U.S. Income Tax Treaties

Trends, Issues & Policies

Recent Developments - Future Prospects

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I. Introduction

A. Focus of this Paper

This article examines recent developments concerning bilateral tax treaties, primarily U.S. income tax treaties.[1] U.S. tax lawyers regularly expend considerable effort trying to understand and apply the often impenetrable language of Subchapter N (the "cross-border" income tax provisions) in the Internal Revenue Code, and the accompanying U.S. Treasury Regulations, only to find that the problem under analysis can be readily solved through the application of the provisions of a specific bilateral income tax treaty to which the United States is a party.[2] That experience is often a reminder that, after the U.S. Constitution, an applicable bilateral income tax treaty (rather than a relevant tax statute) might be the "controlling authority" in a particular situation.[3] However, having determined that an income tax treaty provision

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[1] Note that some of the discussion in this material was previously included in the following published article: William P. Streng, "U.S. Tax Treaties: Trends, Issues, and Policies in 2006 and Beyond," 59 SMU Law Review 853, No. 2, Spring 2006.

[2] The complete text of all the U.S. tax treaties may be found on the following IRS website: http://www.irs.gov/businesses/corporations/article/0,,id=96739,00.html. In a cross-border planning environment the parties may also make use of the tax treaty network of a third country when more favorable treatment is available (and restrictions under any "limitation on benefits" rule are not applicable).

[3] Code § 894(a) provides that "[t]he provisions of this title [i.e., the Internal Revenue Code] shall be applied to any taxpayer with due regard to any treaty obligation of the United States which applies to such taxpayer." Code § 7852(d)(1) provides that "[f]or purposes of determining the relationship between a provision of a treaty and any law of the United States affecting revenue, neither the treaty nor the law shall have preferential status by reason of its being a treaty or law." This latter provision reflects the U.S. rule that the "later in time" of either the treaty or the applicable statute will control the resolution of an issue. Under the U.S. Constitution (Article VI, Clause 2) U.S. treaties and federal statutes have equal status as the supreme law of the land. Consequently, when a conflict exists between the treaty and the statute, the later in time prevails. See Restatement (Third) of the Foreign Relations Law of the United States, § 115 (American Law Institute, 1986). This approach is contrary to the rule in most other developed countries, i.e., the order of priority usually being the relevant country's (1) constitution or other fundamental document, (2) treaties, and,

might be quite beneficial to a taxpayer's situation, the advisor might then find that a superseding statute must be treated as the controlling authority.[4]

The application of tax treaties to the activities and investment of clients of U.S. advisors can be pertinent to two very different types of situations:

(1) Foreign clients with inbound investments, where questions can concern (a) whether the applicable tax treaty changes the existence of tax jurisdiction in the U.S. and (b) the applicability of withholding taxes on outbound payments of dividends, interest, royalties, etc.; and,

(2) U.S. clients with outbound investments where the anticipation is that the treaty might provide tax treatment in the destination jurisdiction which is more favorable than the statutory and regulatory tax regime then existing (or anticipated in the future) in that country. This latter situation may often necessitate the retention of a tax advisor in the destination jurisdiction to assist in the process of identifying and documenting eligibility for these treaty benefits.

Although this paper is limited to the examination of the U.S. income tax treaties in planning international structures for cross-border transactions third country bilateral tax treaty networks may be pertinent and useful. Approximately 3,000 other bilateral

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then, (3) its enacted statutes. See in this context Jamieson v. Commr., T.C. Memo 2008-118 where the Tax Court determined that an ALTMIN provision (limiting the available foreign tax credit) was the later in time and eliminated applicability of a contrary Canada-U.S. income tax treaty provision. See Ehrlich and Dennehy, "Tax Treaty Interpretation and Conflicts with U.S. Federal Law," 122 Tax Notes 1101, March 2, 2009.

[4] As a rule of interpretation U.S. courts will often seek to interpret and apply U.S. treaties and federal statutes on the basis that an actual conflict does not exist. See Restatement (Third) of the Foreign Relations Law of the United States, § 114 (American Law Institute 1986). In some instances, however, when enacting (particularly tax) legislation the U.S. Congress will specifically indicate that a treaty provision (including in a tax treaty) is being superseded by the applicable legislation. Alternatively, the legislative history might indicate (disingenuously?) that conflict between the later statute and the earlier treaty provision does not exist, although the lack of such conflict might be extremely difficult to discern.

income tax treaties are in force around the world (between countries other than the United States. Some countries, such as the Netherlands, have tax treaty networks far more expansive than the U.S. income tax treaty regime.[5]

B. The U.S. Income Tax Treaty Network

The United States has an extensive network of bilateral income tax treaties with 67 countries as of early 2009.[6] Several protocols to existing treaties and revised treaties have been examined by the Senate Foreign Relations Committee during the years 2006-2008.[7] These include recent treaties or protocols with: Bangladesh,[8]

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[5] For a perspective on the use of an unusual tax treaty network, see Langer, "Using U.A.E. Tax Treaties to Invest in OECD Countries," Tax Notes International, Vol. 47, No. 7, p. 683 (August 13, 2007).

[6] A useful summary of outstanding U.S. tax treaties, and ongoing tax treaty negotiations, is periodically included in Tax Management International Journal, a monthly publication issued by Tax Management, Inc. In "Current Status of U.S. Tax Treaties and International Tax Agreements," prepared by Venuti, Corwin and Lainoff, 38 Tax Management International Journal 174 (March 13, 2009), the U.S. is identified as having income tax treaties in force with 67 countries (as of February 16, 2009). Three treaties (or protocols) were identified as signed and awaiting U.S. Senate approval (i.e., with France, Malta and New Zealand). In this report the U.S. is identified as having income tax treaties under various stages of negotiation with 23 countries. The same U.S.-U.S.S.R. Income Tax Treaty, signed June 20, 1973, applies to the countries of Armenia, Azerbaijan, Belarus, Georgia, Kyrgyzstan, Moldova, Tajikistan, Turkmenistan, and Uzbekistan.

[7] Hearings were held before the Senate Foreign Relations Committee on July 17, 2007 concerning the Denmark, Finland and Germany tax treaty protocols and the revised Belgium treaty. On July 10, 2008 the Senate Committee on Foreign Relations held hearings on the proposed protocol with Canada and the proposed income tax treaties with Iceland and Bulgaria. See Joint Committee on Taxation, "Testimony of the Staff of the Joint Committee on Taxation Before the Senate Committee on Foreign Relations Hearing on the Proposed Protocol to the Income Tax Treaty with Canada and the Proposed Income Tax Treaties with Iceland and Bulgaria," JCX-60-08, July 10, 2008 (testimony of Emily McMahon, Deputy Chief of Staff of the Joint Committee on Taxation).

[8] This treaty became effective January 1, 2007. See Joint Committee on Taxation, "Explanation of Proposed Income Tax Treaty Between the United States and the People's Republic

Bulgaria,[9] Belgium,[10] Canada,[11] Denmark,[12] Finland,[13] Germany,[14] Iceland,[15] and

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of Bangladesh," JCX-4-06, January 26, 2006.

[9] See Joint Committee on Taxation, "Explanation of Proposed Income Tax Treaty Between the United States and Bulgaria," JCX-59-08, July 6, 2008. This treaty was ratified by the Senate on September 23, 2008 and became effective January 1, 2009. See Tax Notes International, September 29, 2008, p. 1089.

[10] This treaty became effective January 1, 2008. See Joint Committee on Taxation, "Explanation of Proposed Income Tax Treaty Between the United States and Belgium," JCX-45-07, July 13, 2007.

[11] Joint Committee on Taxation, "Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Canada," JCX-57-08, July 8, 2008. See, further, Kerzner, Timokhov & Chodikoff, "The Tax Advisors' Guide to the Canada- U.S. Tax Treaty," Thomson-Carswell (2008); Arnold, "The New Services PE Rule in the Canada-U.S. Treaty Protocol," Tax Notes International, July 14, 2008, p. 189. This protocol was ratified by the Senate on September 23, 2008 and entered into force on December 15, 2008. See Tax Notes International, September 29, 2008, p. 1089. The provisions became effective on various dates, as specified in Article 27 of the protocol.

[12] See Joint Committee on Taxation, "Explanation of Proposed Income Tax Treaty Between the United States and Denmark," JCX-46-07, July 13, 2007. Various effective dates (e.g., January 1 or February 1, 2008 are applicable).

[13] See Joint Committee on Taxation, "Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Finland," JCX-48-07, July 13, 2007. This protocol entered into force on December 28, 2007.

[14] See Joint Committee on Taxation, "Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Germany," JCX-47-07, July 13, 2007. This protocol entered into force on December 28, 2007, with most provisions effective for tax years beginning on or after January 1, 2008.

[15] See Joint Committee on Taxation, "Explanation of Proposed Income Tax Treaty Between the United States and Iceland," JCX-58-08, July 8, 2008. This treaty was ratified by the Senate on September 23, 2008. See Tax Notes International, September 29, 2008, p. 1089. This treaty entered into force on December 15, 2008, generally effective for any taxable year beginning on or after

Malta.[16] The treaty with Malta, and the recent protocols with France and New Zealand need U.S. Senate approval. The United States also has a limited number of estate, gift and generation skipping transfer tax treaties.[17] Other bilateral treaty variants in the tax context include approximately 23 "tax information exchange agreements,"[18] various reciprocal shipping and aviation agreements, and Social Security totalization agreements.[19] Even bilateral treaties of Friendship, Commerce and Navigation may

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January 1, 2009.

[16] Signed on August 8, 2008, and sent to the U.S. Senate for advice and consent to ratification on January 15, 2009.

[17] These treaties come in a variety of formats, e.g., some only dealing with estate tax, some also with gift tax, and some also encompassing the generation skipping transfer tax. This paper does not examine the U.S. treaties dealing with transfer taxes. Note that the expansion of these treaties has been essentially moribund for several decades, although periodically a protocol to an existing estate tax treaty is entered into, sometimes in conjunction with the negotiation of an amendment to the income tax treaty with the same country. Perhaps this ambivalence about transfer tax treaties derives from the probably larger issue in the United States of the continuation, significant revision, or permanent elimination of the federal estate, gift, and generation skipping transfer taxes.

[18] In "Current Status of U.S. Tax Treaties and International Tax Agreements," prepared by Venuti, Corwin and Lainoff, 38 Tax Management International Journal 174 (March 13, 2009), the U.S. is identified as also having 23 "Tax Information Exchange Agreements" either in force or signed and awaiting final action or under negotiation. Many of these exchange of tax information agreements are with countries in the Carribean where the U.S. is interested in receiving information from tax haven jurisdictions, but a U.S. bilateral income tax treaty would be of limited value. The benefit to the Caribbean country is that when entering into this agreement it is designated as being part of the United States for purposes of the more expansive business expense deduction provisions.

[19] The objective of a social security totalization agreement is to assure that (1) during the contributions phase simultaneous income taxation by two countries (i.e., the source and residence jurisdictions) is limited and (2) during the retirement distributions phase appropriate credit is provided for the prior contributions to the social security systems of several countries for purposes of determining both eligibility and benefit amounts. For example, a social security totalization agreement was recently entered into between the U.S. and Denmark. See BNA Daily Tax Report, Oct. 20, 2008, p. I-1. This treaty, signed in June 2007, came into effect on October 1, 2008. If a U.S. citizen has completed at least six quarters of coverage under U.S. laws, but lacks sufficient

be sufficiently expansive in certain situations to be applicable to cross-border tax matters.[20]

Some of these U.S. income tax treaties have been in effect for a considerable period, some older treaties have been regularly supplemented with protocols,[21] but some are either quite recent replacements of older treaties or new treaties with (particularly) countries with developing economies.[22] Many European countries have much more extensive income tax treaty networks than does the U.S., partly because they have been much more interested in their bilateral income tax treaty networks for an extended period and, also, because many of their treaty partner countries have a more accepting political environment in which to conclude a bilateral tax treaty, i.e., with (smaller) European countries (as contrasted to the U.S., the "bull in the China shop").[23] Consider, in this context, for example, the reluctance of many Latin

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periods of domestic coverage for benefit entitlement, the agreement allows U.S. authorities to take into account periods of coverage in Denmark that are credited under Danish laws. The U.S. will credit one quarter of domestic coverage for every three months of Danish coverage. A totalization agreement with the Czech Republic became effective on January 1, 2009. An agreement with Poland is expected to be effective before mid-year 2009.

[20] To reject the potential applicability of these FCN treaties in the federal tax context the U.S. Congress may limit the types of international agreements which can provide benefits in a particular context. See, e.g., Code § 884(e)(1), in the branch profits tax provision, that specifies that a potential branch profits tax exemption under a treaty is only available if the treaty "is an income tax treaty."

