, and whether the ownership is "direct" or not. The language is not always the same — the 5% rate is available for dividends paid to a corporation that "owns directly at least 10 percent of the voting stock" of the corporation paying the dividend, but the 15% rate for certain REIT dividends turns on whether the dividend is paid to shareholder "holding an interest of not more than 10 percent".

The Technical Explanation says that "beneficial" ownership for purposes of Article 10 is determined under the law of the state of source – *i.e.*, U.S. tax law in the case of a dividend paid by a U.S. corporation. Whether a dividend on shares held through a fiscally transparent entity is "derived" by a resident of the other state is determined pursuant to Article 1(6) based on the tax law of that other state. In some cases the two concepts may differ – *e.g.*, the person deriving the income may not be the

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81 The Technical Explanation takes the view that there is no inconsistency: the "implementation of [the commensurate with income] standard in the section 482 regulations is in accordance with the ...OECD Transfer Pricing Guidelines".

82 Regs. §1.894-1(c).

beneficial owner, but treaty benefits may nonetheless be available.[83] Likewise, what is "direct" ownership is ordinarily determined under the law of the source state.

While the examples that illustrate these statements seem to us to be generally sensible and helpful, one sentence in the Technical Explanation suggests that the less than 15% rate for dividends paid to a corporation is available for dividends paid to a disregarded entity that is wholly owned by an individual.[84] Is this result intended? It would make the availability of the lower rate turn on the other state's characterization of the entity receiving the dividend as a corporation. Elaboration on the point would be useful.

In addition, the Technical Explanation may not be consistent with the language (although not the result) of IRS private rulings, which seem to require that the same person both "derives" the dividend and be the "beneficial" owner of the shares.[85]

The Technical Explanation also says that, in the case of other fiscally transparent entities, such as trusts, estates or partnerships, the ownership thresholds may be met by the interest holders on the basis of their "proportionate share[s] of the shares" held by the entity, "which may be difficult to determine and often will require an analysis of the partnership or trust agreement". The Technical Explanation might spell the last point out more clearly and also indicate that the same rules apply to the different language of the ownership rules for dividends paid by RICs and REITs.

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[83] An example in the Technical Explanation supposes that all of the shares of a U.S. corporation are owned by an entity ("SubDE") that is disregarded for U.S. tax purposes but not in the other state and is wholly owned by a corporation ("PCo") that is a resident of that state. Dividends on the shares are "derived by" SubDE, but "beneficially" owned by the combined SubDE and PCo.

[84] It states, after the example in the preceding footnote which implies a 5% rate on the dividends, that "the analysis and result are unchanged if all of the outstanding shares in SubDE are owned by [a resident] individual."

[85] PLR 200626009 (March 9, 2006).

The Technical Explanation might also address the way that these rules may be applied to dividends received by S corporations from corporations in the other state – presumably, by treating the individual (or trust or estate) shareholders as owning their proportionate shares of the stock owned by the S corporation.

The Technical Explanation of the 2006 Model does clarify that the percentage of stock owned is determined on the date on which the holder is entitled to the dividend, thus answering the question of whether shares redeemed or issued in a transaction that is a dividend are taken into account.

18. Dividends paid by regulated investment companies and real estate investment trusts. As in the case of the 1996 Model, the 5% rate for dividends paid to 10% or greater corporate shareholders is not available for dividends paid by regulated investment companies – the reduction is only to 15%.[86] The theory is that, absent that limitation, the 5% rate would be extended to income that, had it been realized directly, would have been subject to a 15% rate and that the potential for getting the 5% rate in such a case is an abuse.

On the same theory, the 5% rate is not available for dividends paid by real estate investment trusts out of *operating* income, *i.e.*, out of rents, and, originally, the 15% rate was available for such dividends only in cases where the shareholder was an individual with a proportionately small holding in the REIT so that it might be concluded the 15% rate was a fair surrogate for what would have been paid had the individual invested directly in the underlying real estate assets.

