NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON

GUIDANCE UNDER U.S. INCOME TAX TREATIES

MAY 28, 2010

Report No. 1214

Report on Guidance under U.S. Income Tax Treaties

This report, prepared by an ad hoc committee of the Tax Section of the New York State Bar Association,* comments on what might be covered by a program of published Internal Revenue Service ("IRS") and Treasury guidance on income tax treaty issues.

The U.S. is party to some 57 comprehensive income tax treaties. By this measure, and taking into account the significant growth in cross-border investment in the last 20 years, IRS guidance on income tax treaty issues is sparse. There are relatively few published rulings that provide generic or even treaty-specific guidance,[1] and a number of

---

* Consisting of Lee Allison, Dan Altman, Alan Appel, Peter Blessing, Kim Blanchard, Michael Bretholz, Peter Connors, Joseph Czajkowski, Kevin Glenn, Alan Granwell, Adam Greenwood, David Miller, Andrew Orringer, Deborah L. Paul, Rick Reinhold, Elinore Richardson, Jeffrey Tolin, Diana Wollman and Willard Taylor, the principal draftsperson. Helpful comments were received from Peter Canellos, Charles Kingson, Erica Nijenhaus, Michael Schler, Jodi Schwartz and David Sicular.

[1] Published rulings include, in chronological order of those listed, Rev. Rul. 55-617 (no permanent establishment under U.S.-Belgium treaty); Rev. Rul. 62-31 (permanent establishment under U.S.-U.K. treaty); Rev. Rul. 63-113 (no permanent establishment under U.S.-Canada treaty); Rev. Rul. 65-263 (permanent establishment under U.S.-Canada treaty); Rev. Rul. 74-183 (Article X of the U.S.-Canada treaty exempts Canadian private foundation from the Section 4948(a) excise tax); Rev. Rul. 74-330 (loan-out agreements under U.S.-U.K. treaty); Rev. Rul. 75-503 (treatment of foreign entertainers, etc. under U.S.-U.K. and U.S.-France treaties); Rev. Rul. 76-322 (no permanent establishment under U.S.-Australia treaty); Rev. Rul. 76-330 (exemption of Belgian private foundation from the section 4948(a) excise tax); Rev. Rul. 80-147 (ability to annually choose to remain subject to tax where a treaty grants a reciprocal exemption); Rev. Rul. 80-98 (income from National Institutes of Health under various treaties); Rev. Rul. 80-36 (treatment of payments for heart research under the U.S.-Japan treaty); Rev. Rul. 80-243 (ability to deduct UK income tax paid attributable to operations of a U.S. permanent establishment); Rev. Rul. 80-362 (cascading patent royalties); Rev. Rul. 81-78 ("attributable to" language in business profits article of the U.S-Poland treaty); Rev. Rul. 81-132 (the period of ownership for purposes of the reduced rate of withholding under the U.S.-Netherlands treaty does not include ownership by the transferor in a Section 351 transactions); Rev. Rul. 83-11 (income from National Institutes of Health under the Egypt, Korea and Morocco treaties); Rev. Rul. 84-17 ("consistency" in applying the permanent establishment article of the U.S.-Poland treaty); Rev. Rul. 84-21 ("owned" in the dividend article of the U.S.-France treaty means direct ownership); Rev. Rul. 84-84 (interest payments on mortgage loans secured by personal property is exempt under U.S.-Austria treaty); Rev. Rul. 84-169 (Section 4940(a) taxes are generally not covered taxes under a U.S. income tax treaty); Rev. Rul. 84-133 (retroactive application of U.S.-U.K. treaty with respect to interest on a refund); Rev. Rul. 85-7 (application of Regs. §1.882-5 under U.S-Japan treaty); Rev. Rul. 85-60 (attribution of a permanent establishment of a partnership to a beneficiary of a trust that is a partner in such partnership); Rev. Rul. 86-145 (use of "tax year concerned" in Article 15 of U.S.-U.K. treaty); Rev. Rul. 86-156 (U.S. source rent for equipment exempt under U.S.-Netherlands treaty); Rev. Rul. 87-5 (Dutch bank's income from interest rate swaps exempt as "industrial or commercial profits" under the U.S.-Netherlands treaty); Rev. Rul. 87-38 (treatment of salary of hockey player under U.S.-Canada treaty); Rev. Rul. 87-40 (National Institutes of Health and the U.S.-Japan treaty); Rev. Rul. 89-5 (determination of the exemption period starting date for purposes of exempting the income of teachers and researchers under

those deal with marginal issues and sometimes have been outdated by treaty changes, even though not technically obsolete. Private rulings address a number of current issues, but of course cannot be relied on by a taxpayer who did not receive the ruling. Regulations on tax treaty matters are now limited to specific provisions of the Internal Revenue Code, such as the regulations issued under Section 894[2] with respect to fiscally transparent entities,[3] regulations issued under Section 882 on the calculation of a foreign corporation's deductible interest expense,[4] regulations issued under Sections 881 and 7701(l) with respect to conduit financing arrangements,[5] and regulations issued under Section 7701 with respect to dual resident individuals.[6]

Apart from rulings and regulations, the Treasury Department has provided substantive interpretations in the technical explanations of treaties and also in the technical explanations of the 2006 and 1996 Model Income Tax Conventions.[7] Although treaty-specific technical explanations are submitted to the Senate as part of the treaty

---

the U.K.-U.S. treaty and various other treaties); Rev. Rul. 89-95 (treatment of rollovers of retirement savings plans under U.S.-Canada treaty); Rev. Rul. 89-110 (rulings modified after partial termination of U.S.-Netherlands treaty); Rev. Rul. 89-115 (application of Regs. §1.882-5 under the U.S-U.K. treaty); Rev. Rul. 90-80 (barter transaction classified as a partnership which had a U.S. permanent establishment that is attributed to its partners); Rev. Rul. 90-101 (revocation of Rev. Rul. 81-303 regarding the unified estate tax credit under various estate tax conventions); Rev. Rul. 91-32 (treatment of a disposition of an interest in a partnership that has a permanent establishment under a U.S. income tax treaty); Rev. Rul. 91-58 (Section 911 exclusions and deductions under U.S. treaties); Rev. Rul. 92-85 (treaty withholding applicable to Section 304 dividends); Rev. Rul. 97-31 (countries granting equivalent exemptions for income from the international operation of ships and aircrafts); Rev. Rul. 2000-59 (meaning of "liable to tax" for purposes of determining residency under U.S. income tax treaties); Rev. Rul. 2002-16 (eligibility of Netherlands individual taxes for credit); Rev. Rul. 2004-3 (German personal service partnership); Rev. Rul. 2004-76 (foreign corporation resident in two treaty countries); Rev. Rul. 2008-17 (availability of the "equivalent exemption" rule in Section 883); and Rev. Rul. 2008-15 (imposition of Section 4371 excise tax).

[2] Except as otherwise noted, "Section" references are to the Internal Revenue Code of 1986, as amended (the "Code"), and references to regulations are to the Treasury Regulations promulgated thereunder.

[3] Regs. §1.894-1(d).

[4] Regs. §1.882-5(a)(2), which now provide that "Except as expressly provided by or pursuant to a U.S. income tax treaty or accompanying documents (such as an exchange of notes), the provisions of this section provide the exclusive rules for determining the interest expense attributable to the business profits of a permanent establishment under a U.S. income tax treaty".

[5] Regs. §1.881-3.

[6] Regs. §301.7701(b)(7).