[21] For example, the U.S. treaty with Canada seems to be under continual negotiation and amendment by protocols.

[22] On occasion the ratification process takes a considerable period of time. For example, a revised Italy-U.S. tax treaty was signed in 1999. The treated was approved by the U.S. Senate on November 5, 1999 with a reservation concerning a component of the treaty anti-abuse rule. President Clinton signed the "U.S. Instrument of Ratification" but the exchange of "Instruments of Ratification" has not occurred. As reported in Tax Notes, September 29, 2008, p. 1269, the two governments are holding discussions concerning resolving an impasse in the ratification process.

[23] On a positive basis this can enable a U.S. enterprise to use an entity created in a third country (e.g., The Netherlands) to engage in outbound activities in a third jurisdiction (e.g., a

American countries to enter into a bilateral income tax treaty with the "big brother" U.S.A. to the north and, also, the traditional perspective of many middle eastern countries not to enter into economic based treaties with the United States.

C. U.S. Perspectives on Tax Treaty Negotiations

During the early years of the 21st Century the United States Government (i.e., the U.S. Department of the Treasury) appeared to be ambivalent about extending its income tax treaty network.[24] At the beginning of the George W. Bush presidential Administration a considerable period of malaise (or antagonism) appeared to arise concerning whether the U.S. Department of the Treasury should even pursue a program of revising older income tax treaties and expanding the U.S. income tax treaty network.[25] Thereafter, as the U.S. Treasury Department representatives did recognize the value of continuing to modernize the U.S. income tax treaty network

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developing country) with which the U.S. does not have an existing income tax treaty. The benefits of the bilateral tax treaty between The Netherlands and the destination country might be available (and the cost of using The Netherlands as a "conduit country" would often be minimal). If a third country party used The Netherlands - U.S. treaty to come into the U.S. the "limitation on benefits" article of that treaty would impose restrictions on its usage, but in the outbound context (from the U.S.) such limitations are seldom applied (even if limiting provisions are actually included in the pertinent bilateral income tax treaty).

[24] Perhaps some of this hesitancy is practical: a very high percentage (95 percent?) of the investment and commercial transactions into and out of the Untied States are already within the ambit of an existing U.S. bilateral income tax treaty.

[25] Even though most U.S. treaties are negotiated under the jurisdiction of the U.S. Department of State, the bilateral income tax treaty is one of those situations where the treaty is actually negotiated elsewhere within the U.S. Government (i.e., by that Department which has the most interest and expertise, the U.S. Department of the Treasury). Personnel within the Office of the International Tax Counsel (in the Office of the Assistant Secretary of Tax Policy) engage in negotiating these treaties, often acting in conjunction with representatives of the Internal Revenue Service.

they much more vigorously pursued negotiations with multiple trading partners.[26] Whether, after finally being better organized the Obama Administration Treasury official will vigorously pursue expanding and modernizing the U.S. tax treaty network is not certain, but probably should be anticipated to occur.[27]

Often smaller countries with developing economies do want to enter into a bilateral tax treaty with the United States, but the U.S. tax treaty negotiators (being overwhelmed with the volume of their activities) have been known to present the U.S. Model Income Tax Treaty on a "take it or leave it" basis. This is certainly not necessarily the most diplomatic approach to employ in negotiations with another nation state but, from the U.S. Treasury perspective, is time efficient.

One underlying objective of this paper is to emphasize the immense economic and political value to the United States of its bilateral income tax treaty network and the importance to be paid to regularly refining and updating each of these treaties.[28]

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[26] This motivation might also occur because important U.S. commercial interests are making special pleas to the U.S. Government to address these issues for investment into certain selected foreign countries.

[27] Michael Mundaca, Deputy Assistant Secretary (International Tax Affairs), U.S. Treasury Department, in comments made at USA IFA 37th Annual Conference, February 26, 2009, noted that no immediate tax treaty policy changes are anticipated from the Obama Administration.

[28] Perhaps 95 percent of the value of cross-border transactions to and from the U.S. are with jurisdictions with which the U.S. has a bilateral income tax treaty. As noted from the February 2, 2006 testimony of Patricia A. Brown, then Deputy International Tax Counsel (Treaty Affairs), United States Department of the Treasury, before the Senate Committee on Foreign Relations on "Pending Income Tax Agreements" (U.S. Treasury Press Report JS-4001, February 2, 2006), tax treaties are "part of the basic infrastructure of the global marketplace." Subsequent references in this paper to this testimony are identified as "Brown Testimony." For other statements at that February 2, 2006 hearing see: http://foreign.senate.gov/hearings/2006/hrg060202a. Other statements include (1) the Opening Statement of Chairman Richard G. Lugar; (2) the "Testimony of the Staff of the Joint Committee on Taxation Before the Senate Committee on Foreign Relations Hearing on the Proposed Tax Protocols with Sweden and France and the Proposed Tax Treaty with Bangladesh" (JCX-08-06) (identified in this paper as JCT Testimony); and (3)

Hopefully, in this paper this objective is accomplished by identifying a variety of important issues confronting the evolution of U.S. income tax treaty policy.[29] Some of these important issues are identified in a report mandated by the U.S. Congress and (belatedly) delivered by the U.S. Treasury Department.[30]

As identified earlier in this paper, during the last several years of the Bush Administration officials at the U.S. Treasury have seemed to recognize the importance of having a coherent tax treaty policy and have accelerated efforts to solve outstanding income tax treaty issues through a multiplicity of techniques.[31] Hopefully, this effort will continue under the President Obama Administration, but the financial crisis might impede this process as a new U.S. Treasury tax staff at the top levels is being assembled. A further potential complication in this context is the specter of significant U.S. legislative changes concerning the U.S. taxation of income derived by U.S. taxpayers outside the United States. If this U.S. tax system is fundamentally restructured, e.g., from a foreign tax credit system to an exemption

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Testimony of William A. Reinsch, President, National Foreign Trade Council, on "The Ratification of an Income Tax Treaty and Various Protocols."

[29] For a comprehensive (but now somewhat dated) analysis of U.S. income tax treaty policy see American Law Institute, "Federal Income Tax Project; International Aspects of United States Income Taxation II; Proposals on United States Income Tax Treaties" (1992).

[30] See Department of the Treasury, "Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties" (Nov. 28, 2007). The American Jobs Creation Act of 2004, § 806, specified that the U.S. Treasury Department was to "conduct a study of United States income tax treaties to identify any inappropriate reductions in United States withholding tax that provide opportunities for shifting income out of the United States, and to evaluate whether existing anti-abuse mechanisms are operating properly. The study shall include specific recommendations to address all inappropriate uses of tax treaties."

[31] Estate and gift tax treaties have been treated as orphans, presumably on the assumption that the Bush Administration's U.S. Treasury Department is awaiting the final and complete elimination of the federal estate tax. This perspective may change in the President Obama Administration since the probability is that the estate tax will be retained (although its precise configuration remains subject to conjecture).

regime (presumably only with respect to business income) all existing U.S. income tax treaties will need to be renegotiated.

II. The Battle over the "Model Income Tax Treaties"

A. The Battleground

From the U.S. perspective the starting point for considering income tax treaty policy issues has normally been the U.S. Model Income Tax Treaty. Approximately every ten years the U.S. Treasury Department releases its own model income tax treaty, which is to serve as the starting point (from the U.S. perspective) for negotiating income tax treaties. The most recent U.S. model was released late in the year 2006. Even when the 2006 U.S. Model was released it did not deal with some of the positions which had been incorporated into recent bilateral U.S. income tax treaties. For most treaty partner countries, and, in reality, even for the U.S. side, the OECD "Model Income Tax Convention On Income and Capital" has become the de facto starting point for most income tax treaty negotiations.[32]

B. The OECD Model Income Tax Treaty

The Organization of Economic Cooperation and Development (OECD),[33] consisting primarily of the developed countries, also has promulgated its own model

[32] The Model Technical Explanation accompanying the U.S. Model Income Tax Convention dated November 15, 2006 indicates in its preface language to be included in the Technical Explanation to a specific treaty: "Negotiations took into account the U.S. Department of the Treasury's current tax treaty policy, and the United States Model Income Tax Convention of November 15, 2006. Negotiations also took into account the Model Tax Convention on Income and on Capital, published by the Organization for Economic Cooperation and Development (the "OECD Model"), and recent tax treaties concluded by both countries."

[33] The U.S. and 29 other developed countries are the members of the OECD. See Brown Testimony, p. 3.

income tax treaty.[34] Unlike the U.S. Model income tax treaty, the OECD model treaty is "dynamic," i.e., under regular review, analysis, and revision.[35] This model treaty incorporates consensus positions developed after consultation with the representatives of multiple countries.[36] The OECD has working parties (Technical Advisory Groups or "TAGs") regularly examining income tax treaty positions, and the OECD periodically issues updates to incorporate changes or refinements in positions incorporated into its model treaty.[37] Although the United States is an active participant in the OECD, including the regular examination of possible changes to the OECD Model, this is truly an international effort (ordinarily European dominated).[38] Because the OECD Model is under regular review this model treaty has become the real "yardstick" for constructing and revising bilateral income tax

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[34] A condensed version of the OECD "Model Tax Convention on Income and On Capital" (dated July 17, 2008) has been published by the OECD Committee on Fiscal Affairs. This version does include the commentary to each of the treaty articles. A revision of the two-volume looseleaf complete version apparently will be released in the next several months. Electronic access (other through purchase at OECD's website) to the OECD Model Convention is difficult. For an extensive discussion of various elements of the 2008 OECD Model Tax Convention, see European Taxation, Issue No. 9 (2008).

[35] The OECD periodically publishes a condensed period of the loose-leaf publication entitled "Model Tax Convention on Income and on Capital." See, e.g., the seventh edition published during July 2008, as the treaty read on July 17, 2008.

[36] This OECD model treaty (or its prior versions) constitutes the cornerstone for the adoption of approximately 3,000 bilateral tax treaties in the world. This model treaty is accompanied by a "Commentary" providing an explanation of the various provisions. This Commentary is often used by judicial bodies as the controlling legislative history for the interpretation of a particular bilateral tax treaty provision when in litigation over a precise tax treaty issue. During 2008 OECD has celebrated the 50th anniversary of the OECD's model income tax treaty.

[37] Note below are examples of current efforts concerning the refinement of various OECD treaty article applications (i.e., for the scope of Permanent Establishments and personal services).

[38] Another continuing OECD tax treaty group endeavor is to examine the rules relevant to the impact of tax applicability in a cross-border electronic transactions environment.

treaties around the world.[39] The OECD Model significantly influences any current and prospective treaty partners when dealing with the United States on tax treaty matters.[40] Consequently, even the U.S. Treasury Department representatives are often influenced by the OECD Model, more than their traditional perspective of starting negotiations from the U.S. Model Treaty.[41]

The OECD has had multiple projects under analysis with the purpose of revising and refining the OECD model income tax treaty. As examined later in this paper, the OECD has in various stages of developments projects concerning: (1) the definition of a "services" permanent establishment, (2) the attribution of profits to

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[39] In its 1992 study of tax treaties the ALI report states that: "[a]lthough bilateral treaties sometimes adopt individual provisions which vary from those set forth in the OECD Model, these variations are relatively minor when compared to the very large number of instances in which provisions are patterned after the OECD text. The OECD Model Treaty therefore has come to have a special significance. Although it technically is not binding on any country, it has almost acquired the status of a multilateral instrument." See ALI, "Federal Income Tax Project: International Aspects of United States Income Taxation II: Proposals on United States Income Tax Treaties," at p. 3 (1992).

[40] Although the United Nations also has a model income tax treaty available for the use of developing countries in negotiating treaties often those developing countries will agree to the use of the OECD model income tax convention as the starting point for negotiations. See Baistrocchi, "The Use and Interpretation of Tax Treaties in the Emerging World: Theory and Implications," British Tax Review, No. 4, 2008; also available at: http://ssrn.com/abstract=1273089. Treaties between developed countries and developing countries are here described as "asymmetric" because of the economic imbalance between the treaty partners.