The 2006 Model extends the 15% dividend rate that applies to dividends paid by real estate investment trusts to include, in addition to dividends paid to individual shareholders holding interests of not more than 10% of the REIT, dividends paid (1) to a

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86 As amended in 2004, U.S. withholding tax on short-term capital gain and interest-related dividends of regulated investment companies is eliminated. Capital gain dividends continue to be exempt from U.S. tax (assuming the regulated investment company is not a United States real property holding corporation).

pension plan holding an interest of not more than 10% of the REIT, (2) on a class of publicly-traded shares to a shareholder who does not hold an interest of more than 5% in any class of the stock of the REIT and (3) to a shareholder who does not hold an interest of more than 10% of the REIT if the REIT is diversified.

We have a number of comments on these rules.

First, the formulation in the 2006 Model does not focus on the point that there are REITs (so-called mortgage REITs) that primarily hold mortgages, and there are regulated investment companies that primarily invest in shares of REITs. It is not clear why the 15% rate should not generally apply to dividends paid by mortgage REITs (on the same basis that it is allowed for dividends paid by regulated investment companies), without the restrictions imposed on dividends paid by other REITs; or why the 15% rate should always be available for dividends paid by regulated investment companies that are primarily invested in REITs (as opposed to the 30% rate that generally applies to dividends paid by a REIT).

Second, the theoretical basis for the favorable 15% rate on dividends paid by a regulated investment company is to some extent undercut by the rules that allocate expenses of the regulated investment company against income that is paid out as taxable dividends (as opposed to net long term and short term capital gain dividends)[87] and by the amendment to the regulated investment company rules that makes income from publicly traded partnerships "good" income for a regulated investment company.

Third, the further reductions in the 30% rate on dividends paid by a REIT, *i.e.*, the further expansions of the 15% rate, seem to us to be questionable if the theory of the 15% rate is, as originally stated, that 15% is a rough approximation of what would have been paid by the shareholder on a direct investment in the underlying properties. More thought might be given to this.

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87 *See* Rev. Rul. 2005-31.

Fourth, dividends paid by a REIT that is a United States real property holding corporation out of gains from real property sales, whether or not capital gain dividends, are (according to the Technical Explanation) not subject to Article 10 but are taxable under Article 13 (Gains). Thus, such dividends would be subject to FIRPTA withholding except to the extent provided in the second sentence of Section 897(h)(1),[88] as will distributions of such gains by RICs that are United States real property holding corporations. This seems clear from the Technical Explanation of Article 6 (Income from Real Property)[89] and also from the Technical Explanation of Article 13 (Gains), but is confused by the part of the Technical Explanation of Article 10 (Dividends) which implies that, absent special rules in Article 10 for dividends paid by REITs, a REIT could be used to reduce U.S. tax on gain from the sale of U.S. real property[90] — a statement which seems to contradict the first sentence of Section 897(h)(1).[91]

19. Interest. Because of the 1984 enactment of the portfolio interest rule, the zero rate of withholding provided by Article 11 (Interest) of the 2006 Model for interest is important today mainly for interest paid to 10% or greater direct or indirect shareholders (or partners of a partnership borrower), interest paid to corporations that are

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88 Which generally provides for a look through of distributions from gains from sales of U.S. real property interests but excepts distributions by a REIT on a class of publicly traded stock to a shareholder that owned 5% or less of the class during the taxable year of distribution.

89 Stating that "Distributions by a U.S. Real Estate Investment Trust or certain regulated investment companies would fall under Article 13 (Gains) in the case of distributions of U.S. real property gains...."

90 Stating that, absent a special rule for REIT dividends in Article 10, "...by placing ...real property in a REIT, the [foreign] investor could, absent a special rule, transform income from the sale of real estate into dividend income from the REIT, taxable at the rates provided in Article 10".

91 The different language in Article 13 (Gains) (gains "attributable to the alienation" of real property may be taxed in the source/host state) and in the corresponding OECD Model article (gains "from the alienation" of real property may be taxed in the source/host) was precisely to confirm the right of the U.S. to tax such distributions.

banks on extensions of credit made pursuant to loan agreements, and contingent interest that is excluded from the definition of portfolio interest by Section 871(h)(4).[92]

Article 11 of the 2006 Model, unlike the 1996 Model, provides an exclusion, in the case of the United States, from the zero rate of withholding generally provided[93] for interest which is not portfolio interest because of the exclusion in Section 871(h)(4) of the Code for contingent interest. Reciprocally, there is an exclusion in Article 11(2)(a), in the case of the other contracting state, for interest from that state that is determined by the same factors that determine whether interest is contingent under Section 871(h)(4) of the Code (*e.g.*, determined by reference to receipts or sales of the debtor or a related person). Interest so excluded may be subject to a 15% withholding tax.