[7] Earlier model income tax conventions were not accompanied by technical explanations.

ratification process (sometimes with separate reports by the staffs of the Joint Committee and Senate Foreign Relations Committee), and are cited and relied on by the IRS in private rulings,[8] it is not clear what weight, if any, a taxpayer can give to a technical explanation (except in the case of the Canadian treaty, where it is a document mutually agreed upon by the tax authorities).[9] As discussed hereafter, the need for additional published guidance would be significantly less if technical explanations could, without reservation, be relied on by taxpayers. It is also not clear to what extent the OECD commentary on its model convention is relevant to the U.S. interpretation of its treaties, although the U.S. is an active participant in the OECD deliberations and the OECD commentary has been used by the U.S. courts to interpret U.S. tax treaties[10] as well as by the IRS in private rulings.[11]

As a consequence, we strongly support a program of providing guidance on generic income tax treaty issues, and we have set out below a number of areas that we think should be considered as candidates for guidance. A number of our suggestions are drawn from prior Tax Section reports, including our report on the U.S. 2006 Model Income Tax Convention.[12] We have limited our comments to guidance issues and not commented on possible treaty changes.

---

[8] *E.g.,* PLRs 200932017, 200420012, 200406007 and 200209026. They have also been cited by court cases, such as Xerox Crop v. United States, 41 F. 3d 647 (Fed Cir 1994); and Snap-On Tools, Inc. v. United States, 26 Fed. Cl. Ct. 1045 (1992), *aff'd* 26 F.3d 137 (Fed. Cir. 1994).

[9] Together with many items, technical explanations of treaties ("Treasury Department and other official explanations of such treaties") are "authority" for the purposes of determining whether there is "substantial" authority. Regs. §1.6662-4(d)(3)(iii).

[10] *See* National Westminster Bank, PLC v. United States, 512 F.3d 1347 (Fed. Cir. 2008); United States v. Burbank & Co., Ltd., 525 F.2d 9 (2d Cir. 1975); The North West Life Assurance Company of Canada v. Comm'r, 107 T.C. 363 (1996); Taisei Fire & Marine Ins. Co. v. Comm'r, 104 T.C. 535 (1995), Acq. 1995-2 C.B.1; and Podd v. Comm'r, 76 T.C.M. (CCH) 906 (1998).

[11] *E.g.*, PLRs 200048011 and 199941007; and the extensive references to the OECD Model Income Tax Convention in Chief Counsel Advice Memorandum 199938031 (July 30, 1999) and in AM 2009-005, 2009 TNT 127-5 (June 26, 2009).

[12] Report on the Model Income Tax Convention Released by the Treasury on November 15, 2006 (April 11, 2007). *See also*, Report on Limitation on Benefits Provisions and Section 1(h)(11) (June 26, 2006); Letter on Canadian-U.S. Treaty Protocol – Payments Though Hybrids (January 29, 2008); and Letter Re: Notice 2005-53 (September 22, 2005).

Our report assumes that the treaty guidance would be unilateral, addressing only issues that are determined under U.S. law in accordance with treaty articles similar to Article 3(2) of the U.S. Model Income Tax Convention.[13] As a practical matter, therefore, the guidance would primarily relate to the U.S. taxation of foreign investment in the U.S., although the U.S. interpretation of the limitation on benefits and other articles that originated with the U.S. may influence the other country's interpretation of the treaty.

Specific areas where generic treaty guidance might be appropriate are set out below. Whether the guidance is by published rulings or by regulations will depend on the subject.

1. Relevance of technical explanations. In the case of issues determined under U.S. law, in accordance with treaty articles such as Article 3(2) of the U.S. Model Income Tax Convention, it seems to us that taxpayers should be entitled to rely on a treaty-specific technical explanation to the same extent as a published IRS ruling. The ability of a taxpayer to rely on a technical explanation in such a case should be made clear. This view of technical explanations would be consistent with the approach taken by the IRS in private and published rulings[14] and by the courts;[15] and permitting taxpayers to rely on technical explanations would resolve a number of uncertainties. Reliance would be particularly useful in the case for limitation on benefit articles since substantially the only guidance in respect to those articles, outside of what is in the text of the treaty itself, is in the Treasury Department's technical explanations. Likewise, in interpreting one treaty, a taxpayer should be entitled to rely on the technical explanation of another treaty if the language and context are the same – this would be consistent with the approach taken by the IRS in published and private rulings – for example, Rev. Rul.

---

[13] Article 3(2) provides that, absent a different competent authority determination, "[a]s regards the application of the Convention . . . by a Contracting State any term not defined therein shall, unless the context otherwise requires, . . . have the meaning which it has . . . under the law of that State . . . ."

[14] *See* Rev. Rul. 2008-17 (urging taxpayers to consult the technical explanation of a treaty in determining eligibility for the Section 883 reciprocal exemption); T.D. 9281 (adopting changes to Regs. §1.882-5); and, *e.g.*, PLRs 200932017, 200817037, 200626009, 200602046 and 200551016

[15] *See, e.g.,* United States v. Stuart, 489 U.S. 353, 369 (1989), citing Sumitomo Shoji Am. v. Avagliano, 457 U.S. 176, 184 (1982) ("[a]lthough not conclusive, the meaning attributed to treaty provisions by the Government agencies charged with their negotiation and enforcement is entitled to great weight").

81-78, which uses the Joint Committee's interpretation of the U.S.-Germany tax treaty to resolve an issue under the U.S.-Poland treaty. [16]

It would also be useful if the IRS and Treasury were to take and publish a position on the general relevance to U.S. tax treaty issues of the OCED Model Income Tax Convention and the commentary to that convention. While not authoritative, their relevance to the interpretation of U.S. tax treaties is plain and their use by the U.S. Courts, as well as the IRS, in interpreting U.S. treaties makes a strong case for allowing taxpayers to rely on the OECD Model Income Tax Convention and the commentary thereto in appropriate cases, especially where the language of the U.S. tax treaty is substantially the same as that of the OECD Model Income Tax Convention and neither the United States nor the other treaty party has reserved on the relevant OECD provision.[17]

2. Ownership of shares through disregarded entities. Guidance might be provided on the treatment of shares of stock of a U.S. corporation owned by a disregarded entity in determining whether a treaty-imposed holding period has been met or the identity of the shareholder as a corporation, individual or pension fund.[18] The IRS has issued private rulings to the broad effect that the 12-month holding period required for a zero rate of withholding on subsidiary-parent dividends[19] is not affected by a transfer of shares of the U.S. subsidiary by the foreign parent to a disregarded entity,[20] by a transfer by a disregarded entity of shares of the U.S. subsidiary to the foreign parent,[21]

---

[16] *See also,* PLR 200201025 (a corporation resident in Country C was entitled to the benefits of a "comprehensive income tax convention", although that term was not defined in the treaty with Country C, because Country C was a member of the EC and the technical explanation of the U.S.-Netherlands treaty provided that all of the then 12 members of the EC other than Portugal had such income tax conventions); and PLR 8427024 (extending the analysis of Rev. Rul. 81-78 to the U.S.-U.K. treaty).

[17] The OECD commentary, because it does not relate to U.S. treaties as such, is apparently not "authority" for the purposes of determining whether there is substantial authority. Regs. §1.6662-4(d)(3)(iii).

[18] Our comments are limited to these two issues, and we do not address other situations in which ownership through a disregarded or fiscally transparent entity may be relevant.

[19] As provided in, *e.g*., U.S. tax treaties with Australia, Belgium, Denmark, Finland, Germany, Japan, Mexico, the Netherlands, Sweden, and the U.K and the proposed Protocol with New Zealand.

[20] PLRs 200626009 and 200712007.