[41] Some do not agree that the agenda of the OECD in the tax context is to promote a reasonably balanced income tax treaty approach, but, rather, assert that the OECD is a multilateral institution primarily constituting a conspiracy to keep tax rates high. See Daniel J. Mitchell, "The Paris-Based Organization for Economic Cooperation and Development: Pushing Anti-U.S. Policies with American Tax Dollars," January 2006, a "policy analysis from the Center for Freedom and Prosperity Foundation", website: www.freedomandprosperity.org. The position espoused there is that the OECD "international bureaucracy endorses higher taxes, more spending and tax harmonization. These policies may be in the short-term interest of the high-tax nations that dominate OECD decision-making, but they surely are not in the interests of the United States."

permanent establishments, and (3) the treatment of temporary services in the destination country. Further, the OECD is initiating a project to examine the tax treatment of "collective investment vehicles."[42]

C. Evolution of the U.S. Model Income Tax Treaties

Since its release the earlier 1996 U.S. model income tax treaty became significantly outmoded, particularly when contrasted with the subsequently implemented bilateral U.S. income tax treaties.[43] Treaty negotiators from treaty partner countries were quite aware of this evolution of position as to many provisions in the U.S. Model Treaty and could piece together the changes implemented in the most recently negotiated income tax treaties, so as to discern the current probable negotiating position of the U.S. on a particular treaty issue. In some instances the U.S. Treasury also indirectly indicated that its tax treaty negotiating position had fundamentally changed (at least as to those countries in basically the same economic situation). For example, in the U.S. Treasury Department's Technical Explanation

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[42] See "OECD Officials Discuss Tax Treaty Projects," 2006 TNT 246-1 (December 21, 2006), noting that large cross-border portfolio investments held through collective investment vehicles and global custodians total more than US $16 trillion. Jeffrey Owens, head of the OECD's Centre for Tax Policy and Administration, on December 18, 2006 announced that an informal consultative group of government and private sector representatives, under the auspices of the Centre for Tax Policy and Administration, would tackle the tax treaty issues raised by large cross-border portfolio investments. The OECD recruited Patricia Brown, formerly deputy international tax counsel (treaty affairs) at the U.S. Treasury Department, to provide full-time support for the project. "Brown said it is very important that investors, including pension funds, using collective investment vehicles and global custodians to invest cross-border be able to claim treaty benefits when appropriate. Few treaties address investment funds, Brown said, and the consultative group will consider issues such as how to determine the actual beneficiary of the investment income and administrative issues resulting from a large number of beneficiaries."

[43] For example, in revised treaties with Japan, the United Kingdom, The Netherlands, Mexico and Sweden the withholding tax at source on dividends paid by an affiliate to its foreign parent corporation was eliminated, as examined below. The 1996 Model income tax treaty provided for a minimum five percent on such dividends (but the 2006 revision did not implement this zero withholding approach adopted in some treaties).

to the U.K.-U.S. income tax treaty the U.S. Treasury Department indicated that in those treaty negotiations the parties took into account recent income tax treaties concluded by both parties, signaling that in some areas U.S. fundamental positions have changed.

Some (but not all) of these revised U.S. tax treaty position were incorporated into the 2006 U.S. Model income tax treaty, released on November 15, 2006.[44] Quite importantly, the 2006 U.S. Model does not include the zero withholding rate on dividends paid to parent corporations in the treaty partner jurisdiction.[45] As examined below, a zero withholding rate on these dividends has been incorporated into some (but not all) U.S. bilateral tax treaties negotiated after the release of the 2006 model treaty.

III. Structural Considerations

A. The U.S. Tax Treaty Ratification Process

The U.S. tax treaty ratification process itself has some interesting political components which influence attitudes towards U.S. tax treaty policy. Under the United States Constitution a treaty (including a tax treaty) must have the "advice and consent" of the U.S. Senate to achieve its effectiveness. Under international protocols a U.S. tax treaty does not technically become effective on the U.S. side until (after submission of the treaty to the U.S. Senate) both (1) the U.S. Senate has approved the treaty and, (2) thereafter, an exchange between the two governments of ratification instruments has occurred.

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[44] See 2006 TNT 221-20, "Treasury Releases New U.S. Model Income Tax Convention."

[45] For a comparison of the 2006 U.S. model income tax treaty with its 1996 predecessor see Joint Committee on Taxation, "Comparison of the United States Model Income Tax convention of September 15, 1996 with the United States Model Income Tax Convention of November 15, 2006", (JCX-27-07), May 8, 2007.

Under the rules of the United States Senate the matter of the ratification of treaties (including tax treaties) is within the jurisdiction of the Senate Committee on Foreign Relations.[46] Jurisdiction over tax treaties does not reside with the Senate Finance Committee (much to this Committee's consternation, apparently), even though the Senate Finance Committee does have general jurisdiction over federal taxation matters. During the prior 109th Congress this lack of jurisdiction apparently generated some feelings of resentment from members of the Senate Finance Committee who view the subject of taxation as within their particular domain.[47] This problem was (unsuccessfully) sought to be resolved by a change in the rules of the

[46] At a February 2, 2006 Senate Foreign Relations Committee hearing concerning various pending U.S. income tax treaties then Chairman Richard Lugar indicated that maintaining and expanding the U.S. tax treaty network was a "vital endeavor." See "Senate to Move Quickly on Pending Tax Treaties with Sweden, France, Bangladesh," 2006 TNT 23-4 (February 2, 2006).

[47] See Senate Standing Rule XXV(j)(1)(17) which specifies that the Senate Foreign Relations Committee has jurisdiction over treaties and executive agreements, except reciprocal trade agreements, and Standing Rule XXV(1)(7) which indicates that the Senate Finance Committee has jurisdiction over reciprocal trade agreements.

U.S. Senate.[48] This issue apparently did not publicly surface in the 110th Congress and its status as an issue in the 111th Congress is problematical.

As required by the U.S. Constitution, the U.S. House of Representatives is the body where federal tax legislation must originate.[49] Tax treaties do not constitute tax legislation for the purpose of this constitutional provision. Since treaties are subject to the "advice and consent" of the U.S. Senate (and not the U.S. House of Representatives) the tax writers on the Ways & Means Committee in the House of Representatives are also not much interested in the tax treaty process. For this reason these House of Representatives tax writers are more inclined to adopt legislation which may even be contrary to (i.e., "override") a tax treaty provision, since they have little political capital invested in the bilateral tax treaty process and they are often

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[48] An interesting proposal concerning this tax treaty review jurisdiction was included in S. 1637, 108th Congress, 1st Sess., the "Jumpstart Our Business Strength Act," (i.e., JOBS), as included as Act Section 236 in the modification of the Chairman's Mark, passed by the Senate Finance Committee on October 1, 2003. The Senate Committee on Foreign Relations was to be required to consult with the Senate Committee on Finance with respect to proposed tax treaties prior to reporting any such treaty to the Senate. The Senate Committee on Finance would be required to respond in writing within 120 days of receipt of a request for consultation from the Senate Committee on Foreign Relations. If the Senate Committee on Finance did not respond within this time period the Finance Committee would be considered to have waived the right to consult with respect to the provisions of the tax treaty. The Senate Committee on Foreign Relations would be required to consider the views of the Senate Committee on Finance when reporting a tax treaty to the Senate and would be required to include the views of the Senate Committee on Finance in its report to the Senate. This legislation was to provide an amendment to the "Standing Rules of the Senate," Rule XXV, paragraph 1(j), rather than an amendment to the Internal Revenue Code. See JCX-85-03, JCT Description; and, JCX-87-03, JCT Description, "Additional Modifications to the Chairman's Mark of S. 1637," the "Jumpstart Our Business Strength ('Jobs') Act", October 1, 2003. This proposal did not survive into the final legislation, but presumably the Senate Finance Committee (when then in control of the Republicans) made its point on this issue at that time.

[49] The U.S. Constitution, Article 1, Section 7, Clause 1, provides that all bills for raising revenue shall originate in the House of Representatives; but the Senate may propose or concur with amendments as on other bills.

somewhat inimical to tax treaties as being part of the U.S. international tax structure.[50]

A delicate balance does exist in this context. One result of the requirement in the U.S. Constitution that tax raising bills originate in the House of Representatives is that a U.S. bilateral tax treaty can only reduce potential U.S. tax liabilities. It can not be used to impose any additional tax liabilities on any taxpayer.

B. U.S. Budget Impact of Tax Treaties

Since U.S. tax treaties can not be used to increase a taxpayer's U.S. tax liability, with respect to U.S. income of foreigners the impact of a tax treaty will only be to produce a revenue loss to the U.S. Government.[51] Of course, for U.S. taxpayers, if the tax is reduced in the tax treaty partner's (foreign) jurisdiction and, thereby, the income is subject to U.S. tax (without a foreign tax credit offset) the overall U.S. revenues might be increased. Thus, the net effect of an income tax treaty is that U.S.

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[50] In July 2007 the House passed the farm bill (H.R. 2419) that included a provision that would prevent foreign parent companies from benefitting from reduced withholding rates (otherwise available through the U.S. tax treaty network) on cross-border interest and royalty payments. Code § 894 would be amended to limit treaty benefits associated with deductible cross-border payments between related parties. Senate Finance Committee ranking minority member Grassley has indicated his opposition to this tax provision in the House farm bill, asserting that it violates current U.S. income tax treaties. He noted that if lawmakers want to change tax treaties they should be renegotiated rather than being "unilaterally" undercut. See "Grassley Warns Against Violating Tax Treaties With Farm Bill Tax Provision," 2007 TNT 159-2 (Aug. 16, 2007). Note, however, "Senate Should Enact the Doggett Proposal to Close Loophole That Allows Foreign Corporations to Dodge Taxes on U.S. Profits," a Citizens for Tax Justice release, which asserts that this proposal actually enforces the rules specified in our treaties, rather than violating them. See 2007 TNT 155-24 (Aug. 8, 2007).

[51] Compare the situation in Australia where the Australian Taxation Office takes the position that tax treaties do bestow an independent taxing power. See "ATO Issues Statement on Treaty Right To Independent Taxing Power," Tax Notes International, Feb. 16, 2009, p. 573, noting that this position is contrary to the conventional view that treaties only allocate taxing powers.

government tax revenues might be reduced or be increased by particular tax treaty provisions, dependent upon overall capital flows between the several countries.

Note that the Joint Committee on Taxation may very well consider the impact of income tax treaties and protocols. Of course, U.S. Government revenue estimators have regularly considered the tax revenue impact of tax treaties, but that information has not normally been publicly available. Interestingly, during the year 2006 the Joint Committee on Taxation did indicate that the proposed protocols to income tax treaties with Sweden, France and Bangladesh and a proposed protocol to the Estate, Inheritance and Gift Tax Treaty with France would only "cause a negligible change in Federal budget receipts during the fiscal year 2006-15 period."[52] With respect to the agreements with Sweden and Bangladesh (but not France) the JCT statement notes that these estimates were "based solely on the amount and type of historical income flows between Sweden and the United States." The impression is that the JCT does not project that these agreements will enhance (or reduce) economic flows in either direction between these treaty partners.

Whether this observation would be accurate in all tax treaty discussions would seem quite problematical. The U.S. regularly agrees to the imposition of some withholding tax at source in tax treaties with developing countries, since the capital flows of investment income in those situations will be predominantly in the direction of the U.S. If those withholding taxes at source are reduced or eliminated, the U.S. should benefit from taxation on the enhanced flows of investment income into the U.S., but the repatriations of those earnings may then merely be longer delayed.

Folklore suggests that the renegotiation of the Japan - U.S. Income tax treaty was long delayed by the U.S. Treasury Department because the benefits were tilted heavily in favor of the U.S. This was asserted to occur because considerably more interest and dividend income was assumed to flow outbound from the U.S. to Japan (rather than vice versa). A publicly released revenue estimate for this revised treaty has not been identified.

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[52] Joint Committee on Taxation, "Budget Impact of the Proposed Tax Protocols With Sweden and France and the Proposed Tax Treaty with Bangladesh," JCX-11-06 (February 16, 2006).

C. Confronting the European Union Perspective

The U.S. has separate bilateral income tax treaties with all the members of the European Union (EU), including, recently, a proposed treaty with Malta.[53] This total number is more than one-half of the existing bilateral income tax treaties of the United States. Eventually, the U.S. perhaps will have one tax treaty with the EU which will encompass all the members of the EU. This would be consistent with the assertion by EU countries and others (e.g., U.S. multinational corporations) that the EU countries should be treated as "one country" for Subpart F purposes. Such Subpart F treatment would enable the cross border payment of dividends, and sales and service payments between affiliates, without those items being treated as Subpart F income.[54]

A much larger issue has arisen, however, which has wide ranging implication for U.S. tax treaty policy with the EU and its members. Under the EU "Freedom of Establishment Principle" Article 43 of the EU treaty provides that "within the framework of the provisions set out below, restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited. Such prohibition also applies to restrictions on the setting-up of agencies, branches or subsidiaries by nationals of any member State established in the territory of any member State." Further, Article 48 of the EU treaty provides that "companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the [European] community shall, for the purposes of this Chapter, be treated in the same way as natural persons who are nationals of member States."