The statutory exclusion from portfolio interest is only for the portion of the interest that is contingent, *i.e.*, "the amount of ... interest determined by reference" to the factors that make it contingent.[94] The Technical Explanation might clarify this limitation on the rule, both in the case of the United States and the other contracting state.

For withholding tax and all treaty purposes, interest includes substitute payments of interest in securities lending and "repo" transactions.[95] That might usefully be noted.

20. Royalties. Article 12 (Royalties) and the related Technical Explanation are largely unchanged from the 1996 Model. Article 12 exempts from tax in

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92 Portfolio interest also excludes interest paid to a controlled foreign corporation related to the payor.

93 Income from REMIC residual interests is also excluded.

94 Section 871(h)(4)(A)(i). The Conference Report on the enactment of Section 871(h)(4) gives, as an example, interest that is payable at the greater of 6% of principal amount or 10% of gross profits and concludes that only the interest, if any, in excess of 6% is contingent.

95 Regs. §1.894-1(c).

the source country royalties "arising in" the source country and beneficially owned by a resident of the other country.

It would be useful to know whether the "arising in" rule is meant to differ from the rule in the Code, which provides that royalties are U.S. source income if "for the use" or the "privilege of using" the underlying intangible property in the U.S. (and conversely foreign source if not for such a use or privilege of using). How the Code's source rule applies in the case of royalties paid by a foreign corporation for the license of intangible property sublicensed for use in the U.S. was litigated in SDI Netherlands, B.V. v. Comm'r, 107 T.C. 161 (1966), which held that the royalties paid under the license, although seemingly for the use of the intangibles in the U.S., did not retain their U.S. source if the sublicense was separate and distinct from the license.[96] The Internal Revenue Service has not acquiesced in SDI Netherlands and took a different view in Rev. Rul. 80-362, which remains outstanding.

Article 12(3) also provides that the lower treaty withholding rate will not apply if the right or property in respect of which the royalties are paid is "effectively connected" with a permanent establishment. The effectively connected language replaces the 1996 Model Treaty language, which denied the reduced withholding tax if the royalties were "attributable to" a permanent establishment.[97] The Technical Explanation of the 2006 Model continues, however, to explain that the denial is for royalties attributable to a permanent establishment. Is this a drafting oversight? Or does it intentionally mean that, unlike business profits covered by Article 7, the attribution of royalties to a permanent establishment will be made under the U.S. "effectively connected" standards and that the taxpayer does not have the choice of applying the OECD Transfer Pricing Guidelines to royalties? Would this be the case if the taxpayer chose to use the OECD guidelines under Article 7 and is required under the consistency rules to apply the "attribution" rules of Article 7 to all types of income including royalties

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96 107 T.C. 161 (1996).

97 Another ambiguity is that, under U.S. tax law, the term "effectively connected" refers to the royalty income and not to the underlying property.

21. Directors' Fees. Article 15 (Directors Fees) provides that the state of which a corporation is resident may tax directors' fees and other compensation received in an individual's capacity as a member of the board of directors for services performed in that state. This differs from the OECD Model, which does not limit taxation by the state in which the corporation is resident to services performed in that state. Where the OECD Model is followed, the "re-sourcing" rule in Article 23 (Relief from Double Taxation) will be particularly important for U.S directors of corporations resident in the other state.

22. Entertainers and sportsmen. Paragraph (1) of Article 16 (Entertainers and Sportsmen) is essentially the same as Article 16 of the 1996 Model and thus permits the state in which the activities are performed to tax the entertainer's or sportsman's income unless it is $20,000 or less in a year, notwithstanding the rules in Article 7 (Business Profits) or Article 14 (Income from Employment).