[21] PLR 200522006.

or by a transfer of shares of the U.S. subsidiary by one disregarded entity of the foreign parent to another disregarded entity of the foreign parent.[22] The private rulings are consistent with the general treatment of disregarded entities, and it would be hard to justify the opposite result.[23]

Broadly, the ownership thresholds for reduced rates of withholding tax on dividends in U.S. tax treaties may depend on who the shareholder is (a corporation, an individual or a pension fund), the amount of the shareholder's ownership, and the period of ownership.[24] A published ruling on ownership through a disregarded entity for purposes of the zero rate on subsidiary-parent dividends would eliminate the need for further private rulings on the issue, but would necessarily have to address, implicitly or explicitly, another context in which the issue of stock ownership through a disregarded entity may come up – *i.e.*, whether ownership of stock by a pension fund or individual through a disregarded entity is ownership by the plan or the individual.

While the treaty language on qualification for reduced rates is not always the same (sometime referring to "owns directly", to "holding" or to "beneficial" ownership of the dividend),[25] we do not believe that those differences should affect the conclusion that ownership through a disregarded entity is direct ownership for purposes of the treaty provisions referred to.

A related question is how ownership thresholds are met in the case of fiscally transparent entities other than disregarded entities, such as non-grantor trusts, estates or partnerships. The technical explanation of the 2006 U.S. Model Income Tax Convention says that the ownership thresholds may be met by the interest holders in such an entity on

---

[22] PLR 200522006.

[23] Solely for purposes of the conduit financing regulations, Proposed Regulations would treat a disregarded entity as a person. *See* Prop. Regs. §1.881-3(a)(2)(i)(C).

[24] For example, under Article 10 (Dividends) of the 2006 U.S. Model Income Tax Convention, the rate of withholding may be affected by whether the owner of the shares is a pension fund, an individual or a company, and whether ownership is 5% or less or 10% or more.

[25] For example, in Article 10 (Dividends) of the 2006 U.S. Model Income Tax convention, 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 a shareholder "holding an interest of not more than 10 percent".

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". Without disagreeing that the analysis may in some cases be complicated, that will not always be the case and the IRS might consider other Internal Revenue Code sections that raise the same issue (*e.g.*, Sections 902(c)(7), 856, 897(c)(4) and 958) and, for example, in the case of a partnership, generally allow for treaty purpose the use of the "capital interest" test in the Section 706 regulations, *i.e.*, treat a partner as owning the greater of the share of assets it would receive on withdrawal from, or liquidation of, the partnership.[26]

3. <u>Effect of a reorganization on the 12-month holding period required for a zero rate on subsidiary-parent dividends</u>. Guidance might be provided on whether a reorganization of a U.S. subsidiary or its foreign parent affects the running of the 12-month holding period required for a zero rate of withholding on subsidiary-parent dividends. A private ruling holds that an "F" reorganization of a U.S. subsidiary does not affect the running of the holding period,[27] and presumably the result would be the same if there was an "F" reorganization of the foreign parent within the same country.[28] The private ruling emphasizes the limited nature of an "F" reorganization (*i.e.*, that it is "a mere change in identity, form, or place of organization"), but under the Code the holding period of assets transferred in a tax-free reorganization does not depend on the form of the reorganization,[29] and it is difficult to see why that should not be the rule that generally applies, whether the reorganization is of the U.S. subsidiary or the foreign parent, so long as the reorganization does not change the country of the corporation's residence. The requirements for a reorganization, such as continuity of shareholder interest and business

---

[26] Regs. §1.706-1(b)(4)(iii); *see also* Regs §1.897-1(e)(2) and (3).

[27] PLR 200932017.

[28] PLR 200932017 "Note[s], however, that a foreign corporation that changes its place of organization in a reorganization described in section 368(a)(1)(F) is deemed under [the Section 367 regulations] to have transferred all of its assets to another corporation in exchange for stock of that corporation, regardless of whether the applicable foreign or domestic law treats the acquiring corporation as a continuation of the foreign corporate transferor."

[29] Section 1223.

enterprise, provide protection against "trading" in eligibility for the zero rate.[30] Applying such a rule to reorganizations would not be inconsistent with the position that there is no carryover of "ownership" in the case of a Section 351 transfer.[31] If the test for a reorganization is based on holding period, rules similar to those in Section 246(c)(4) and comparable sections of the Code might be applied for treaty purposes.

4. Business profits of fiscally transparent entities. Guidance might be provided on how the fiscally transparent entity rules in Section 894 and those U.S. treaties that incorporate the equivalent of Article 1(6) of the 2006 U.S. Model Income Tax Convention[32] apply to business profits of an entity that is fiscally transparent in the U.S. but not the other country (*i.e.*, a "regular" hybrid) and, specifically, the availability of the permanent establishment clause of the treaty and any treaty reduction in the rate of branch profits tax in such a case. If provided, the guidance should be by amendment of the Section 894 regulations. We made this point in our Report on the 2006 U.S. Model Income Tax Convention.[33]

The Section 894 regulations on U.S. source income of a regular hybrid relate only to interest, dividends and other items of fixed and determinable annual or periodic income (*i.e.*, income taxed under Section 871(a) or 881(a)).[34] Article 1(6) of the U.S. Model Income Tax Convention, as well as U.S. treaties that generally incorporate the

[30] The alternative of basing the test on "ownership", while consistent with the language of treaties that, for example, express the rule as measuring the period that the recipient "has owned" the shares, would make the answer turn on which entity survives the reorganization and this in our view is less sensible.

[31] Rev. Rul. 81-132, which holds that a Netherlands subsidiary of a Canadian corporation that acquired shares of a U.S. subsidiary of the Canadian corporation in a Section 351 transaction did not "own" the shares of the U.S. corporation for purposes of the 12 month holding period until it acquired the shares. It does not involve a case where the shares are owned by the same corporation or its successor in a reorganization.

[32] Article 1(6) provides that "[a]n item of income, profit or gain derived through an entity that is fiscally transparent under the law of either contracting State shall be considered to be derived by a resident of a State to the extent that the income is treated for purposes of the taxation law of such Contracting State as the income, profit or gain or a resident."

[33] New York State Bar Association Tax Section, Report on the Model Income Tax Convention Released by the Treasury on Nov. 15, 2006, at pp. 21-22 (April 11, 2007).

[34] Regs. § 1.894-1(d)(1).

Section 894 rule, however, apply to any "item of income, profit or gain derived through" a fiscally transparent entity, and thus seem to include as well income that would only be taxable under Sections 871(b) or 882.

By way of illustrating the issue, suppose that a treaty-eligible foreign corporation has business activities in the U.S. that are carried on through a regular hybrid whose income is not taxed to the foreign corporation as its income (although it may be currently taxed under the foreign tax law's equivalent of subpart F). Should the permanent establishment clause of the treaty with the parent's state, and any reduction under that treaty in the rate of branch profits tax, be available?[35]

Amending the Section 894 regulations to specify that business profits of such a fiscally transparent entity are covered by that Section would be consistent with its purpose and within the regulatory authority provided by Section 894(c).[36] If the purpose of Section 894 is to limit treaty benefits to cases where there would otherwise be double taxation, there is no reason to allow a foreign corporation the benefits of the permanent establishment article of a treaty or a reduced rate of branch profits tax with respect to profits of a fiscally transparent entity owned by it when the foreign tax laws that apply to the corporation do not treat the entity's income as derived by the corporation. This would be consistent with treaties that include a provision corresponding to Article 1(6) of the 2006 U.S. Model Income Tax Convention.

Conversely, however, if the Section 894 regulations are amended to deny treaty benefits to business income of a fiscally transparent entity in a case where its income is not taxed as the income of a treaty country resident, the regulations should also provide that, if the entity's income is taxed as the income of a resident of that country, whether because the entity is fiscally transparent or otherwise, the treaty with that country (including any reduction in the rate of branch profits tax) will apply to the income of the

---

[35] Or suppose that 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).