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[53] Apparently a former tax treaty between Malta and the United States was terminated because of tax haven/treaty shopping concerns. See John Iekel, "U.S.-Malta Tax Treaty Terminated; U.S., Swiss Officials to Resume Treaty Talks, 11 Tax Notes Int'l 1426 (Nov. 27, 1995).

[54] Of course, the careful use of disregarded entities (available because of the "check-the-box" rules) can essentially obliterate the applicability of this rule. This can result where all the entities below an offshore holding corporation are, e.g., limited liability companies, categorized as conduit entities for federal tax purposes.

The essence of these provisions is that this "freedom of establishment principle" requires that an EU member state treat companies or individuals of another member state as its nationals. In several situations the European Court of Justice (ECJ) has noted this principle in repealing EU member states' tax legislation that restricted the benefits of the legislation to nationals of the particular enacting EU member state and, thereby, discriminated against the nationals of another member state. For example, in the Compagnie de Saint Gobain case[55] the ECJ ruled that the "freedom of establishment" principle requires that a member state that is a party to a bilateral international treaty for the avoidance of double taxation with a nonmember state must grant to permanent establishments of companies resident in another EU member state the same advantages that companies resident in the first EU member state receive.

The objective here is to note that U.S. income tax treaty policy is increasingly at odds with decisions of the European Court of Justice concerning these issues (and not to discuss the particular, increasingly numerous cases in this context).[56] What this does suggest is that the U.S. perhaps needs to eventually reconsider its approach to tax treaties - from a bilateral approach to (at least with the EU) a multilateral approach. The U.S. and the OECD already have model income tax treaties (as noted above) and a great amount of similarity exists between these treaties. Most bilateral treaties are based on the OECD model, but the model is continually evolving and, additionally, each, tax treaty negotiation is unique.[57] Consequently, fundamental differences also do exist (particularly with respect to the applicability of a "limitation on benefits") provision.

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[55] ECJ, C-307/97, Sept. 21, 2001.

[56] For a quite useful analysis in this context see Mason, "U.S. Tax Treaty Policy and the European Court of Justice," 59 Tax Law Review 65 (2005).

[57] Note from Mason, "U.S. Tax Treaty Policy and the European Court of Justice," 59 Tax Law Review 65 (2005), at p. 56, that for every country in the EU to have a bilateral treaty with every other Member State and the United States, 325 such treaties would be required.

A precedent in this context for moving forward with a multilateral approach might be the EU-OECD "Convention on Mutual Assistance in Tax Matters," which provides for exchange of information relevant to the enforcement of domestic tax laws and assistance in the collection of taxes.[58] Fourteen countries, including the United States and eight EU countries, have signed this convention. The United States does participate in the information exchange but not administrative assistance or tax collection components under this multilateral treaty.[59]

IV. The Process for the Interpretation and Application of Tax Treaties

A. Basic Approaches to Tax Treaty Analysis

In considering applicability of the provisions of a tax treaty a wide variety of techniques (some unique to the tax treaty context) are available to amplify and interpret tax treaty provisions.[60] In researching a narrow issue in the domestic

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[58] See OECD "Convention on Mutual Assistance in Tax Matters," Jan. 25, 1988.

[59] In a peripheral context, under the "check-the-box" rules the U.S. does recognize the EU's common business entity, i.e., the "Societas Europaea," categorized for federal tax purposes as a "per se" corporation. See Reg.§ 301.7701-2(b)(8).

[60] Tax advisors are sometimes prone to forget that tax treaties are a variant of international agreements. As such, they are subject to the rules for the interpretation of treaties as specified in the Vienna Convention on the Law of Treaties (May 23,1969), UNTS 11155, p. 331. On occasion the favorable interpretation of an income tax treaty may be facilitated through the use of those international law rules. For a detailed examination of this treaty interpretation process, under the rules of the Vienna Convention, see Gardiner, "Treaty Interpretation," Oxford University Press, 2008. Courts outside the United States may be especially prone to use the Vienna Convention to interpret treaties, perhaps to the detriment of the U.S. taxpayer. Of particular relevance is Article 31 of this treaty which specifies a "general rule of interpretation":
"1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.
"2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:
(a) any agreement relating to the treaty which was made between all the parties in connection

statutory context a tax planner will examine the potential existence of a solution in U.S. Treasury Regulations, a published Revenue Ruling, a Revenue Procedure, private letter rulings, and other IRS pronouncements. This universe of interpretive material is similarly applicable and available in the tax treaty context, but the possibilities of significant additional resources must be considered. The identification of these additional sources reinforce the premise of this article, i.e., that tax treaties are of a unique character to be considered in tax planning.

The Commentary to the OECD Model Tax Convention and the Model Technical Explanation to the 2006 U.S. Model Tax Treaty are often useful places to start, but this represents only the beginning of the process. Reference to the U.S. Technical Explanation reminds us that (1) the bilateral income tax treaty is a two-party agreement, but (2) the U.S. Technical Explanation is ordinarily only a one-party document (i.e., a unilateral pronouncement by the U.S. Treasury Department). The U.S. Technical Explanation for a treaty provides the perspective from the U.S. side concerning a particular tax treaty provision. However, in the interpretation of a particular provision the treaty partner country may not be in agreement. If considered in advance of particular bilateral tax treaty negotiations, a specific issue might be considered and addressed in any accompanying exchange of diplomatic "notes," but often these issues are not adequately addressed until being identified after the treaty becomes effective.

The U.S. Technical Explanation of the particular bilateral income tax treaty, often released shortly after the conclusion of a new (or reviewed) treaty, is ordinarily

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with the conclusion of the treaty;

(b) any instrument which was made by one or more of the parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.

"3. There shall be taken into account, together with the context:

(a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;

(b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;

(c) any relevant rules of international law applicable in the relations between the parties.

"4. A special meaning shall be given to a term if it is established that the parties so intended."

only the U.S. Treasury's perspective. The U.S. Treasury Department representatives may have given their counterparts from the treaty partner country an advance opportunity to comment on the draft Technical Explanation, but the U.S. Treasury representatives may not have included any objections or adverse comments when releasing that specific Technical Explanation. Ordinarily, the treaty partner country does not release its own Technical Explanation (or other interpretive guidance) or release a statement of objection to the U.S. release of a Technical Explanation, so tax advisors may not necessarily be able to identify where the conflicts exist.

In some limited situations the treaty partner country may have reviewed the pertinent Technical Explanation and have actually agree to its substance. This has occurred with the U.S. Treasury's Technical Explanation to the Canada-U.S. protocol. This Technical Explanation states that the Government of Canada has reviewed this Technical Explanation and subscribes to its context. This Technical Explanation specifies that in the view of both governments this document accurately reflects the policies behind the particular protocol provisions, as well as the understandings reached regarding the application and interpretation of the protocol and the convention. The Government of Canada's participation in the preparation of this Technical Explanation were confirmed in a press release issued by the Canadian Department of Finance on July 10, 2008. The agreement of the Government of Canada in this Technical Explanation will presumably enhance its status as providing authority for interpreting and applying this Protocol.[61]

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[61] Note the "Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Canada," Staff of the Joint Committee on Taxation, JCX-57-08, p. 112, July 8, 2008, stating that it may be more likely that a court would view the Technical Explanation as expressing the mutual intent of both treaty countries if (1) the Technical Explanation is expressly endorsed by the Canadian Government, such as through the issuance of a press release, and (2) the U.S. Senate fully embraces all aspects of the Technical Explanation during the ratification process. In the absence of an express endorsement by the Canadian Government, Senate support for the Technical Explanation clearly would not be sufficient to establish the mutual intent of the treaty partners. On the other hand, the absence of Senate support could undermine the status of the Technical Explanation as a mutual agreement, even if the Technical Explanation is expressly endorsed by the Canadian Government. If the Canadian Government and the Senate both favorably embrace the Technical Explanation, U.S. courts may also find it persuasive that at least one

B. Tax Treaty Interpretation by Reference to Foreign Law and Foreign Courts

Many provisions in income tax treaties are quite uniform (including being consistent with the OECD Model Income Tax Convention, having provisions similar to those in a specific U.S. Income Tax Treaty). Consequently, the primary source of guidance in this context for the resolution of tax treaty controversies in foreign courts is often the Commentary to the OECD Model Treaty (perhaps as existing as of the time that the particular treaty was implemented, rather than as that commentary has evolved to its current status). This commentary is provided by the OECD Secretariat as a detailed explanation of the various articles of a tax treaty. The question often arises in the U.S. concerning whether foreign legal authority, such as a court decision in a foreign jurisdiction, or analysis such as the OECD Commentary (if even treated as "authority"), is relevant and, perhaps, persuasive, in resolving a controversy in a U.S. court involving a similar income tax treaty provision. For example, in The Taisei Fire and Marine Insurance Co., Ltd. v. Commissioner,[62] Judge Tannenwald relied on the commentary to the 1963 OECD Draft Model Convention in examining whether a "permanent establishment" existed (when Japanese property and casualty insurance companies were enabled to write reinsurance through a U.S. corporation operating in the United States). Further, in this case a decision of the Federal Republic of Germany Tax Court (at Bremen) was cited in the Tax Court's opinion as being relevant.[63] Although noting that this case had clearly distinguishable facts, the implication is that the foreign court authority, here a German case, could certainly be exceedingly useful in the Tax Court's decision making, if relevant.

Canadian court has relied on a Treasury technical explanation, based on Canada's representation that it accurately reflected the understandings reached during negotiation of the 1983 Protocol. Given the lack of deference shown by U.S. courts in cases in which a technical explanation is viewed as unilateral in nature, the Committee may wish to inquire whether Treasury intends to pursue agreed technical explanations in future negotiations with other treaty partners.

[62] 104 T.C. 535 (1995), acq. 1995-2 CB 1.

[63] This was a proceeding involving the application to a German insurance agent of the "independent agent" provision of the Germany-Netherlands Income Tax Treaty.

Similarly, in a supplemental memorandum opinion in Podd v. Commissioner,[64] the court noted that:

"Paragraph 2 of Article IV [of the U.S.-Canada treaty] would require a decision as to whether petitioner had a permanent home available to him in either the United States or Canada ... during 1990. Art. 4, par. 2 [of the OECD Model Treaty (1977] contains substantially the same language as the above-quoted Art. IV., par. 2, of the Canada Convention. The commentary to the [OECD] Model Treaty ... further explains the requirements of Model Treaty Art. 4. Because both the United States and Canada were OECD members when the Model Treaty and the commentary were drafted, courts have used the commentary to interpret income tax treaties between the United States and Canada. See United States v. A.L. Burbank & Co., 525 F.2d 9, 15 (2d Cir. 1975); Birth W. Life Assurance Co. of Canada v. Commissioner; see also Taisei Fire & Marine Ins. Co. v. Commissioner ... (which construed the [United States-Japan treaty] with reference to the Model Treaty and its commentary)."

The Tax Court of the United States does not seem reluctant to refer to foreign law, or international understandings (e.g., the Commentary to the OECD Model Tax Treaty), when seeking to determine results in particular situations involving the application of U.S. tax treaty concepts. Outside the tax context, however, reliance on foreign law seems to have become a highly volatile issue in the United States.[65] Consequently, litigants, planners and, particularly judges, should take note of these

[64] Tax Court Memo 1998-231 (1998).

[65] For example, during the 109th Congress the "Constitution Restoration Act" was introduced by Rep. Aderholt (R-Ala) and Sen. Shelby (R-Ala). H.R. 1070, 109th Congress, and S. 520, 109th Congress. This legislation would provide that "[i]n interpreting and applying the Constitution of the United States, a court of the United States may not rely upon any constitution, law, administrative rule, Executive order, directive, policy, judicial decision, or any other action of any foreign state or international organization or agency, other than English constitutional and common law up to the time of the adoption of the Constitution of the United States."

developments outside the tax context.[66] Although prospects for its eventual enactment might be limited, and even though most tax decisions involving tax treaties do not ordinarily involve "constitutional issues," from these developments a "chilling effect" on court opinion writing (including in the U.S. Tax Court) might be observed.[67]

Whether this "chilling effect" will eventually spill over more substantially into the tax adjudication context in the United States is difficult to predict. Perhaps, however, these judges in U.S. tax cases are becoming aware of the (probably political) risks in relying on foreign (including international organization) laws and model rules.