The Technical Explanation goes further than the Technical Explanation of the 1996 Model in clarifying the distinction between royalties covered by Article 12 (Royalties) and income covered by Article 16, by stating that the question under Article 16 is whether the income is "predominantly attributable to the performance itself" and setting out the IRS' view[98] that income from the endorsement of a performance is therefore covered by Article 16.[99]

According to the Technical Explanation, the purpose of the $20,000 exclusion is to exempt "relatively modest amounts" of compensation since these are "not easily distinguishable from" what is earned from "other types of personal service income." The exclusion was $15,000 in the 1977 Model, but $20,000 in the 1981 and

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98 *See* Technical Assistance Memorandum, July 30, 1999, WTA-N-112248-98, taking the view that the question is whether there is a "proximate relationship" between the performance and the income.

99 Uncertainty as to what income is covered may be the reason why the recent regulations on the source of income from services (*i.e.*, Regs. §1.861-4) reserve (see -4(b)(3)) on the treatment of income earned by artists and athletes.

1996 Models — after 25 years, it seems to us that it would be logical to increase the $20,000 amount. Since we do not know the basis on which the $20,000 (or $15,000) was calculated, we make no recommendation as to what the new amount should be.

Paragraph (2) of Article 16, which turns off the $20,000 exclusion if the income from the activities accrues to another person, differs from the 1996 Model and now excepts out only a case in which the other person can designate who is to perform the activities. This -- sensibly in our view -- conforms the test (which previously was based on whether there was participation by the entertainer or sportsman in the profits of the other person) to the definition of personal service contract income in Section 954(c)(1)(H).

How does the rule in Article 16(2) of the 2006 Model Treaty relate to rulings, such as Rev. Rul. 74-330, in which the Internal Revenue Service used common law tax principles to determine whether an individual was or was not an employee for purposes of a treaty that did not at the time include such a rule?[100] Do these rulings have any validity under a treaty that incorporates Article 16(2)? That might be clarified by the Technical Explanation.

23. Pensions, etc. The 2006 Model Treaty restructures old Article 18 (Pensions, Social Security, Annuities, Alimony, and Child Support) of the 1996 Model by splitting it into Articles 17 (Pensions, Social Security, Annuities, Alimony and Child Support) and 18 (Pension Funds).

Article 17 deals with jurisdiction to tax the covered amounts, and it incorporates, without significant change, the rules in paragraphs 2 through 5 of old Article 18 that deal with the taxation of individuals who receive social security payments,

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100 Other rulings include Rev. Rul. 75-503 and Rev. Rul. 70-543.

annuities,[101] alimony and child support.[102] Social security payments are taxable only in the source state, but the other items are taxable only in the state of residence.

In the case of "pensions and similar remuneration", Article 17(1) gives taxing jurisdiction to the state of residence, but requires that state to exempt amounts "arising in" the other state that would have been exempt from tax had the individual been a resident of that state. In so far as U.S. tax is concerned, the exemption is intended to cover Roth IRAs, rollovers and distributions that are a return of non-deductible contributions and thus to exempt from foreign tax such amounts, given that the U.S. would not have taxed them had the individual been a resident of the U.S. This differs somewhat from old Article 18(1) which had no exemption from taxation in the state of residence, except to the extent amounts had already been taxed in the other state, and was essentially the same as the corresponding Article in the OCED Model.[103]

Article 18(1) provides that payments by a "pension fund" that is resident in one state to a resident of the other can be taxed only as set out in Article 17(1)[104] and only when paid to or for the benefit of the individual and not rolled over to a plan in the

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101 Absent such a provision, the IRS would treat annuities paid by a U.S. corporation as U.S. source income that was subject to tax under Section 871(a)(1). Rev. Rul. 2004-75.

102 There are some changes – annuities expressly includes life annuities and alimony is covered whether or not deductible by the payor. In some existing U.S. treaties, alimony, child support and annuities are covered by the "other income" article.

103 *See* OECD Model Article 18 (Pensions) which provides for residence based taxation of pensions and other similar remuneration in respect of past employment.

104 In the absence of a treaty, payments from qualified plans are U.S. source income to the extent of contributions made for services performed in the U.S. and to the extent of earnings on contributions and otherwise foreign source. A revenue procedure sets out rules for making these determinations in the case of defined benefit plans. Rev. Proc. 2004-37 and authorities cited therein. The U.S. source income would be subject to U.S. tax, limited by a narrow exception in Section 871(f).

same state (*i.e.*, not transferred to another pension fund in the state in which the first fund was a resident).