[36] Section 894(c) authorizes regulations that would apply to "benefits under any income tax treaty . . . with respect to . . . income attributable to any activities of" a fiscally transparent entity.

permanent establishment.[37] Absent that change, there would be double taxation of the income, which would be contrary to the purpose of the treaty.[38] We would make that change in the Section 894 regulation both in the case of a "regular" hybrid and a "reverse" hybrid; and, in the case of a reverse hybrid, specify that it applies to investment income as well as business profits.[39] This is not now stated in the Section 894 regulations, but would be consistent with the rules in the Section 894 regulations for fixed or determinable annual or periodic income of a regular hybrid.[40]

We further believe that guidance should specify that, in the case of a regular hybrid that derives business profits and is eligible for benefits under a treaty with a provision corresponding to Article 1(6) of the U.S. Model Income Tax Convention, the owners of the entity (other than U.S. citizens, residents, or domestic corporations or persons holding the entity's shares as effectively connected assets) will not be subject to U.S. filing obligations in respect of the business profits of the entity. The entity itself is deemed to derive the income and therefore should report the income.

5. Other issues under the Section 894 Regulations. Our report on the 2006 U.S. Model Income Tax Convention noted that the present Section 894 regulations deny treaty benefits to payments made to a fiscally transparent entity that is not taxed as a resident of the other country if the owners are not required to take the payments into

---

[37] This would be consistent with the view recently taken by the Tax Court of Canada with respect to the application of the Canadian branch profits tax to the income derived by a U.S. corporation from a business carried on in Canada through a U.S. limited liability company that was a disregarded entity. *See* TD Securities (USA) LLC v. Her Majesty The Queen, 2010 TCC 186 (April 8, 2010).

[38] It might also be clarified that, in the case of a regular hybrid that is a resident of a treaty country, the treaty with that country will apply to its income, even though it is transparent under U.S. law. The regulations under Section 1441 (Regs. §1.1441-1(c)(6)(ii)(B)) may be confusing on this point because they suggest that it may be necessary to look through a regular hybrid.

[39] So that, for example, if an individual or an entity, in either case eligible for the benefits of a U.S. tax treaty with the country in which the individual or entity is a resident, derived U.S. source investment income through a reverse hybrid, the income of the hybrid would be treated as income of the individual or entity and would be eligible for the benefits of the U.S. treaty with the country of residence.

[40] Regs. §1.894-1(d)(1).

income currently in that country, notwithstanding that the income, if currently distributed by the entity, would not have been taxed to the owners. [41]

We made this comment in the context of investments by foreign pension funds through "regular" hybrid entities (*i.e.*, fiscally transparent in the U.S. but not in the foreign country) where it is a matter of indifference to the fund, and to 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.[42]

If the Section 894 regulations are extended to the business income of a regular hybrid (*i.e.*, income that is not fixed or determinable annual or periodic), as suggested above, the same point can be made in respect of a foreign investor in a hybrid which would, if the income of the hybrid was derived directly, be exempt from tax in its country of residence because, in lieu of a foreign tax credit, that country simply exempts from tax the business profits of a foreign permanent establishment. There is no reason to deny treaty benefits in respect of the business income in such a case.

We recommend, therefore, that the Section 894 regulations be amended to allow treaty benefits for income of a regular hybrid entity which, had it been received directly (and had the same character as the underlying income) would have been exempt from tax in the country of the investor's residence, either because the investor is tax-exempt generally or because the income would have been tax-exempt under the country's tax system.

6. Consistency. Because of confusion resulting from the technical explanations of the 2006 U.S. Model Income Tax Convention and of recent treaties with Germany and Belgium, it is important to have guidance on whether the IRS interprets the "consistency" requirement of Rev. Rul. 84-17 to go beyond the specific holding of that

[41] Regs. §1.894-1(d)(3)(iii)(A).

[42] A point illustrated by Examples (11) and (12) of Regs. §1.894-1(d)(5), which allow treaty benefits for U.S. source dividends received directly by a charitable organization and a pension trust, notwithstanding the absence of tax in the country of residence. 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.

ruling and in effect force a taxpayer to choose between the permanent establishment article of a treaty and specific statutory provisions such as Sections 864(c)(4), which generally limits the extent to which foreign source income will be treated as effectively connected, and 864(b), which provides safe harbors for trading in stocks, securities and commodities. We made this comment in our report on the U.S. Model Income Tax Convention.

While U.S. tax treaties generally provide that the treaty does not subtract from the benefits to which a person would be entitled under the Internal Revenue Code,[43] Rev. Rul. 84-17 holds that the permanent establishment and business profits articles of a U.S. treaty must be applied consistently and that the Internal Revenue Code and a treaty cannot be used by a foreign enterprise to reach different results with respect to different parts of its U.S. operations.[44]

The technical explanation of the U.S. Model Income Tax Convention adds to this 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 that the IRS identified in the preamble to the revisions to Regs. §1.882-5 and said it was "continuing to consider."[45]

We have no issue with Rev. Rul. 84-17 (which, apart from any treaty-based rational, could be justified as consistent with the disallowance under Section 265 of

[43] *E.g.*, Article 1(2) of the 2006 U.S. Model Income Tax Treaty, which provides that "This Convention shall not restrict in any manger any benefit now or hereafter accorded . . . by the laws of either Contracting State . . ."

[44] Specifically, Rev. Rul. 84-17 held that a foreign corporation which carried on two separate activities in the U.S. that were not permanent establishments, and which resulted in effectively connected taxable income in one case and an effectively connected tax loss in the other, could not use the loss against income from a third activity that was a permanent establishment. The ruling involved the U.S.-Polish treaty and 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, 200612013, (November 29, 2005).

[45] *See* T.D. 9281 (September 25, 2006).

expenses attributable to tax-exempt income); or, since the rules on these two issues have always moved in tandem, with requiring the use of consistent methods under Article 7 to determine deductible interest expense and branch profits tax. We do think, however, that the IRS's and Treasury's position on the use of consistent methods under Regs. §1.882-5 and Section 884 should be set out in a ruling (or in amended regulations under Section 884).

The confusion with respect to other applications of the consistency rule largely derives from the part of the technical explanations of the 2006 U.S. Model Income Tax Convention and of the recent Belgian and German treaties which address the rule. These suggest that the use of the permanent establishment clause of a treaty precludes reliance on Section 864(c) to eliminate U.S. tax on foreign source royalties attributable to a permanent establishment and, by implication, reliance on the safe harbors in Section 864(b) for trading in stocks, securities and commodities.[46]

Forcing taxpayers that seek treaty benefits to surrender specific exclusions from effectively connected income that are set out in the Code or the Regulations requires that "consistency" be reconciled with the policy of treaty provisions, such Article 1(2) of the 2006 U.S. Model Income Tax Convention, which say that the "Convention shall not restrict in any manner any benefit now or hereafter accorded . . . by the laws of either Contracting State"; and which, as explained by the Technical Explanation, means that

---

[46] The Technical Explanation of the 2006 Model Income Tax Convention says that

"In effect, paragraph 2 [of the business profits article] allows the United States to tax the lesser of two amounts of income: the amount determined by applying U.S. rules regarding the calculation of effectively connected income and the amount determined under [that] Article . . . of the Convention. That is, a taxpayer may choose the set of rules that results in the lowest amount of taxable income, but may not mix and match.

In some cases, the amount of income "attributable to" a permanent establishment under Article 7 may be greater than the amount of income that would be treated as "effectively connected" to a U.S. trade or business under section 884. For example, a taxpayer that has a significant amount of foreign source royalty income attributable to a U.S. branch may find that it will pay less tax in the United States by applying section 864(c) . . ., rather than the rules of Article 7, if the foreign source royalties are not derived in the active conduct of a trade or business and thus would not be effectively connected income. But, as described in the Technical Explanation to Article 1(2), if it does so, it may not then use Article 7 principles to exempt other income that would be effectively connected to the U.S. trade or business. Conversely, if it uses Article 7 principles to exempt other effectively connected income that is not attributable to its U.S. permanent establishment, then it must include the foreign source royalties in its net taxable income even though such royalties would not constitute effectively connected income."