[66] Note that in an October 28, 2003 speech by (now former) Justice Sandra Day O'Connor to the Center for International Studies in Atlanta, where she received the "World Justice Award", she indicated (commenting on the Texas sodomy case, Lawrence v. Thomas) that she and her colleagues on the Supreme Court had looked to international norms in the Lawrence case and another recent case involving the execution of the mentally retarded. She noted that "over time we will rely increasingly, or take notice at least increasingly, on international and foreign courts in examining domestic issues." In the November 1, 2003 issue of the Christian Coalition's weekly report the Christian Coalition suggested that this comment meant that Justice O'Connor would ignore the U.S. Constitution, adding that such a move "seems to be an impeachable offense." See BNA Daily Report for Executives, November 4, 2003, page A-17. What does this imply for (lower level) U.S. judges in U.S. tax cases who might have the audacity to rely on the OECD Model Treaty commentary? Perhaps tax cases will be "under the radar" on this issue.

[67] Similarly, on January 13, 2005 a forum at American University Law School entitled "Foreign Courts and U.S. Constitutional Law" occurred at which U.S. Supreme Court Justices Scalia and Breyer debated this precise issue. Justice Breyer stated that reference to foreign law was appropriate, noting "I may learn something" and "[f]oreign law doesn't determine the result, but it shows what other people have done." But, Justice Scalia indicated that it is "arrogant" to rely on foreign law to determine issues in the United States, noting that "if we don't want [foreign law] to be authoritative, then what is the criteria for using it?" See BNA Daily Report for Executives, January 14, 2005, p. A-32.

C. The "Memorandum of Understanding" (MOU) Approach

1. The Function of the MOU

When significant specific technical issues arise concerning tax treaty interpretation the question often presents itself concerning whether the treaty should be amended by protocol or whether that process can be avoided through the issuance by the Service of either (1) a unilateral interpretation, or (2) some other agreement with an authorized representative of the other government, such as a "Memorandum of Understanding" (MOU). An important element of this discussion is that, on the U.S. side, the MOU is treated as not necessitating the U.S. Senate's "advice and consent" (as is required for a treaty or a protocol, a document which amends the treaty). The position of the Service in implementing a MOU is that it is merely an interpretation of provisions within the treaty and, therefore, is permitted within the already existing jurisdiction of the Competent Authority. The Service seems increasingly willing to use the MOU technique in a variety of areas, premised upon the assumption that the basic subject matter is already included within the fundamental scope of the income tax treaty itself (and, therefore, the authority exists to interpret and apply the terms of the existing treaty). Over the last several years the Service and U.S. Treasury have been active in the implementation of MOUs. These are signed on behalf of the U.S. Government by the Director, International (LMSB), as the IRS "Competent Authority," thereby indirectly representing that these are merely administrative decisions (and, consequently, that they do not necessitate U.S. Senate approval).[68]

In contrast, a "protocol" to a tax treaty does constitute an amendment to the original treaty, thereby necessitating further "advice and consent" from the U.S. Senate before it can become effective. Whether a protocol is required (rather than merely a unilateral interpretation) can be a close issue, and, of course, the U.S. government representatives would like, if possible, to avoid the necessity of being forced to clear the hurdle of obtaining Senate approval when the Senate (perhaps

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[68] A complete listing of these various MOUs and similar agreements is provided on the IRS website. See www.irs.gov/businesses/small/international/competent authority agreements

quite recently) has approved the tax treaty itself. This ratification process both takes time and requires a serious, rational explanation to be made to the Senate Foreign Relations Committee by both U.S. Treasury Department representatives and members of the Staff of the Joint Committee on Taxation. Examples of various recent MOUs are noted below.

2. The Japan-U.S. MOU

The U.S. and Japan have entered into a MOU on the meaning of the term "investment bank" under the U.S.-Japan income tax treaty.[69] The treaty exempts investment banks resident in the other contracting state from source country taxation of interest income. This agreement specifies that this provision will only apply where "investment bank" activities constitute at least sixty percent of the bank's gross income for each of the three tax years preceding the tax year in which the interest payment arising from the "investment bank activity" is made.

3. The Canada-U.S. MOU

The U.S. and Canada have entered into a MOU on the resolution of factual disputes under the mutual agreement procedure (or "MAP") specified in the Canada-U.S. income tax treaty.[70] If "factual" disputes are not resolved within six months of inception of the proceeding those disputes can be forwarded to administrative appeal

[69] IRS Announcement 2006-6, 2006-1 C.B. 340; electronic citation 2006 TNT 14-7 (January 23, 2006).

[70] IRS Announcement 2006-7, 2006-1 C.B. 342; electronic citation 2006 TNT 14-8. The purpose of this MOU is to establish an independent review process for resolving disagreements regarding the underlying facts and circumstances ("factual disagreement") of a specific mutual agreement procedure case for further negotiations by the Competent Authorities. A factual disagreement is identified as a disagreement concerning any of (i) whether a fact has occurred (e.g., whether a party made a payment or not), (ii) the relevance of a fact agreed to exist (e.g., if the payment was made, is that fact relevant to determining the transfer price for transactions covered by the MAP case), or (iii) the significance to be accorded a fact agreed to exist (e.g., what significance should be given to the fact that a payment was made).

bodies of the U.S. and Canada, and the decisions will be binding on the competent authorities.

4. The Mexico-U.S. MOU

The U.S. and Mexico have entered into a MOU concerning limited liability companies and the treatment of fiscally transparent entities under the Mexico-U.S. income tax treaty.[71]

5. The Switzerland-U.S. MOU

An "Agreement on Treaty Benefits" was concluded between the U.S. and Swiss competent authorities regarding the "Limitation of Benefits" Article of the income tax treaty, with an accompanying "Revised Memorandum of Understanding" between the United States and the Swiss Confederation.[72]

D. Tax Information Exchange Agreements

A further U.S. alternative (or supplement) to a bilateral income tax treaty is the "Tax Information Exchange Agreement" (TIEA). This approach is often used when

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[71] See IRS Announcement 2006-8, 2006-1 C.B. 344; electronic citation 2006 TNT 14-9, indicating that it is understood that income from sources within one of the Contracting States received by an entity that is organized in either of the Contracting States, or a third state with which Mexico has in force a comprehensive exchange of information agreement, and that is treated as fiscally transparent under the laws of either Contracting State will be treated as income derived by a resident of the other Contracting State to the extent that such income is subject to tax as the income of a resident of the other Contracting State. See prior IRS Announcement 2005-72, 2005-2 C.B. 692, providing News Release IR-2005-107, indicating that the U.S. and Mexico had reached a mutual agreement regarding the eligibility of entities that are treated as fiscally transparent under the laws of either country for the benefits of the 1992 U.S.-Mexico Income Tax Treaty.

[72] IRS Announcement 2003-59, 2003-2 C.B. 746, and IR-2003-103, August 22, 2003. Note that the Swiss government on March 25, 2009 gave approval for its tax authorities to begin talks with the United States on incorporating OECD information exchange standards into the existing Switzerland-U.S. tax treaty. See 2009 TNT 56-5, March 26, 2009.

the U.S. Treasury has little incentive to enter into a complete bilateral income tax treaty. This is often because the economy in the partner country is not significant, and perhaps because that country is perceived as a "tax haven" country. However, the U.S. may desire to extend a "carrot" to those countries so that the IRS (and the U.S. Department of Justice) can obtain a "stick" to use to obtain information from those countries, often islands located in the Carribean.[73] During the last several years the U.S. Treasury Department seems to have been particularly motivated to conclude further TIEAs.[74]

For example, the U.S. entered into a TIEA with the Netherlands Antilles (entry into force on March 22, 2007),[75] the British Virgin Islands (March 10, 2006), the Cayman Islands (March 10, 2006), and Jersey (June 26, 2006). For example, the Netherlands Antilles agreement specifies that "[t]he Contracting States shall assist each other to assure the accurate assessment and collection of taxes, to prevent fiscal

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[73] A "carrot" includes the designation of that country as being within the "North American area" for purposes of Code § 274(h), thereby enabling the U.S. income tax deductibility of expenses incurred in conventions and business meetings in those areas. See Rev. Rul. 2007-28, 2007-1 C.B. 1039.

[74] The U.S. Department of the Treasury may be even more motivated to implement TIEAs and other information gathering arrangements during the Obama Administration. See "Obama Backs Crackdown on Tax Havens,"November 9, 2008 at
www.guardian.co.uk/business/2008/nov/09/barack-obama-tax-havens-crackdown
This U.K. source indicates that then President-elect Barack Obama planned to crack down on international tax havens, including Jersey, Guernsey and the Isle of Man, within weeks of taking power in January, "putting him on a collision course with Gordon Brown." This article notes that then President-Elect Obama was one of the signatories of the "Stop Tax Haven Abuse Act" introduced into the U.S. Congress last year that "blacklisted" more than 30 jurisdictions and that "[k]ey aides to Obama said he will introduce a similar law as part of a wide-ranging revenue-raising and tax reform package, within weeks of taking power."

[75] See "Treasury Release Announcing Entry into Force of U.S.-Netherlands Antilles Tax Information Exchange Agreement," dated March 29, 2007. This agreement had been pending since signed by former U.S. Treasury Secretary Paul O'Neill and the former Prime Minister of the Netherlands Antilles on April 17, 2002. See 2007 TNT 62-8.

fraud and evasion, and to develop improved information sources for tax matters. The Contracting States shall provide assistance through exchange of information ....”[76]

The U.S. entered into a TIEA with Brazil on March 20, 2007.[77] Note, of course, that Brazil (1) is not a country in the Carribean and (2) is not a perceived to be a “tax haven.” Brazil was a party to an ill-fated income tax treaty with the U.S. some years ago which failed ratification in the U.S. Senate because of the inclusion of a “tax-sparing” provision.[78] The inclusion (or non-inclusion) of that provision apparently still remains a “deal-breaker” from the perspective of the U.S. Senate.[79] In the TIEA negotiations situation apparently the parties agreed that disagreements about tax treaty policy are so significant that they still cannot implement an income tax treaty.[80] Perhaps this disagreement is also the result of antipathy towards the U.S.

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[76] Netherlands Antilles Agreement, Article 1(1). This agreement can be located electronically at 2002 TNT 75-22.

[77] See “U.S. Brazil Sign Tax Information Exchange Agreement,” U.S. Treasury Department Press Release, HP-335 (March 30, 2007), available at: http://www.treas.gov/press/releases/hp335.htm. Links are provided there to the “U.S., Brazil Tax Information Exchange Agreement” and the “U.S., Brazil TIEA Joint Declaration.”

[78] The objective of a “tax sparing” provision is to make available in the residence country permit a foreign tax credit for taxes not paid in the source country, but which would have been paid absent a tax holiday in the source (or destination) country (e.g., Brazil).

[79] Brazil does have tax treaties with about 25 other countries but apparently none of these treaties provide much relief for inbound investors. Comments of Michael Mundaca, Deputy Assistant Secretary (International Tax Affairs), U.S. Treasury Department, made at USA IFA 37th Annual Conference, February 26, 2009.

[80] The “Joint Declaration” notes: “The business community has long expressed its concerns that the statutory measures to relieve double taxation under the laws of both the United States and Brazil do not adequately mitigate the tax-related barriers to cross-border investment, and that the conclusion of a bilateral income tax treaty could contribute to ameliorate these issues. The United States and Brazil, however, diverge on a number of important areas of tax treaty policy, making the conclusion of a mutually acceptable tax treaty difficult.

“Nevertheless, the Governments of both countries hope that the signing of this Agreement by many South American countries, resulting in only a very few income tax treaties between the U.S. and South American countries (i.e., only Venezuela - strangely, considering current political conditions, and Mexico (not located in South America)). Apparently, some negotiations with Chile have occurred.[81]

The expansion of bilateral agreements for the exchange of information (particularly with "tax haven" or "tax secrecy" countries) is not limited to the U.S. being the sole proponent of such arrangements. Other countries have encountered tax evasion scandals and are pursuing information exchanges.[82]

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for the Exchange of Information Relating to Taxes will be the first step to developing a deeper bilateral tax relationship between the United States and Brazil. The U.S. Treasury Department and the Brazilian Secretaria da Receita Federal initiated informal discussions in 2006 to exchange views on a number of aspects of tax treaty policy, including transfer pricing, permanent establishment, the taxation of income from services and mutual agreement procedures. Both the Treasury Department and the Secretaria da Receita Federal are committed to continuing this informal dialogue with the hope that common ground can eventually be found to reconcile the tax policy differences that have prevented the conclusion of a bilateral tax treaty in the past."