The relationship between Article 17(1) and Article 18(1) is confusing.

First, are the payments covered by the two Articles different? Article 18(1) is limited to "pension funds," and thus generally to payments out of qualified plans. Notwithstanding the different language of Article 17(1) ("pensions and similar remuneration"), the Technical Explanation limits that article to payments made by qualified plans (*i.e.*, it "is intended to encompass payments made by qualified private retirement plans")[105], and that other deferred compensation from employment is covered by Article 14.[106] Further, the technical explanations of specific treaties, construing the same language, reach a different answer.[107] If the same meaning is intended, shouldn't this be made clear in the text of the 2006 Model by, for example, using the same words in both Articles 17(1) and 18(1) to describe pension payments that are covered?

Second, how does the exemption in Article 18(1) from residence-state taxation for certain amounts rolled over (*i.e.*, "and not transferred to another pension fund in" the state of the fund) differ from the exemption from residence-state taxation in Article 17(1) for amounts that would not be taxed in the source state (*i.e.*, "would be exempt from taxation in" the state of source if the recipient was a resident of that state)?

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105 The language is stated to "also" cover Section 457 plans and, in some technical explanations, Section 414(d) plans.

106 According to the Technical Explanation, other deferred compensation (including, according to the Technical Explanation, bonuses and income from the exercise of stock options) is covered by Article 14 (Income from Employment) and thus is taxable by the source country, regardless of when paid, if the 183 day and other tests are met in the year the services are performed.

107 *E.g.*, the technical explanations of the U.S.-Switzerland and U.S.-Ireland treaties say that the corresponding article covers payments from "all private retirement plans and arrangements in consideration of past employment, regardless of whether they are qualified plans under U.S. law...."

Paragraphs 2 and 3 of Article 18 of the 2006 Model incorporate what was formerly in Article 18(6) and broadly provide, as did Article 18(6), that if an individual participant in a pension fund who is a resident of one state and performs services in the other ("exercises an employment or self-employment"), (1) contributions by or on behalf of the individual to the pension fund will be deductible or excludible by the individual in determining taxable income in the service state, (2) the individual's taxable income in the service state will not include benefits accrued under the plan during the period of service, and (3) the employer in the residence state may deduct such contributions in determining its income in the service state.[108]

The first two rules are needed only when the income is not exempt in the source state under Article 14 (Income from Employment) or Article 7 (Business Profits). If the income is not taxable under those Articles, Article 18's exemption should be unnecessary. This might be spelled out in the Technical Explanation which, under "Relationship to Other Articles", makes no mention of the connection.

Paragraphs 2 and 3 of Article 18, which have no counterpart in the OECD Model, are subject to three restrictions: (1) the relief provided in the service state cannot exceed what it provides to its own residents in respect of its own pension plans, (2) contributions must have been made to the plan before the individual began performing services in the other state, and (3) the pension fund generally corresponds to the pension funds of the service state. It is not clear what purpose the second restriction serves – in some cases an individual may be hired to provide the services and therefore will not previously have been included in the plan.

The Technical Explanation of the 1996 Model specified that the exclusion of employee contributions from income, the deduction of employer contributions and the exclusion of roll-overs were subject to specified limitations in the Internal Revenue Code. This was dropped, without explanation, from the Technical Explanation of the 2006

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[108] Article 18(4) provides rules for U.S. citizens exercising employment in the other state.

Model, as were a number of other elaborations on the text of the Article. Unless the rules have changed, we think these might usefully be restored.

24. Other income. The Technical Explanation to Article 21 (Other Income) provides, as an example of "other" income, "guarantee fees paid within an intercompany group" unless the guarantor is engaged in the business of providing guarantees to unrelated persons. This was not in the Technical Explanation of the 1996 Model. The example is presumably based on the IRS' view, supported by the Bank of America holding with respect to the commissions involved in that case,[109] that a guarantee fee paid by a U.S. corporation is U.S. source income that is not interest but may be business profits or other income, depending on the facts.[110] The Technical Explanation might reconcile this sourcing rule with the Section 482 regulations, which in their proposed form suggested that guarantee fees might be income from services for sourcing purposes, but as finally adopted disavow that position and state that forthcoming guidance will include sourcing rules for financial guarantees.[111] The Technical Explanation might also note that guarantee fees may be treated as dividends in certain circumstances.[112]

The Technical Explanation of the 2006 Model also says that Article 21 will apply to "securities lending fees derived by an institutional investor". This could use clarification.