"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."[47]

The technical explanations of the 2006 U.S. Model Income Tax Convention and the Germany and Belgian treaties notwithstanding, the technical explanations of other specific treaties or protocols, including treaties or protocols entered into after the release of the 2006 U.S. Model Income Tax Convention that include references to the OECD Transfer Pricing Guidelines, such as those with Canada, Bulgaria and Iceland, simply refer to Rev. Rul. 84-17 and go no further. This suggests that the Treasury and IRS may have re-thought the consistency rule described in the technical explanation to the U.S. Model Income Tax Convention. Likewise, the reports of the Senate Foreign Relations Committee and Joint Committee on Taxation do not go beyond Rev. Rul. 84-17. It would be useful to have a clear statement by the IRS and Treasury on consistency and whether, in their view, consistency goes beyond what is required by Rev. Rul. 84-17. [48]

7. Business profits attributable to a permanent establishment. Guidance might be provided on whether transfer pricing methods can be used to attribute business profits to a permanent establishment or fixed base, both under more recent treaties that specifically refer to the use of the OECD Transfer Pricing Guidelines for this purpose (such as those with Belgium, Canada, Germany and Iceland) and under "older" (and sometimes newer) treaties (such as the recent protocol with France) that do not specifically refer to the OECD Transfer Pricing Guidelines.

[47] *See* October 1, 2007 letter from the Institute of International Bankers to the Treasury Department on "New Treasury Department Position on Consistency between Income Tax Treaties and U.S. Domestic Law".

[48] Our report on the 2006 U.S. Model Income Tax Convention also recommended guidance on (1) whether the consistency requirement applies outside of the business profits article of a tax treaty, (2) how the election between the treaty and the Code is made, (3) whether the election can be changed as a result of an audit, and (4) whether the election is made on a year by year basis (taking into account Article 7(5), 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").

The Internal Revenue Code's rules for determining the income and expense of a U.S. trade or business are different than those that would apply if there is a treaty and the treaty was interpreted as treating the permanent establishment as a separate entity.

What is "effectively connected" with a U.S. trade or business is a two step process in which effectively connected gross income, as determined under the Internal Revenue Code, is determined and then expenses and losses, as so determined (but excluding interest), are allocated and apportioned against that income under rules (*i.e.*, Regs. §1.861-8) which stress the factual connection between the expense and the income. Thus, under the Internal Revenue Code, revenue and expense from inter-branch transactions would generally not be recognized (*i.e.*, do not exist). Additionally, some items of gross income would be attributed (under the "material factor" tests in Sections 864(c)(2)(B)) to the 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. trade or business far exceeds what would be taxable under any arm's length principles.[49] This may be because of the U.S. rules on the source of income (such as the title passage rule that applies to sales of inventory[50] or the payroll based allocation that may apply to income from services rendered by an enterprise[51]), or because under the "material factor" tests in Section 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. personnel in the activity.[52] The "effectively

[49] Additionally, Section 842(b)(1) would determine the attributable investment income of a foreign insurance company on a formulary basis.

[50] For example, under the title passage rule all of the income from the sale of purchased inventory is sourced where title passes; and, in the case of property that is produced abroad and sold within the United States, 50% of the income is U.S. source unless there is an "independent factory price". Regs. §§1.861-7 and 1.863. These rules may obviously overstate the income attributable to the functions, if any, that are performed at the place where title passes.

[51] While the general principle is to source compensation "on the basis that most correctly reflects [its] proper source . . . under the facts and circumstances of the particular case", the only example suggests that payroll costs will ordinarily have that effect. *See* the example in Regs. §1.861-4(b)(1)(ii).

[52] Under the material factor test, the U.S. activities have to "provide a significant contribution to, by being an essential economic element in, the realization of the income [or] gain", but they need not be "a major factor in the realization" and certainly do not have to be the only material factor. Regs. §1.864-6(b). In the

connected" rules are sharply different from the functional analysis required to determine the appropriate amount of income under the Section 482 regulations; and they are influenced by quite different tax policies — for example, in the case of the title passage rule, to permit U.S. exporters to generate foreign source income for foreign tax credit purposes. The inadequacies of the source of income and material factor rules in the Internal Revenue Code and the regulations to measure income accurately are the backdrop to the IRS's advance pricing agreement program, insofar as it applies to global dealing in financial instruments, and also to the proposed global dealing regulations.

Attribution of profits articles in U.S. tax treaties generally provide that, if there is a permanent establishment, "there shall . . . be attributed to that permanent establishment the profits that it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions."[53] "Older" (and some newer) treaties stop there, but some more recent treaties, which include the notes or a protocol contemplated by the U.S. Model Income Tax Treaty,[54] add that "the profits to be attributed . . . shall include only the profits derived from the assets used, risks assumed and activities performed by the permanent

---

case of income from lending, notional principal contracts and other specified items of income, it is enough that U.S. based personnel "participate" in soliciting, negotiating, or performing another activity "required" to complete the transaction. Regs. §§1.864-6(b)(2)(ii) and 1.864-5(b)(2).

[53] *See* the first sentence of Article 7(2) of the 2006 U.S. Model Income Tax Treaty.

[54] The notes or protocol to Article 7(2) of the 2006 U.S. Model Income Tax Treaty would provide that

> "It is understood that the business profits to be attributed to a permanent establishment shall include only the profits derived from the assets used, risks assumed and activities performed by the permanent establishment. The principles of the OECD Transfer Pricing Guidelines will apply for purposes of determining the profits attributable to a permanent establishment, taking into account the different economic and legal circumstances of a single entity. Accordingly, any of the methods described therein as acceptable methods for determining an arm's length result may be used to determine the income of a permanent establishment so long as those methods are applied in accordance with the Guidelines. In particular, in determining the amount of attributable profits, the permanent establishment shall be treated as having the same amount of capital that it would need to support its activities if it were a distinct and separate enterprise engaged in the same or similar activities. With respect to financial institutions other than insurance companies, a Contracting State may determine the amount of capital to be attributed to a permanent establishment by allocating the institution's total equity between its various offices on the basis of the proportion of the financial institution's risk-weighted assets attributable to each of them. In the case of an insurance company, there shall be attributed to a permanent establishment not only premiums earned through the permanent establishment, but that portion of the insurance company's overall investment income from reserves and surplus that supports the risks assumed by the permanent establishment."

establishment," and also provide that the attributable profits may be determined by using the OECD Transfer Pricing Guidelines.

Under either formulation of the rules for attributing profits, the "distinct and independent enterprise" language may imply attribution of profits by the use of transfer pricing methodology, including the use of inter-branch agreements (rather than the "material factor" test) to divide income between or among branches; rules other than title passage to determine taxable income from sales of inventory; and a functional analysis, rather than a payroll or like-based allocation, to determine income from the performance of services.

We make two suggestions.

