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

[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

[51] Sections 651 and 661.

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