First, the statement is presumably limited to amounts received in "true" securities lending transactions in which the borrower has the right to transfer the securities, whether documented as securities loans or as repurchase agreements, and does

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109 Bank of America v. United States, 680 F.2d 142 (Cl. Ct. 1982). *See also*, Cental Communications, Inc. v. Comm'r, 920 F.2d 1335 (7th Cir. 1990).

110 National Office Field Service Advice, August 14, 2001, TL-N-7160-00.

111 *Compare* Prop. Regs. §1.482-9 (2003) *with* Preamble to Temp. Regs. §1.482-9T.

112 *E.g.*, Tulia Feedlot, Inc. v. United States, 513 F.2d 800 (5th Cir. 1975).

not cover "repos" in which the purchaser has no such right, since "fees" received in those repo transactions would be interest covered by Article 11 (Interest).[113]

Second, if securities lending "fees" are paid by a U.S. borrower to a foreign "institutional investor" — which, as stated below, we do not think is typically the case — the fees would seem to be business income that was ordinarily covered by Article 7 (Business Profits) since the lending of securities by investment companies, benefit plans and others is hardly an incidental non-business activity.

Finally, the income that might be derived by a foreign lender in a securities lending transaction[114] would normally consist, first, of substitute payments which, under the Regulations, would be treated for tax treaty purposes as U.S. source dividends or interest if the underlying securities generated U.S. source dividends or interest and otherwise foreign source income.[115] Why would Article 21 be relevant to these payments? The lender may also have the right to invest cash collateral posted by the borrower and keep the income on that collateral, but that income is not as such a payment of a "fee" by the borrower to the lender. A fee would be paid if the borrower posts non-cash collateral, but that is a limited case. Some of this might usefully be spelled out in the Technical Explanation.

25. Limitation on benefits. Article 22 (Limitation on Benefits) of the 2006 Model Treaty does not refer to "triangular" cases, addressed in several recent U.S. tax treaties, in which income received by a third jurisdiction permanent establishment of a resident of a contracting state is not entitled to treaty benefits if the combined tax paid in the state of residence and in the permanent establishment jurisdiction is substantially

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113 *E.g.*, Rev. Rul. 77-59; Rev. Rul. 74-27; and Rev. Rul. 72-171.

114 Whether documented as a securities lending transaction or as a repurchase agreement. *See* The Bond Market Association, Master Securities Lending Agreement and Master Repurchase Agreement.

115 Regs. §1.894-1(c).

lower than the regular tax in the state of residence.[116] The provision is presumably relevant in negotiations with any treaty partner which exempts from tax, by treaty or otherwise, income of a permanent establishment in a third country. It might be useful to comment on the absence of this provision in the 2006 Model.

Additionally, Article 22 does not include provisions for "equivalent beneficiaries" under which residents of a contracting state may derive U.S. treaty benefits in part from the U.S. treaty benefits to which its owners would be entitled if they earned the income directly.[117] This might also be explained.

We have commented above on the application of Article 22 to trusts and estates. We also submitted last year a report on what is a qualified foreign corporation for purposes of Section 1(h)(11), relating to the 15% rate of tax on dividends paid by such corporations.[118] That report commented on two aspects of the limitation on benefits articles in U.S. tax treaties – the "base erosion" test and the "active trade or business" test -- both of which may be relevant to Article 22 (Limitation on Benefits) of the 2006 Model.

The Technical Explanation of the 2006 Model Treaty seems to have dropped the safe harbor rule for the "substantiality" requirement of the active trade or business test. Was the deletion intentional? If so, why? The safe harbor rule, set out in the technical explanation to the 1996 Model, used relative asset values, gross income and payroll expense to determine whether a business was substantial.[119] (We previously

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116 *See* U.S. tax treaties and protocols with Denmark, Finland, Germany, Sweden and Switzerland.

117 *See* U.S. tax treaties and protocols with Denmark, Finland, the Netherlands, Sweden and the U.K.