First, it would be useful to have guidance on the interpretation of the language of "older" treaties that do not incorporate the explicit reference to the OECD Transfer Pricing Guidelines or to the "assets used, risks assumed and activities performed by" the permanent establishment. The "separate and distinct enterprise" rule is self-executing, *i.e.*, it does not require a taxpayer to wait on regulations. The absence of a clear IRS administrative position as to what the rule means will likely influence the outcome of any dispute in which taxpayers make their own determination of what the rule means. The statement in technical explanations of "older" treaties that the "attributable to" concept of Article 7 is "an alternative to the analogous but somewhat different 'effectively connected' concept in Code section 864(c)" is of no help at all.[55] And, contrary to the apparent view of the Treasury and the IRS, it is not clear to us that there is a stark difference between the proper interpretation of the "older" treaty language and the "newer" language that refers explicitly to the OECD Transfer Pricing Guidelines,[56] particularly in a case where the other treaty partner is an OECD member and interprets

---

[55] *See also,* Rev. Rul. 91-32 and Rev. Rul. 81-78 ("Although there are many areas in which the 'attributable to' and 'effectively connected' principles overlap, these principles are only analogous. They are not synonymous.").

[56] *See* Treasury Department, Report to The Congress on Earnings Stripping, Transfer Pricing and U.S. Income tax Treaties (November 28, 2007), stating that "[O]lder U.S. tax treaties generally do not adopt the arm's length standard provided for in Article 7 of the OECD Model Income Tax Treaty. However, several recent U.S. income tax treaties provide that the arm's length standard will be used to allocate profits within a single enterprise based on a functional analysis of assets used, risks assumed, and functions performed."

the language as being consistent with the OECD Transfer Pricing Guidelines. Although differences remain, the OECD Transfer Pricing Guidelines are in most respects similar to the Section 482 rules for arm's length pricing and the trend is clearly towards convergence.

There is a significant risk to the IRS and Treasury in not clarifying its interpretation of the rules. The Court in The North West Life Assurance of Canada case, relying on the Commentary to the then-OECD Model Convention, interpreted the "older" treaty language (which did not incorporate the reference to the OECD Transfer Pricing Guidelines or to "assets used, risks assumed and activities performed by" the permanent establishment) as requiring that the "attributable" investment income of a permanent establishment be determined by the specific facts of the permanent establishment, not under the formula prescribed for insurance companies by Section 842(b)(1); and the Court in National Westminster Bank interpreted the "older" treaty language as permitting transfer pricing methodologies to determine the interest expense of a permanent establishment.[57] The specific issue in National Westminster Bank, which was the determination of the deductible interest expense of a branch and the recognition of inter-branch loans, is now governed exclusively by Regs. §1.882-5,[58] but the general principle on which the decision is based would apply to other expenses and income, including income from inter-branch notional principal contracts or inter-branch service agreements.

Moreover, it seems to us that the use of arm's length pricing, whether under the principles of the Section 482 regulations or under the OECD transfer pricing guidelines, would in general produce more sensible results than the "effectively connected" rules that apply in the absence of a tax treaty.

Second, it would be useful to have guidance on how the transfer pricing rules would apply if they may be used, either because of the interpretation of the "distinct and

---

[57] *See* National Westminster Bank PLC v. United States, 513 F.3d 1347 (Fed. Cir. 2008), stating that "[o]n a fundamental level, we do not read the separate enterprise language of Article 7 [of the 1975 U.S.-U.K. income tax treaty] . . . as permitting transactions between the permanent establishment and the enterprise to be disregarded . . . . We find the comparison to a separately incorporated U.S. subsidiary instructive. In that situation, intracorporate transactions . . . are not disregarded but are adjusted to reflect arm/s length terms", citing the regulations under Section 482.

[58] Regs. §1.882-5(a)(2).

separate enterprise" language of "older" treaties or because of the language in more recent treaties that explicitly refers to the OECD Transfer Pricing Guidelines and to the "assets used, risks assumed and activities performed by" the permanent establishment.[59] For example, can a taxpayer use the appropriate method under the Section 482 regulations to determine the net income attributable to a U.S. permanent establishment in, say, a case where the permanent establishment is making loans and/or entering into derivatives, rather than the all-or-nothing rule in the effectively connected regulations? In a case where the permanent establishment is part of an enterprise performing services?

8. Guidance might in any event be provided with respect to the IRS position on The North West Life Assurance of Canada case.[60] In The North West Life Assurance Co. of Canada, the Tax Court held that the business profits article of the then U.S.-Canada tax treaty trumped the formulary determination under Section 842(b) of the investment income of an insurance company, and held that the 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". The holding in The North West Life Assurance of Canada is plainly endorsed by those newer treaties that incorporate "the profits derived from the assets used, risks assumed and activities performed by the permanent establishment" language, but what about "older" treaties which, like the U.S.-Canada treaty involved in The North West Life Assurance Co. of Canada case, do not have this language?

9. Guidance on risk-weighting in the case of financial institutions. A number of recent U.S. tax treaties permit the portion of the interest expense attributable to a permanent establishment of a bank or other financial institution, other than an insurance

[59] The Technical Explanation of the 2006 Model Income Tax Convention, which contemplates the notes or a protocol explicitly authorizing the use of OECD Transfer Pricing Guidelines, says that this "incorporates the arm's length standard for purposes of determining" attributed profits. It also says that "[i]n the case of financial institutions, the use of internal dealings to allocate income within an enterprise may produce results under Article 7 that are significantly different than the results under the effectively connected income rules. For example, income from inter-branch notional principal contracts may be taken into account under Article 7, notwithstanding that such transactions may be ignored for purposes of U.S. domestic law."

[60] The Northwest Life Assurance Co. of Canada v. Comm'r, 107 T.C. 363 (1996).

company, and presumably also its branch profits tax liability, to be determined by risk-weighting assets.[61] There is, however, no meaningful guidance, even in the technical explanations, on the methodology for risk-weighting – the typical technical explanation provides that "the amount of capital attributable to a permanent establishment is determined by allocating the institution's total equity between its . . . offices on the basis of the proportion of the . . . institution's risk-weighted assets attributable to each of them."[62] How does risk-weighting fit into the three step calculation under Regs. §1.882-5? Does it adjust assets determined in the first step, without affecting the next step? Or something else? Does it allow taxpayers to net offsetting assets and liabilities? We commented some years ago on the need for guidance.[63] We are not suggesting that the Treasury and IRS address the risk-weighting of particular assets, but rather that there be guidance on the methodology to be used by a taxpayer under Regs. §1.882-5 if risk-weighting is elected.

To repeat a point previously made, risk-weighting, like most treaty terms, is self-executing and does not require a taxpayer to wait on IRS regulations. The absence of a clear IRS administrative position on what risk-weighting means will likely influence the outcome of any dispute in which the taxpayer makes up its own mind as to how to risk weight assets.

10. Guidance on limitation on benefits articles. A number of private rulings have been issued on different aspects of limitation on benefit articles, including on the meaning of "ultimate beneficial owner," [64] whether a trade or business is "substantial",[65] what is a "comprehensive income tax convention,"[66] what is "gross income" for purposes

---

[61] *E.g.*, treaties with Belgium, Bulgaria, Canada, Germany, Iceland and Japan. *See also*, Regs. §1.882-5(a)(2).

[62] *E.g.*, technical explanations of the treaties with Germany and Iceland.

[63] *See* NYSBA Tax Section, Letter Re: Notice 2005-53 (September 22, 2005).

[64] PLR 200201025; PLR 200409025; and PLR 199912028.

[65] PLR 200620017.

[66] PLR 200201025 and PLR 200409025.

of the base erosion test,[67] what is a "recognized stock exchange,"[68] and whether U.S. source interest income was "connected" with an actively-conducted trade or business.[69]

The evolving language of the limitation on benefit articles makes generic guidance difficult (and underscores the importance of letting taxpayers rely on the technical explanations, which provide substantially on the only guidance, outside of the text of the articles, on what limitation on benefits articles mean). We do recommend, however, that guidance be provided on at least two issues.