[81] Note "Former Treasury Official Hicks Talks about Transition, Tax Reform," 2007 TNT 50-8 (March13, 2007), noting that "the need to continue treaty negotiations and expand the treaty network is greatest in Asia and Central and South America."

[82] See an OECD New Release dated October 30, 2008 noting that some 16 new bilateral agreements on the exchange of information were signed for that week between OECD countries and the British Virgin Islands, Guernsey and Jersey. This news release indicated that these agreements have now been signed with the Isle of Man, Guernsey, Jersey, the Netherlands Antilles and the British Virgin Islands, also stating: "Progress is being made in other financial centres. Cyprus and Malta have removed the last impediments to a full exchange of information; Belgium has negotiated its first tax treaty with full exchange of information; Bahrain and the United Arab Emirates are implementing the OECD standards; and the government of Hong Kong (China) recently launched a review of its policy on exchange of information."

V. Substantive Income Tax Treaty Issues

A. Important Substantive Tax Provisions

A number of the substantive income tax treaty rules are in transition, as noted from various selected OECD and U.S. tax law developments, summarized below. One of the most important substantive changes included in U.S. income tax treaties negotiated on amended over the last several years is the inclusion of a provision reducing the withholding at source tax rate on dividends to zero in those situations involving dividends being paid from a controlled foreign subsidiary to its parent corporation. Many of the substantive benefits provided under an income tax treaty are the reductions of the rate (sometimes to zero) of the withholding tax at source (with the residual taxation occurring at the residence). This is particularly the situation for interest income (often zero withholding), royalties (often zero withholding), dividends (often reduced withholding) and capital gains (often zero withholding, except for gains from real estate).[83]

B. Dividend Withholding at Source

1. Reduced Withholding at Source

In addition to certain procedural elements of income tax treaties (discussed above), the imposition of (or relief from) withholding taxes at source on corporate dividends paid continues to evolve as U.S. treaties are negotiated. Under the U.S. statutory tax rules dividends, when paid from the U.S. to the foreign shareholder, are subject to withholding at source on the gross amount at the rate of 30 percent.[84]

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[83] Even the IRS has exhibited some interest in alerting taxpayers to possible benefits available under U.S. income tax treaties. See the IRS Release entitled "Tax Treaties Can Affect Your Income Tax," in its "International Tax Gap Series," November, 2008 at the IRS website: www.irs.gov/businesses/article

[84] Under the Code rule that withholding is at the rate of 30 percent of the gross payment. Code §§ 871(a)(1) and 881(a)(1).

Foreign countries have similar tax withholding at source on dividends being paid from their countries to U.S. (and other non-home country) shareholders, as imposed under their domestic tax statutes. The rate of this withholding tax at source is ordinarily reduced under an applicable bilateral income tax treaty.[85] This reduced rate of dividend tax withholding at source is ordinarily reduced for either a U.S. corporate or a non-corporate shareholder receiving dividends from a corporation in the treaty partner country.

Of course, this reduced withholding tax rate at source will not really benefit the U.S. individual recipient shareholder receiving the dividend if then being subject in the U.S. to a 35 percent tax rate on the dividend received. The usual anticipation currently in the U.S. is that the dividend to the U.S. shareholder will be taxed at the maximum rate of 15 percent (equivalent to the capital gains tax rate). That tax rate is only available when a dividend by the U.S. shareholder from a foreign corporation is received from a "qualified foreign corporation." For this purpose a "qualified foreign corporation" includes certain foreign corporations that are eligible for the benefits of a comprehensive income tax treaty with the United States which the Secretary determines is satisfactory for purposes of this provision and that includes an adequate "exchange of information" provision.[86] The Service during 2006 updated

[85] OECD Model Income Tax Treaty, Article 10(2). The five percent rate would be available if the beneficial owner of the dividends is a company other than a partnership which holds directly at least 25 percent of the capital of the company paying the dividends. OECD Model Treaty Article 10, Comment 10, provides that, if a company of one of the States owns directly a holding of at least 25 percent in a company of the other State, it is reasonable that payments of profits by the subsidiary to the foreign parent company should be taxed less heavily to avoid recurrent taxation and to facilitate international investment. Article 10, Comment 13, specifies that the tax rates fixed by this Article for the tax in the State of source are maximum rates. The States may agree, in bilateral negotiations, on lower rates or even on taxation exclusively in the State of the beneficiary's residence. As noted in the text, this advice concerning taxation only at residence has been implemented by the U.S. in various recent treaties (limited to situations involving a greater increase in the percentage of ownership of the dividend paying subsidiary).

[86] Qualified dividend income means dividends received during the taxable year from domestic corporations and "qualified foreign corporations." Code §1(h)(11)(B)(i). Subject to certain exceptions, a qualified foreign corporation is any foreign corporation that is either (i) incorporated

its listing of those countries which have adequate tax treaty provisions for this purpose, enabling the 15 percent rate in the U.S. to non-corporate shareholders.[87]

Starting in 2001, with the renegotiation of the U.K.-U.S. income tax treaty, some income tax treaties have been revised to significantly modify this position so that the withholding tax at source on intercompany dividends (under the conditions specified in each separate treaty) is completely eliminated, with all the taxation on the dividends assumed therefore to be imposed at the taxpayer's residence.[88] Of course,

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in a possession of the United States, or (ii) eligible for benefits of a comprehensive income tax treaty with the United States that the Secretary determines is satisfactory for purposes of this provision and that includes an exchange of information program (the "treaty test"). Code §1(h)(11)(c)(i). A foreign corporation that does not satisfy either of these two tests is treated as a qualified foreign corporation with respect to any dividend paid by such corporation if the stock with respect to which such dividend is paid is readily tradable on an established securities market in the United States. Code §1(h)(11)(C)(ii). See Notice 2003-71, 2003-2 C.B. 922, for the definition, for taxable years beginning on or after January 1, 2003, of "readily tradable on an established securities market in the United States." A qualified foreign corporation does not include any foreign corporation that for the taxable year of the corporation in which the dividend was paid, or the preceding taxable year, is a passive foreign investment company (as defined in Code §1297). IRC §1(h)(11)(C)(iii). A dividend from a qualified foreign corporation is also subject to the other limitations included in Code §1(h)(11). For example, a shareholder receiving a dividend from a qualified foreign corporation must satisfy the holding period requirements of Code §1(h)(11)(B)(iii).

[87] See IRS Notice 2006-101, 2006-2 CB 930. The Service noted that Treasury and the IRS intend to update this list, as appropriate. Situations that may result in changes to the list include the entry into force of new income tax treaties and the amendment or renegotiation of existing tax treaties. Further, the IRS noted that Treasury and the IRS continue to study the operation of each of our income tax treaties, including the implications of any change in the domestic laws of the treaty partner, to ensure that the treaty accomplishes its intended objectives and continues to be satisfactory for purposes of this provision. It is anticipated that any changes to the list of income tax treaties that meet the requirements of Code §1(h)(11)(C)(i)(II) will apply only to dividends paid after the date of publication of the revised list.

[88] See, e.g., Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Sweden Joint Committee Print, JCX-1-06 (January 26, 2006) which notes: "Although the United States only recently first agreed to bilateral zero rates of withholding tax on direct dividends, many other countries have a longer history of including such provisions in one or

we often consider this in terms of repatriation of profits into the United States from foreign subsidiaries, but this is also obviously applicable to dividend distributions from United States subsidiaries to their foreign country parent corporations (thereby reducing the tax collections to the U.S. Treasury Department).

2. Specific Countries With Zero Withholding Under Treaty

This liberalized dividend treatment has occurred in the following treaties between the U.S. and the following countries:

(a) The United Kingdom.[89] This treaty requires 80% ownership by the parent corporation to enable a zero withholding rate on dividends payable to the parent corporation. The IRS has issued a favorable private letter ruling that ownership through a disregarded entity constitutes direct ownership for purposes of this

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more of their bilateral tax treaties. These countries include OECD members Austria, Denmark, France, Finland, Germany, Iceland, Ireland, Japan, Luxembourg, Mexico, the Netherlands, Norway, Sweden, Switzerland, and the United Kingdom, as well as non-OECD-members Belarus, Brazil, Cyprus, Egypt, Estonia, Israel, Latvia, Lithuania, Mauritius, Namibia, Pakistan, Singapore, South Africa, Ukraine, and the United Arab Emirates. In addition, a zero rate on direct dividends has been achieved within the European Union under its Parent-Subsidiary Directive. Finally, many countries have eliminated withholding taxes on dividends as a matter of internal law. Thus, although the zero-rate provision in the proposed protocol is a relatively recent development in U.S. treaty history, there is substantial precedent for it in the experience of other countries. It may be argued that this experience constitutes an international trend toward eliminating withholding taxes on direct dividends, and that the United States would benefit by joining many of its treaty partners in this trend and further reducing the tax barriers to cross-border direct investment."

[89] A revised U.K.-U.S. income tax treaty was signed on July 24, 2001 and entered into force on March 31, 2003. See (i) U.S. Congress, Joint Committee on Taxation's explanation of the proposed United Kingdom-United States income tax treaty, signed July 24, 2001, which also includes the JCT's description of a related U.K.-U.S. protocol signed July 22, 2002 (JCS-4-03) and (ii) the U.S. Department of the Treasury's "Technical Explanation" of this treaty and a related protocol dated March 5, 2003, 2003 WTD 45-27.

dividend exemption (under Article 10(3) of the U.S. - U.K. Income Tax Treaty).[90] In that situation a U.K. corporation wholly owned a third country company (X) which made an election under Regs. § 301.7701-3(a) to be treated as a disregarded entity. X in turn wholly owned all the shares of a U.S. corporation. X transferred its shares in the U.S. Corp to the U.K. corp. Then U.S. corp contemplated purchasing some of its own stock then held by its U.K. parent corporation. This redemption transaction would be treated as a dividend distribution. This redemption transaction was contemplated to occur less than twelve months after those shares were transferred to the U.K. parent corporation. The U.S. - U.K. tax treaty requires a twelve month minimum holding period to be eligible for the zero withholding rate at source.[91] The Service concluded that ownership for this purpose included the ownership through a disregarded entity and, therefore zero withholding eligibility was available.[92]

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[90] See PLR 200522006. See the discussion of this PLR: "Ownership Through Disregarded Entity Constitutes Direct Ownership for Purposes of Dividend Exemption under U.S.-U.K. Income Tax Treaty," Tax Management Memorandum, Vol. 46, No. 23 (November 14, 2005). Similarly, see PLRs 200626009 and 200712007.

[91] The Technical Explanation for this treaty, as issued by the U.S. Treasury Department, states that, for the purpose of this holding period requirement, the stock must have been held "directly." The Service considered whether the U.K. corporation's ownership of the stock of the U.S. corporation through the third country disregarded entity constituted "direct" ownership. The tacking of that holding was apparently necessary to enable the satisfaction of the twelve month holding period requirement. A question does arise whether (as specified in the Technical Explanation) the U.S. Treasury Department's imposition of a "direct" ownership requirement in this context is consistent with the treaty, but that question did not need to be resolved in this situation.

[92] The Service cited Reg. § 301.7701-7(a) which provides that, if an entity is disregarded, "its activities are treated in the same manner as a sole proprietorship, branch, or division of the owners." The Service further cited Regs. § 1.367(e)-1(b)(2) which provides that stock owned by or for an entity that is disregarded as an entity separate from its owner is owned directly by the owner of the disregarded entity.

(b) Australia.[93] This treaty requires 80% ownership by the parent corporation to enable a zero withholding rate at source on dividends paid outbound to that owner.
(c) Japan.[94] This treaty requires more than a 50% ownership by the parent corporation to enable a zero withholding rate on dividends paid outbound to that owner.[95]

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[93] A protocol to the Australia-U.S. income tax treaty entered into force on May 12, 2003. This protocol also provides for zero-rate withholding tax on certain intercompany dividends and for the elimination of source country withholding taxes on several important types of interest, particularly interest derived by a financial institution (if dealing independently with the payor, i.e., is not related) and interest paid to governmental entities. However, other types of interest (including interest received by financial institutions in back-to-back loans or their economic equivalent) continue to be subject to source-country withholding tax at the maximum rate of 10 percent. See, generally, Ng, "Asia-Pacific Tax Review: Australia-U.S. Treaty Protocol an Example of New U.S. Treaty 'Gold Standard' ", 2003 WTD 168-6, August 29, 2003.

