NEW YORK STATE BAR ASSOCIATION
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The Honorable Mark Mazur
Assistant Secretary
(Tax Policy)
Department of the Treasury
1500 Pennsylvania Ave., N.W.
Washington, D.C. 20220

The Honorable John Koskinen
Commissioner
Internal Revenue Service
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Washington, D.C. 20224

The Honorable William J. Wilkins
Chief Counsel
Internal Revenue Service
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Washington, D.C. 20224

Re: **Report No. 1325 on the Tax Treaty Consistency Principle**

Dear Messrs. Mazur, Koskinen and Wilkins:

I am pleased to submit the enclosed New York State Bar Association Tax Section Report No. 1325 offering commentary and recommendations on whether and to what extent there is or should be a duty of consistency on taxpayers claiming benefits under the United States tax treaties.

By way of background, Revenue Ruling 84-17, 1984-1 C.B. 308 ("Ruling 84-17") considered the U.S. taxation of a Polish corporation having three separate businesses in the United States: profitable business *A* conducted through a permanent establishment, profitable business *B* not conducted through a permanent establishment, and a loss making business *C* not conducted through a permanent establishment. The taxpayer sought to elect treaty benefits to exclude the income of business *B* while electing out of the treaty to permit its losses from business *C* to offset taxable profits of business *A*. The Ruling held that the taxpayer could not mix and match the provisions of treaty rules

and rules of the Internal Revenue Code of 1986, as amended (the "Code"), in such a fashion.

In the Technical Explanation to the 2006 U.S. Model Tax Treaty (the "2006 Model Treaty TE" and the "2006 Model Treaty"), the Treasury cited Ruling 84-17 to support a broader duty of consistency (of somewhat uncertain scope). In the New York State Bar Association's Report No. 1127 on the 2006 Model Treaty (April 11, 2007), we stated our view that the holding of Ruling 84-17, with which we agreed, did not justify the creation of a broader duty of consistency.

In the attached Report No. 1325, we revisit and expand our prior views in the hopes of assisting the Treasury as it seeks to publish a new U.S. Model Treaty and Model Treaty Technical Explanation. In that connection, the attached Report suggests two areas of clarification. First, we believe that the holding of Ruling 84-17 should be articulated in a more precise form relating to the inconsistency of the taxpayer's election of treaty exclusion of profits from one business not conducted through a permanent establishment while simultaneously electing out of the treaty to use losses from a separate business not attributable to a permanent establishment to offset profits from a third business attributable to a permanent establishment. This inconsistency would undermine the retained taxing rights of the U.S. to tax the profits of a permanent establishment as negotiated in our treaties. We believe that a re-articulation of the holding of Ruling 84-17 in a regulation (*e.g.*, Treas. Reg. §1.871-12) will both clarify the scope of its holding and provide a greater level of formality to the principle its expresses.

Second, as the newer U.S. treaties have adopted the "Authorized OECD Approach" ("AOA") for the attribution of profits to a permanent establishment, the Treasury has in its technical explanations to some of the recent treaties incorporated the Ruling 84-17 principle as requiring that a taxpayer either elect treaty based taxation under the AOA or Code based taxation under U.S. domestic law principles. In this formulation, the Treasury has suggested that certain Code-based benefits (*e.g.*, the exclusion of foreign source royalty or service income from U.S. business profits) are not available under the AOA even though they would be available under U.S. domestic law. We believe that this construction gives inadequate deference to the domestic benefit preservation clause in Article 1, paragraph 2 of the 2006 Model Treaty as well as the non-discrimination provision of Article 24(2) of the 2006 Model Treaty. Moreover, we are concerned that such a broad principle could override a host of other well established U.S. tax benefits, including the Section 103 exclusion of tax exempt income and the securities trading safe harbor of Section 864(b). We believe these results would be inappropriate. We recommend instead that the application of the AOA in Article 7 of the Model Treaty should be applied under general principles of treaty and statutory interpretation to be in harmony with domestic law benefits except where the provisions are explicitly inconsistent.

In this Report we make certain specific suggestions, including the following recommendations:

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

B. Consistency Principle Should be Limited to Preventing Inappropriate Selectivity of Treaty Benefits. While we believe that Ruling 84-17 reaches an appropriate result based on the facts that were present in that ruling, but we regard the expansion of this highly fact-specific holding into the broad based Consistency Principle that is articulated in the 2006 Model Treaty TE as unnecessary and unjustified. We suggest that, in its new Model Treaty TE, the Treasury should revise its articulation of the Ruling 84-17 position to state that a taxpayer may not mix the taxation of income from a permanent establishment with losses that are not attributable to a permanent establishment in a manner contrary to the purpose of the Model Treaty to preserve the right of the United States to tax the profits of a permanent establishment (unless the taxpayer would owe less tax under the Code).

C. Treaty Elections on an Enterprise-by-Enterprise Basis. The 2006 Model Treaty determines taxability and attributes taxable income on an enterprise-by-enterprise basis. Assuming that the Treasury is comfortable that it has the tools to determine the separateness of enterprises, we suggest that consideration be given to clarifying in the Model Treaty TE and/or in Treas. Reg. § 1.871-12 that each separate business enterprise may separately choose to invoke the protection of a treaty (subject only to the constraint described in the preceding recommendation that a taxpayer may not mix and match such elections in a way that would thwart the purposes of the Model Treaty in a manner analogous to Ruling 84-17). While separating one business enterprise from another may present factual challenges, such a determination is already required by our treaties in order to separately attribute profits for each business enterprise and there are domestic law authorities to provide relevant guidance.

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

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

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

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

G. Formality. The announcement of a broad Consistency Principle in the 2006 Model Treaty TE has certain deficiencies in terms of formality. While we presume that treaty partners would read the Model Treaty TE when entering into treaty negotiations with the U.S. and therefore should be on notice of any articulation of the Consistency Principle in the Model Treaty TE, the Model Treaty TE lacks the formality and administrative procedural impact of a regulation. We would recommend that if and to the extent that the Treasury determines that it should expand or refine the Consistency Principle beyond the facts of Ruling 84-17, such changes should be presented as an amendment to the existing Treas. Reg. § 1.871-12 (regarding determination of tax on treaty income). We believe that such a regulatory change should have prospective effect only. Such a regulation could then guide the courts and taxpayers with respect to the intended scope of protection for treaties ratified thereafter. While Ruling 84-17 should still apply to any period prior to the issuance of such a regulation, we would also recommend that a notice or superseding ruling be issued to clarify the scope of Ruling 84-17.

We very much appreciate your consideration of this Report and its recommendations, and would be happy to discuss them with you or provide additional assistance.

Respectfully submitted,

David R. Sicular
Chair

Enclosure

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