First, there should be guidance on that part of the limitation on benefits article that allows a foreign corporation to qualify if it meets an ownership and a base erosion test.[70] In a prior Tax Section report, we commented on the circumstances in which payments made by, and the gross income of, a foreign corporation should be taken into account for purposes of the base erosion test incorporated into limitation on benefit articles of U.S. tax treaties,[71] and we continue to recommend that the tax classification of a subsidiary of a foreign corporation should not be relevant to whether payments made by, and the gross income of, the subsidiary should be taken into account for the purposes of applying a base erosion test to the foreign parent corporation.

Second, it would be useful to have guidance on the application of the rule in Article 22(3) of the U.S. Model Income Tax Convention and similar articles of U.S. treaties that allows treaty benefits for an "item of income" that is "derived in connection with" or is "incidental to" a trade or business conducted in the other state. While the technical explanations of this part of the limitation on benefits article clarify a number of points (*e.g.*, what is a trade or business, the treatment of lines of business that are part of

---

[67] PLR 200551016.

[68] PLR 199912028.

[69] PLR 200620017.

[70] The purpose of the base erosion test is to ensure that a foreign person otherwise eligible for treaty benefits is not used as a mere conduit to pass income to a third party which is not eligible for treaty benefits. Under Article 22(2)(e)(ii) of the 2006 U.S. Model Income Tax Convention, treaty benefits may not be available if 50% or more of that foreign person's gross income is paid in the form of deductible payments to persons who are not residents of either contracting state.

[71] NYSBA Tax Section, Report on Limitation on Benefits Provisions and Section 1(h)(11) (June 26, 2006)

or complementary to the trade or business conducted in the other state, that an item of income includes interest, dividends, royalties and income from the active conduct of a trade or business), other issues remain. Specifically, it is not clear whether the treaty benefits allowed for an item of income would include, in the case of income derived from a trade or business in the United States, the reduction or elimination of the branch profits tax. It seems to us that, in a case where an item of income is derived from a trade or business carried on in the United States, "the benefits of the Convention" should include the permanent establishment and attribution of profits articles and any treaty elimination or reduction in the rate of branch profits tax.

11. Source of Compensation; Entertainers and Sportsmen. The "source" of compensation is central to all treaty articles that apply to compensation of an individual for services[72] and, in a case where services are performed in the U.S., is generally determined under the Internal Revenue Code. It would be useful to make this point in connection with the Proposed Regulations under Sections 861 and 862, relating to performance at specific events,[73] *i.e.*, that, absent any contrary treaty provision, the Internal Revenue Code rules will be used to determine the compensation that is taxable under the specific treaty article relating to entertainers and athletes, including income in respect of an entertainer or athlete that "accrues" to "another person" under treaty articles that correspond to Article 16 of the 2006 U.S. Model Income Convention.

Additionally, we recommend that the IRS propose regulations under Sections 861 and 862 with respect to the treatment of income from endorsements and the like, *i.e.*, whether that income is compensation that is covered, if at all, by the treaty article on entertainers or sportsmen; is a royalty for the use of an intangible that is generally exempt from U.S. withholding tax; is business profits that is covered by the permanent establishment article and therefore potentially exempt from tax if there is no fixed base;

[72] *I.e.,* as an employee, director, entertainer or sportsman, or as independent contractor.

[73] Prop. Regs. §§1.861-4(b) and -4(c), Examples (7)-(11) (October 17, 2007). These would use an "events basis" rule to determine the source of compensation received by artists, athletes or others for performing at specific events (as opposed to the general "time basis" rule used in other situations).

or is something else.[74] Although the classification of endorsement and similar income is a current issue, there is no citable guidance. The technical explanation to the 2006 U.S. Model Income Tax Convention, citing the commentary to the OECD model, says that the article "applies to all income connected with a performance by the entertainer, such as appearance fees, award or prize money, and a share of the gate receipts" and makes this determination on the basis of whether the income is "predominantly attributable to", or "closely associated with" a performance. A 1999 IRS Chief Counsel's Memorandum, setting out the IRS informal position in more detail, says that such income will be treated as derived from the activities of a sportsman or entertainer if it is "closely and proximately related to a performance by" the entertainer or sportsman in the United States;[75] and a 2009 general legal advice memorandum applies similar reasoning to retainer fees and ranking and placement bonuses paid to professional golf and tennis players pursuant to on-court endorsement contracts.[76]

We recommend that the treatment of endorsement and like income be dealt with by regulations, rather than rulings, because that process would allow for public comment on the substantive issues involved and because the issuance of regulations would be consistent with the approach taken in issuing proposed regulations on the source of "event"-based compensation of entertainers and athletes, as discussed above.

Finally, consideration should be given to revisiting published rulings issued some 30-plus years ago on income derived by entertainers and sportsmen[77] in light of the specific provisions, now included in most U.S. treaties, that limit the source country tax exemption for income from service performed as an entertainer or sportsman and, in

---

[74] This and a number of other issues are discussed in the Discussion Draft on the Application of Article 17 (Artistes and Sportsmen) of the OECD Mdel Tax Convention that was released by the OCED in April of this year.

[75] IRS Chief Counsel Advice 199938031 (September 24, 1999), which provides a number of examples, including rights to use a name, a photograph or a signature, and income from broadcasts that are simultaneous with a performance.

[76] Chief Counsel Advice Memorandum AM 2009-005, 2009 TNT 127-5 (June 26, 2009).

[77] Rev. Rul. 75-503 (treatment of exclusive service contracts under U.S.-U.K. and U.S.-France treaties); Rev. Rul. 74-330 ("single loan-out" arrangement under the U.S.-U.K. treaty); and Rev. Rul. 74-330 (employee-employer relationship for purposes of the U.S.-U.K. treaty).

addition, under certain circumstances, deny even that limited exemption where the income "accrues not to the entertainer or sportsman . . . but to another person".[78] The employee-employer inquiry made by the published rulings is not as such relevant to the way the treaty rules now work, and it is unclear what meaning is to be ascribed to the rulings in cases where specific treaty rules govern the treatment of the income derived from the activities of an entertainer or sportsman. The limitation on income that "accrues to" another person has been in the U.S. model income tax conventions since 1977 (and the OECD model since 1992) and is now in virtually every U.S. tax treaty.[79]

12. Pensions. Recent U.S. tax treaties generally provide tax relief to an individual working in one country for contributions to, and benefits accrued under, a pension fund that is resident in the other country – so that, for example, an alien individual, initially resident in a treaty country but subsequently working in the U.S., would not be taxed by the U.S. during the period of employment in the U.S. on contributions to, or benefits accrued under, a pension fund of the individual's home country; and, conversely, a U.S. resident working in a treaty country would not be taxed by that country during the period of employment in that country on contributions to, or benefits accrued under, a U.S. resident pension fund.[80] Consistent with the U.S. Model Income Tax Convention, however, the amount of the relief is limited to the amount of

[78] Article 16 (Entertainers and Sportsmen) of the 2006 U.S. Model Income Tax Convention which, in paragraph (1), limits the exemption to $20,000 a year of gross receipts; and, in paragraph 2, limits the situations in which the income from the activities of a sportsman or entertainer may be exempt from tax because accruing to another person to cases in which the contract for the activities allows the person to whom the income accrues to designate the individual who is to perform the services.

[79] Although the limitation on the taxability of income that "accrues . . . to another person" in the 2006 U.S. Model Income Tax Convention is turned off under different circumstances, *i.e.*, unless the contract allows the other person to designate the individual who is to perform, as opposed to (under prior U.S. models) unless the individual and any related person does not "participate directly or indirectly in the profits of that other person in any manner . . . ."