[94] This treaty, initialed during June 2003, was signed on November 6, 2003. See BNA Daily Report for Executives, No. 216, p. L-5, November 7, 2003. This treaty constitutes a modernization of the 1971 Japan-U.S. income tax treaty, one of the oldest U.S. income tax treaties. This treaty accomplishes a significant reduction in cross-border withholding taxes. All source-country withholding taxes on royalty income was eliminated, an item particularly significant because of the large inflow of royalties into the United States from Japan. The treaty has eliminated withholding on interest earned by financial institutions and reduced the higher withholding rates to lower rates of the preferred U.S. model. Also eliminated was the withholding on dividend payments to a controlling parent corporation. Under this revised treaty, the withholding tax is eliminated on dividends paid by a U.S. subsidiary to the Japanese parent company that owns more than a 50 percent interest (and, similarly, in the reverse situation). If the parent company owns a 50 percent interest or less in a subsidiary the dividends remain subject to withholding under the revised treaty. Of course, in situations like this planning devices (such as an additional limited preferred share investment) might be implemented to enable surpassing the 50 percent hurdle imposed by this provision.

[95] For a thorough and quite useful examination of the Japan-U.S. Income Tax Treaty see Pamela Fuller, "The Japan-U.S. Income Tax Treaty: Signaling New Norms, Inspiring Reforms, or Just Tweaking Anachronisms in International Tax Policy?" 40 The International Lawyer 773, No. 4 (Winter 2006).

(d) The Netherlands.[96] This treaty requires 80 % ownership by the parent corporation to enable a zero withholding rate on dividends paid outbound to that owner.
(e) Sweden.[97] This treaty requires 80 % ownership by the parent corporation for at least a 12 month period to enable a zero withholding rate on dividends on dividends paid outbound to that owner.[98]

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[96] See Protocol to 1992 Netherlands-United States Income Tax Convention (March 8, 2004), particularly, Article 3, amending Article 10 of the treaty to provide for no withholding on dividends from an 80 percent or greater owned subsidiary, at 2004 TNT 46-23 (March 9, 2004). See, further, "JCT Explains Proposed Protocol to Netherlands-U.S. Income Tax Treaty" (JCX-54-04) 2004 TNT 181-5 (September 16, 2004).

[97] Protocol to Sweden-United States Income Tax Convention, signed September 30, 2005. 2005 TNT 191-24, October 3, 2005. Article IV provides for a complete replacement of Article 10, the current dividends article. See Brown Testimony, p. 6, indicating that the provision dealing with inter-company dividends was very important to Sweden because it had unilaterally eliminated its withholding tax on inter-company dividends. "The legislative history to that domestic law change makes it clear that the main beneficiaries of that change were expected to be U.S. companies, In fact, it refers specifically to assurances given to the Swedish negotiators that the United States would not agree to eliminate the withholding tax on inter-company dividends in any bilateral agreement with any country. Now that U.S. policy has changed, failure to provide a reciprocal benefit for Swedish companies would have jeopardized the exemption from Swedish withholding tax that currently benefits U.S. companies. We believe that securing that protection, as well as eliminating the withholding tax on dividends paid to pension funds, is a sufficient quid pro quo."

[98] Protocol effective August 31, 2006. See Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Sweden Joint Committee Print, JCX-1-06 (January 26, 2006). This Explanation notes that since Sweden does not currently impose a withholding tax on these dividends under its internal law, the zero-rate provision would principally benefit direct investment in the United States by Swedish companies, as opposed to direct investment in Sweden by U.S. companies. In other words, the potential benefits of the provision would accrue mainly in situations in which the United States is importing capital, as opposed to exporting it. However, it should be noted that, although Swedish internal law currently does not impose a withholding tax on dividends paid by Swedish subsidiaries to U.S. parent companies, there is no guarantee that this will always be the case. Thus, the inclusion of a zero-rate provision under the proposed protocol would give U.S.-based enterprises somewhat greater certainty as to the applicability of a zero rate in Sweden, which arguably would facilitate long-range business planning for U.S. companies in their capacities as capital exporters. Along the same lines, the provision would protect the U.S. fisc

(f) Denmark. This treaty also requires 80 percent ownership by the parent corporation for at least a 12 month period to enable a zero withholding rate on dividends paid outbound to that owner.[99]

(g) Belgium.[100] A zero dividend withholding rate applies to:

- dividends paid by a Belgian subsidiary to a U.S. parent company, if the U.S. parent has owned 10 percent or more of the capital of the Belgian subsidiary for at least 12 months before the date on which the dividends are declared; and
- dividends paid by a U.S. subsidiary to a Belgian parent company, if the Belgian parent has owned 80 percent or more of the voting stock of the U.S. subsidiary for at least 12 months before the dividend record date.

Note that the 10 percent threshold for dividends paid by a Belgian subsidiary to its U.S. parent company is significantly lower than the threshold in other treaties recently concluded by the United States. For example, the U.S. treaties with Germany, the Netherlands, and Sweden all have an 80 percent threshold, while the treaty with Japan has a 50 percent threshold. This much lower threshold might encourage U.S. companies to invest outbound into - or through - Belgium.

(h) Mexico. Under a 2002 protocol to the 1993 Mexico-U.S. Income tax treaty the zero withholding tax rate is applicable to 80 percent ownership by the parent corporation to enable a zero withholding rate on dividends.[101]

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against increased foreign tax credit claims in the event that Sweden were to change its internal law in this regard.

[99] Protocol, dated May 2, 2006, entered into force on December 28, 2007.

[100] See "Belgium, U.S. Sign Tax Treaty," 2006 TNT 229-5 (November 28, 2006). This treaty entered into force on December 28, 2007.

[101] A protocol to the Mexico-U.S. income tax treaty was signed on November 26, 2002 and entered into force on July 3, 2003. See, generally, U.S. Department of the Treasury, "Technical Explanation of the Mexico-U.S. Tax Treaty Protocol," 2003 WTD 45-29. This also contained zero dividend withholding tax provisions. This revision provides Mexico with tax treaty treatment equivalent to the best treatment negotiated by the United States with any other tax treaty partner (i.e., a "most favored nation" clause). In the Senate Foreign Relations Committee Report (Exec. Rpt. 108-4, 2003 TNT 55-17, March 21, 2003) the Committee noted its displeasure with such a provision, indicating: "The Committee notes its continuing concern regarding the effect of such

(i) New Zealand. This protocol would provide for the elimination of source-country taxation on some direct dividends.
(j) France. This proposed protocol would provide for the elimination of source-country taxation on cross border dividends paid to another company that owns at least 80 percent of the stock of the dividend-paying company.

As can be observed, the percentage ownership required to enable zero withholding is ordinarily 80 percent but does vary from treaty to treaty. The holding period requirement may also vary and will need verification under the applicable treaty.

Note, however, that the 2008 effective Canada-U.S. treaty revision does not provide for zero withholding at source but, rather, provides for a five percent tax with the corporate shareholder-dividend recipient owns at least a 10 percent interest in the dividend payor.

3. Future U.S. Tax Treaty Negotiation Policy Concerning Dividend Withholding

Note that the 2006 U.S. model income tax treaty specifies that withholding at source is to be imposed at the rate of 15 percent, but at the reduced rate of 5 percent of the gross amount of the dividends if the beneficial owner of the dividends being received is a company that owns directly at least 10 percent of the voting stock of the company paying the dividends.[102] The OECD Model Income Tax Treaty provides for the same tax rates, except for the percentage of ownership required to obtain the reduced five percent withholding rate.[103]

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provisions [the self-executing MFN provision] and expects that the Treasury Department will not include such provision in future treaties."

[102] 2006 U.S. Model Income Tax Treaty, Article 10(2).

[103] OECD Model Income Tax Treaty, Article 10(2). The five percent rate would be available if the beneficial owner of the dividends is a company other than a partnership which holds directly at least 25 percent of the capital of the company paying the dividends. OECD Model Treaty Comment 10 on Article 10 provides that, if a company of one of the States owns directly a holding of at least 25 percent in a company of the other State, it is reasonable that payments of profits by the

In 2006 testimony before the Senate Foreign Relations Committee (before the release of the 2006 U.S. Model Treaty) the U.S. Treasury Department position on this dividend withholding issue was then stated as being that the decision to eliminate the source country withholding on inter-company dividends "is made independently with respect to every treaty negotiation."[104] The indication from Treasury is that, upon the adoption of the U.S. Treasury position to possibly eliminate the source country withholding tax on inter-company dividends, "a number of treaty relationships that had been at best stagnant and at worst problematic have changed for the better."[105] A further observation made was that bilateral tax treaty relationships between other countries (i.e., non-U.S. relationships) have resulted in similar exemptions on intercompany dividends, and that this could be beneficial upon the transfer of profits

subsidiary to the foreign parent company should be taxed less heavily to avoid recurrent taxation and to facilitate international investment. Comment 13 to Article 10 specifies that the tax rates fixed by the Article for the tax in the State of source are maximum rates. The States may agree, in bilateral negotiations, on lower rates or even on taxation exclusively in the State of the beneficiary's residence. As noted in the text, this advice has been implemented by the U.S. in various recent treaties (limited as to an increased percentage of ownership).

[104] Brown Testimony, p. 5. The statement is made that "[t]he United States will agree to the provision only if the agreement includes limitation on benefits and information exchange provisions that meet the highest standards, and if the overall balance of the agreement is appropriate." Earlier, when reviewing the Mexico-US. Income Tax Treaty the Senate Foreign Relations Committee noted with approval Treasury's statement that "[i]n light of the range of facts that should be considered, the Treasury Department does not view [elimination of withholding tax on intercompany dividends] as a blanket change in the United States' tax treaty practice." See Senate Foreign Relations Committee Report (Exec. Rpt. 108-4, 2003 TNT 55-17, March 21, 2003).

[105] The Brown Testimony, p. 5, specifies that this changed policy has enabled the U.S. Treasury Department to achieve the following objectives: (a) strengthen treaty shopping provisions, including the introduction of rules that prevent the use of tax treaties after a corporate inversion transaction; (b) significantly improving information exchange provisions, allowing access to information even when the treaty partner does not need the information for its own tax purposes; (c) reducing withholding taxes on interest and royalties to levels lower than those to which the treaty partners had previously agreed; (d) eliminating withholding taxes on dividends paid to pension funds (thereby eliminating eventual double taxation); and (e) protecting U.S. companies against the retaliatory re-imposition of withholding taxes on inter-company dividends.

from one foreign country subsidiary upstream to another foreign country subsidiary where both of these countries have implemented withholding exemptions under their treaty. In the 2008 tax treaty advise and consent proceedings the Senate Committee on Foreign Relations was further informed on this matter by the Staff of the Joint Committee on Taxation, as relevant to the Canada-U.S. protocol.[106]

As further evidence that this intercompany dividend exemption has not been adopted as absolute U.S. tax treaty policy one can observe the Bangladesh-U.S. income tax treaty which was also subject to review at the February 2006 hearings.[107] This U.S. income tax treaty was signed in September, 2004, became effective January 1, 2007, and provides for a maximum source country withholding tax rate on dividends of 15 percent and a ten percent rate applicable to direct investment dividends. This treaty requires a ten percent ownership threshold for the application of the ten percent withholding tax rate. An explanation for not including a zero intercompany dividends rate is that this is a tax treaty with a developing country. Future tax treaties with developing countries will presumably implement a similar approach. The objective, one must assume, is that the outbound dividend flows are predominantly sourced from the developing country and, therefore, the economic objective of maintaining a withholding tax would be to enable the source

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[106] See Joint Committee on Taxation, "Testimony of the Staff of the Joint Committee on Taxation Before the Senate Committee on Foreign Relations Hearing on the Proposed Protocol to the Income Tax Treaty with Canada and the Proposed Income Tax Treaties with Iceland and Bulgaria," JCX-60-08, p. 4, July 10, 2008 (testimony of Emily McMahon, Deputy Chief of Staff of the Joint Committee on Taxation), indicating that "[i]n previous testimony before the Committee, the Treasury Department has indicated that zero-rate dividend provisions should be allowed only under treaties that have restrictive limitation-on-benefits rules and that provide comprehensive information exchange. Even in those treaties, according to previous Treasury Department statements, dividend withholding tax should be eliminated only based on an evaluation of the overall balance of benefits under the treaty. The Committee may wish to consider what overall balance of considerations prompted the Treasury Department not (emphasis added) to seek a zero-rate provision in the proposed protocol and treaties, all of which have comprehensive limitation-on-benefits and information-exchange provisions."

[107] See the Technical Explanation to the Bangladesh-U.S. Income Tax Treaty at 2006 TNT 23-21 (February 3, 2006).

(developing) country to capture some of that tax benefit, even though profits taxes on the distributed dividend may have previously been imposed on the distributing corporation (perhaps at a level even higher than the 35 percent U.S. maximum corporate tax rate).