118 NYSBA Tax Section, Report No. 1113, June 26, 2006.

119 It has also been included in a number of treaties -- e.g., in the technical explanations of the U.S.-Netherlands and U.S.-Switzerland tax treaties.

recommended that this safe harbor be used for purpose of determining whether there were substantial business activities under Section 7874.[120])

26. Relief from Double Taxation. Article 23 (Relief from Double Taxation) of the 2006 Model Treaty is the same as the corresponding article of the 1996 Model except that it provides in Article 23(3) a rule which re-sources income as foreign source for foreign tax credit purposes if the income "may be taxed" in the other country.[121]

The Technical Explanation says that re-sourcing applies to income for which the treaty "assigns primary taxing jurisdiction" to the other state, that the re-sourced income would still be subject to the separate basket rule in Section 904(h)(10) for re-sourced income and that the re-sourcing under Article 23(3) is of gross not net income. The Technical Explanation does not mention the re-sourcing rule that may apply to gain from dispositions of intangibles and stock under Section 865(h)(10).

The re-sourcing rule of Article 23(3) is in some but not most U.S. treaties,[122] and sometimes takes different forms.[123] Re-sourcing for foreign tax credit purposes is important in cases where, because of different timing rules or otherwise, the U.S. sourcing rules do not match up with the foreign tax system – for example, in a case to which Article 14 (Income from Employment) does not apply, if deferred compensation of a U.S. person is taxed by the other state on a basis that differs from the sourcing rules in Regs. §1.861-4. The issue may also come up if the other state, contrary the 2006

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120 NYSBA Tax Section, Report No. 1107, March 22, 2006.

121 Both the 2006 and 1996 Model treaties also provide rules for U.S. citizens resident in the other state, including a rule that re-sources income to the extent necessary to avoid double taxation.

122 For example, it is in the U.S.-U.K. treaty, the proposed Belgian treaty, the U.S.-Canada treaty and the U.S.-Sweden treaty, but not in U.S. treaties with Austria, Australia or Switzerland.

123 *E.g.*, in the U.S.-U.K. tax treaty the re-sourcing does not include gains from the alienation of property that may be taxed in both countries.

Model, does not limit the taxation of directors' fees to fees for services rendered in the state in which the corporation is resident; or if a redemption of shares by a corporation is treated as a dividend in the other state (and thus subject to withholding tax) but as U.S. source capital gain in the United States.

The Technical Explanation might illustrate the re-sourcing rule with some of these situations and also explain the difference between the language of the 2006 Model ("may be taxed" by the other country) and the language of the Technical Explanation ("assigns primary taxing jurisdiction" to the other country).

We note that the re-sourcing rule is not a complete solution to mismatches. For example, a number of countries tax the value of compensatory stock options at the time of grant, not exercise, and thus create a mismatch in the timing of income that will not be corrected by Article 23(3).

27. Non-Discrimination. Article 24 (Non-Discrimination) and the related Technical Explanation are essentially unchanged from the 1996 Model and the Technical Explanation of that Article.

Article 24 and the Technical Explanation imply that the contracting states have undertaken not to discriminate against foreign investment. Despite its length and complexity, however, Article 24 is ultimately quite narrow and not a complete answer to the problem. In the case of taxes imposed on foreign-owned U.S. corporations, which is the most common context in which the issue comes up in the U.S., discrimination is prohibited only if specifically directed at foreign-owned U.S. subsidiaries.[124] It seems clear from the Section 163(j) earnings stripping rules enacted in 1989 (and expanded in 1993) that Congress understands the impact of Article 24 can be avoided by grouping foreign persons with domestic tax exempt organizations (or by prescribing a rule that applies to all foreign "related" persons); and the Section 894(c) domestic reverse hybrid regulations imply that the Treasury believes it can avoid Article 24 by treating related

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[124] Square D Company v. Comm'r, 438 F.3rd 739 (7th Cir. 2006). *Cf.* Unionbancal Corp. v. Comm'r, 305 F.3d 976 (9th Cir. 2002).

party interest as dividends "for all purposes of the Internal Revenue Code," [125] notwithstanding that the targets of the regulations are foreign corporations resident in treaty countries.

[125] Regs. §1.894-1(d)(2)(ii)(B)(1)(iii).