[80] Separately, because U.S. tax is imposed on nonresident citizens, recent U.S. tax treaties provide relief from U.S. tax on contributions to, and benefits accrued under, a pension plan of the other country in the case of a U.S. citizen resident and working in that other country, but also limit the amount of that relief to what would be allowed under a "generally corresponding" U.S. plan. *See, e.g.*, Article 18(4)(b) of the U.S. Model Income Tax Convention (limiting relief to the lesser of what would be allowed by the U.S. to its residents under "a generally corresponding pension plan established in the United States" and the amount that would qualify for tax relief in the other country).

relief that would have been allowed by the country in which the services are performed to its residents in the case of a resident pension fund.[81]

Guidance is needed on how to apply the limitation on the amount of the allowable relief, *i.e.*, how to determine the amount of relief that would be allowed in respect of the notional pension plan of the country in which the services are performed. Foreign pension plans may not be easily compared to U.S. plans, and the allowable contributions to, and benefits accrued under, a U.S. pension plan will depend upon the type of plan and upon various other factors that may not readily apply in the case of a foreign plan.[82] The technical explanations elaborate somewhat on the way the limitation applies when services are performed in the U.S., but not sufficiently – for example, the limitations on deductions in Section 404 differ, depending on the type of plan, and it may not be readily apparent what type of plan the foreign plan is for that purpose.

Separately, it would be useful to have guidance on which individuals are covered by articles similar to Article 18(2) of the U.S. Model Income Tax Convention. In the case of an individual resident in the other country, the relief allowed by the U.S. applies even though the individual becomes a resident of the U.S. on account of working here unless the individual is admitted to the U.S. for permanent residence, i.e., has a "green card".[83] If the individual is not initially a resident of the other country (*i.e.*, the country in which the pension fund is resident), however, relief would apparently not be available,

[81] *See, e.g.*, Article 18(2) of the U.S. Model Income Tax Convention ("The relief available under this paragraph shall not exceed the relief that would be allowed by the other State to residents of that State for contributions to, or benefits accrued under, a pension plan established in that State.") *See also* the U.S. treaties with Belgium, Chile (pending) and Germany.

[82] The Technical Explanation to the 2006 U.S. Model Income Tax Convention says that, where the services are performed in the U.S., the relief "is limited to contributions not in excess of the amount specified in section 402(g) for election contributions. Deduction of employer contributions is subject to the limitations of sections 415 and 404. The section 404 limitation on deductions is calculated as if the individual were the only employee covered by the plan."

[83] The Technical Explanation to Article 18(2) of the 2006 U.S. Model Income Tax Convention says that "[i]t is irrelevant for the purposes of [Article 18(2)] whether the participant establishes residence in the State where the individual renders services . . . ." While treaty benefits are generally available only to residents of the other contracting state, Article 1(5)(b) extends the benefits of Article 18(2) to individuals who have not become citizens or been admitted for permanent residence.

whether or not the individual was a resident of a third country that had a treaty with the U.S. which incorporated an article similar to Article 18(2).[84]

13. Need to Review Outstanding Published Rulings. We noted at the outset of this report that a number of published rulings, although technically not obsolete, have become marginal, if not irrelevant, in light of changes in treaties or the Internal Revenue Code. It would be useful to review the outstanding published rulings to take into account these changes.

As an example, all of the published rulings addressing the circumstances in which sales into the United States may cause a foreign corporation to have a permanent establishment here were issued under treaties that have in material ways been changed since the rulings were issued.[85] It would certainly be useful to have a ruling that stated the IRS' position on this issue under the 2006 U.S. Model Income Tax Convention. Going further, the rulings which hold that, under the U.S.-Japan and U.S.-U.K. treaties, the exclusive authority for determining the deductible interest expense of a foreign corporation's U.S. permanent establishment are the rules set out in Regs. §1.882-5 [86] are out of date, given the subsequent incorporation of the exclusivity rule in Regs. §1.882-5; and the ruling which treats income of a foreign bank from an interest rate swap as "industrial or commercial profits", and thus exempt from U.S. tax if there is no permanent establishment, is out of date, given the subsequent adoption of the source rules for notional principal contracts in Regs. §1.863-7.[87] A further example, discussed above, are the two published rulings dealing with "loan-out" and like arrangements with foreign

[84] Unless a specific treaty provision so provides — *e.g.*, the U.S.-Belgium treaty provides, in Article 17, that the exemption applies to contributions to "a similar fund that is resident of a comparable third State", as well as to a resident pension fund; and that, in the case of Belgium, the relief is limited to the amount allowed for contributions to, and benefits accrued under, a plan "recognized for tax purposes in" Belgium. A "similar" fund is one resident in Switzerland or in a country that is a member of the EA, the EEA, or NAFTA.

[85] *See* Rev. Rul. 55-617 (no permanent establishment under U.S.-Belgium treaty); Rev. Rul. 62-31 (permanent establishment under U.S.-U.K. treaty); Rev. Rul. 63-113 (no permanent establishment under U.S.-Canada treaty); Rev. Rul. 65-263 (permanent establishment under U.S.-Canada treaty); and Rev. Rul. 76-322 (no permanent establishment under U.S.-Australia treaty).

[86] Rev. Rul. 89-115 and Rev. Rul. 85-7.

[87] Rev. Rul. 87-5.

entertainers and athletes,[88] both of which pre-date the introduction, and now universal adoption, of a specific treaty article dealing the issue of when income that "accrues to" a person other than the entertainer or athlete is eligible for treaty benefits. Rev. Rul. 87-38, relating to the taxation of Canadian hockey players, will likewise need to be reconsidered if the proposed regulations relating to "event" based compensation are adopted.

Another example, raising different issues, might be Rev. Rul. 80-362, which held that the source of income from the use of intangible property is not changed by multiple layers of licenses – that is, that the U.S. withholding tax on royalties is a "cascading" tax and that a foreign corporation which pays royalties to another foreign corporation for the use by a licensee of intangible property in the United States is required to withhold.[89]

The point in reviewing Rev. Rul. 80-362 would be to balance legitimate concerns about treaty shopping with a rule that may result in a withholding obligation in transactions that in no way involve treaty shopping – where, for example, the ultimate licensor (which of course may under Section 865(d) include the seller of intangible property) is unrelated to, and several transactions away from, the person that uses the intangible property in the United States. Rev. Rul. 80-362 ruling was issued before the adoption of the conduit financing regulations, which would generally treat back-to-back royalties as paid directly by the licensee to the ultimate licensor,[90] and before the almost universal inclusion of limitation on benefits articles in U.S. tax treaties. These changes provide substantial protection against the abuse perceived by Rev. Rul. 80-362. Additionally, the ruling was rejected by the Tax Court in the SDI Netherlands, B.V. case,[91] which held that the royalties paid under the sublicense, although literally for the

---

[88] Rev. Rul. 74-330 (loan-out agreements under U.S.-U.K. treaty); and Rev. Rul. 75-503 (treatment of foreign entertainers, etc. under U.S.-U.K. and U.S.-France treaties).

[89] *See also* Example 10 of Regs. §1.881-3(e).

[90] Regs. §1.881-3.

[91] SDI Netherlands B.V. v. Comm'r, 107 T.C. 161 (1996). The IRS has not acquiesced in SDI Netherlands and Rev. Rul. 80-362 remains outstanding. The language of the typical U.S. treaty, which taxes royalties "arising in" the U.S. (and thus differs from the place of use test in Sections 861(a)(4) and 862(a)(4)) provides a possible basis for following the SDI Netherlands case in appropriate circumstances. We do not believe that the IRS' position that the Section 4371 excise tax is a cascading tax (s*ee* Rev. Rul. 2008-15; and Announcement 2008-18) requires it to take the same position with respect to royalties.

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. Rev. Rul. 80-362 (and the related example in the conduit financing regulations)[92] might be re-evaluated in light of these developments.

[92] Example 10 of Regs. §1.881-3(e).