More recently the Bulgaria-U.S. income tax treaty also reinforced this U.S. policy position of the continued imposition of dividend withholding at source in certain situations.[108] This treaty reduces withholding taxes on dividends, interest, and royalties. Dividends are subject to a maximum withholding tax rate of 5 percent if the beneficial owner is a company that directly owns at least 10 percent of the voting stock of the company paying the dividends. A 10 percent tax rate applies in other cases. A zero withholding tax rate applies to dividends paid to pension funds, and a 5 percent rate applies to interest and royalties.[109]

C. "Services" Permanent Establishments

The OECD's Working Party No. 1 on tax conventions on December 8, 2006 issued a discussion document on proposed changes to the commentary on the Permanent Establishment article (Article 5) of the OECD model income tax treaty

[108] See "U.S., Bulgaria Sign Tax Treaty," 2007 TNT 38-3 (February 26, 2007). This treaty was approved by the U.S. Senate on September 23, 2008.

[109] The treaty also includes articles on the limitation of benefits and the exchange of information. Unlike the recent U.S. tax agreements with Germany and Belgium, it does not include a mandatory arbitration provision. Under the protocol to the Bulgaria income tax treaty, it is specifically provided that the principles of the OECD transfer pricing guidelines will apply for purposes of determining profits attributable to permanent establishments.

concerning the taxation of services.[110] The OECD solicited comments on the draft by February 17, 2007.[111]

Under the current OECD model income tax treaty, profits from services performed in the territory of a contracting state by an enterprise of the other contracting state are not taxable in the first state unless they are attributable to a "permanent establishment" located there.[112] The revised commentary is to reflect the reality of some tax treaty relationships. An alternative P.E. provision is provided for countries that wish to agree to source-based taxation of cross-border services. Those countries may wish to tax income from cross- border services in the country where the services are provided.

The alternative provision follows the principle that source based taxation should not be extended to services performed outside the territory of a state. If source taxation of services is agreed to by treaty partners, only the profits from the services should be taxed, and the source taxation should be permitted only if there is a minimum level of presence in a state.

D. Attribution of Profits to Permanent Establishments

The OECD has been working for several years to achieve a consensus on precisely how profits should be attributed to permanent establishments under the business profits article of the OECD Model Income Tax Treaty.[113] OECD issued a

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[110] Note more generally that an examination of the concept of the "permanent establishment" will be a subject for discussion at the Annual Congress of the International Fiscal Association to be held in Vancouver, Canada during September, 2009.

[111] See the following comment: "Baker & McKenzie Asks OECD to Withdraw Services Proposal," 2007 TNT 33-38 (February 15, 2007).

[112] OECD Discussion Draft on Proposed Commentary Changes on the Tax Treaty Treatment of Services, December 8, 2006.

[113] OECD Report on the Attribution of Profits to Permanent Establishments, December 21, 2006. See, also, the subsequent 2008 report with the same identification.

new business profits article (Article 7) in 2007, along with a new commentary to accompany the new text of the article. The OECD revised and finalized its commentary to the current Article 7 during July, 2008.[114]

Note the following extract from paragraph 1 of the Commentary on Article 7 of the OECD Model Tax Convention:
".....when an enterprise of a Contracting State carries on business in the other Contracting State the authorities of that second State have to ask themselves two questions before they levy tax on the profits of the enterprise: the first question is whether the enterprise has a permanent establishment in their country; if the answer is in the affirmative the second question is what, if any, are the profits on which that permanent establishment should pay tax. It is with the rules to be used in determining the answer to this second question that Article 7 [of the OECD Model Tax Convention on Income and Capital (OECD Model Tax Convention)] is concerned. Rules for ascertaining the profits of an enterprise of a Contracting State which is trading with another enterprise of another Contracting State when both enterprises are associated are dealt with in Article 9 [of the OECD Model Tax Convention]."

The particular concern is that considerable variation exists in the domestic laws of the member countries regarding the taxation of PEs. Currently, no consensus exists amongst the member countries as to the correct interpretation of Article 7. The authorised OECD approach does not dictate the specifics or mechanics of domestic law, but only sets a limit on the amount of attributable profit that may be taxed in the host country of the PE. Accordingly, the profits to be attributed to a PE are the profits that the PE would have earned at arm's length if it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market.[115] This is in line with one of the fundamental rationales behind the PE concept, which is to allow, within certain limits, the taxation of non-resident enterprises in respect

[114] See the TEI comments on the discussion draft of Article 7 at 2009 TNT 11-148, January 15, 2009.

[115] OECD Treaty, Article 7(2); Commentary on Article 7, Paragraph 14.

of their activities (having regards to assets used and risks assumed) in the source jurisdiction.

The fundamental objective is to hypothesize the PE as a distinct and separate enterprise. This is relevant to relationships with both related and unrelated enterprises. Relevant to this inquiry are (1) people functions, (2) attribution of assets to particular functions, (3) attribution of risks, (4) attribution of free capital, and (5) recognition of dealings between the PE and other portions of the enterprise. Much of this very extensive discussion consists of terminology quite reminiscent of the Code § 482 transfer pricing analysis in the U.S. Special analyses are applicable to banks and to global trading operations for financial instruments.

The "OECD Report on the Attribution of Profits to Permanent Establishments, December 21, 2006" is almost 200 pages in length. As the fundamental discussion document in this context it has provided very extensive analysis identifying the various economic functions which may be relevant to segregating income among the various components of an enterprise, particularly to the PE in the source country.[116]

In refining this Commentary in 2008 two core matters were noted as important in this context:[117]

a) The generally accepted principal of double taxation conventions is stated that an enterprise of one State shall not be taxed in the other State unless it carries on business in that other State through a permanent establishment situated therein;

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[116] The U.S. Treasury issued a statement concerning the OECD proposal on PE attribution of profits, as follow: "While we fully support the Authorised OECD Approach (AOA) for attributing profits to a permanent establishment (PE), it will not apply to most existing U.S. tax treaties. We generally provide in Article 7(3) for a "reasonable allocation" of certain expenses, which is not consistent with the arm's-length approach of the AOA. We have, however, specifically incorporated the AOA in a few (e.g., U.K. and Japan) recent treaties, and it is now in the 2006 U.S. Model Income Tax Convention." See "Treasury Releases Statement on PE Attribution of Profits," June 7, 2007; electronic citation: 2007 TNT 212-53.

[117] OECD Treaty, Article 7(1); Commentary on Article 7(1), Paragraphs 9 & 10.

b) The right to tax of the State where the permanent establishment is situated does not extend to profits that the enterprise may derive from that State but that are not attributable to the permanent establishment. This constitutes a strong rejection of the "force of attraction" rule.

A further dilemma in this context involves the attribution of income to PEs (and the relief from double taxation) where more than two (often three) countries are involved. This can occur, e.g., where a resident of one state carries on business in a second state through a PE to which income derived in a third state is attributable. Of course, the fundamental question concerns which states will recede from their positions that they have the primary taxing rights.[118]

E. Temporary Services in the Destination Country

1. Issues Concerning Temporary Services

Numerous issues arise periodically involving:

(1) whether employees of a foreign enterprise are taxable in the destination country;
(2) whether that person is actually an employee, or is an independent contractor;
(3) whether, if having employees in the destination jurisdiction, the employees cause the employer to have a permanent establishment in that jurisdiction; and,
(4) if the employer has a permanent establishment in the foreign jurisdiction because of services rendered there by its employees, what is the amount of the employer's income subject to tax in that destination jurisdiction.

These questions have been confronted in the last several years by both litigation in the destination jurisdiction and through the attempts of the OECD to refine the governing principles through appropriate amendments to its Commentaries on the OECD Model Income Tax Convention.

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[118] See Zhai, "Triangular Cases Involving Income Attributable to PEs," Tax Notes International, March 23, 2009, p. 1105.

2. Taxation of the Individual Employee

Article 15 of the OECD Model Tax Convention deals with the treatment of "Income from Employment," specifying in Paragraph 1 that salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State.[119] If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other state.

Paragraph 2 of Article, of the current OECD Model Tax Convention provides that a non-resident employee who performs services in a country during a short period of time is not subject to tax in that country under certain circumstances. Particularly, this provision specifies:
"2. Notwithstanding the provisions of paragraph 1 [salaries and wages are taxed where services are rendered], remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State [i.e., at the residence] if:
a) the recipient is present in the other State for a period or periods nots exceeding in the aggregate 183 days in an twelve month period commencing or ending in the fiscal year concerned, and
b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the other States, and
c) the remuneration is not borne by a permanent establishment which the employer has in the other state."

Of course, an important question arising in this context is who actually is the employer of the foreign resident engaging in services in the destination country. The local taxing authorities may take the position that, in substance, the local affiliate, and

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[119] Fn. 1 to the Article 15 Commentary to the OECD Model Income Tax Convention provides that before the year 2000 the title of Article 15 referred to "Dependent Personal Services" in contrast to Article 14 which referred to "Independent Personal Services." As a result of the elimination of Article 14 the title of Article 15 was changed to refer to "Employment" " a term that is more commonly used to describe the activities to which the Article applies."

not the home country affiliate, is the actual employer of the individual temporarily rendering services in the destination country.[120]

3. Deemed P.E. Status of the Employer in the Destination Country

Article 7 (entitled "Business Profits") specifies that the profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. The OECD Commentary provides that the principle of the business taxation article is that until an enterprise of one State sets up a permanent establishment in another state, it should not be regarded as participating in the economic life of that State to such an extent that it comes within the taxing jurisdiction of that other State.[121] However, the OECD recognized that some countries seek to expand the scope of taxation in this context even though a P.E. really does not exist. Consequently, the Commentary provides that the treaty countries could bilaterally agree to include a treaty provision specifying that:

where an enterprise of a Contracting State performs services in the other Contracting State

a) through an individual who is present in that other state for a period or periods exceeding in the aggregate 183 days in any twelve month period and more than 50 percent of the gross revenues attributable to the active business activities of the enterprise during this period or periods are derived from the services performed in that other State through that individual, or

b) for a period or periods exceeding in the aggregate 183 days in any twelve month period, and these services are performed for the same project or for connected

[120] See Gamble, "Canada-U.S. Treaty Article Clarified," Tax notes International, Feb. 9, 2009, p. 495, analyzing Canadian Revenue Agency Document 2008-0300571C6 clarifying that an amendment made to Article XV(2)(b) of the Canada-U.S. treaty by the treaty's fifth protocol does not broaden Canada's right to tax a U.S.-resident employee of a multinational corporation who is on a short-term assignment in Canada.

[121] OECD Commentary on Article 5, ¶ 42.11.

projects through one or more individuals who are present and performing such services in that other State,
the activities carried on in that other State in performing these services shall be deemed to be carried on through a permanent establishment of the enterprise situated in that other state (subject to certain limitations).[122]

The effect of this treatment has the impact of deeming a permanent establishment to exist where one would not otherwise exist. This situation would arise, for example, where a consultant provides services over a long period in a country but at different locations that do not meet the usual conditions to constitute a permanent establishment.

4. Defining the "Employee" in the Destination Country

Apparently, somewhat similar to the "employee vs. independent contractor" issue (for wage withholding and social security purposes in the U.S. domestic tax context), a gap might still exist between an "employee" and services of an independent character (treated as a business for tax treaty purposes). Or, more importantly, both jurisdictions might assert primary taxing jurisdiction, interpreting the employee's status under the treaty differently.[123] This is particularly complicated where the "employee" is not acting on his own behalf but on the behalf of an enterprise which has contracted his services. The distinction made is where services rendered by an individual to an enterprise should be considered to be rendered in an employment relationship (contract of service) from cases where such services should be considered to be rendered under a contract for the provision of services between two separate enterprises (contract for services).[124]

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[122] OECD Commentary on Article 5, ¶ 42.23.

[123] Of course, in the U.S. context, under the "savings" clause in the tax treaty, the U.S. taxpayer will always be subject to U.S. income tax (on a worldwide basis), but also may have available a foreign tax credit when the other jurisdiction has the first right to impose tax on income derived in the other jurisdiction.

[124] OECD Draft Commentary, Article 15, Paragraph 8.4.

The OECD has sought to clarify this situation through its extensive draft Commentary on Article 15, Paragraph 2, of the OECD Model Treaty. Guideposts for making this tax jurisdiction determination were provided in this draft Commentary.[125] In finalizing its commentary in this context during the year 2008 the Commentary provides that numerous cases of abuse have arisen through adoption of the practice know as "international hiring-out of labour." In this system, a local employer wishing to employ foreign labour for one or more periods of less than 183 days recruits through an intermediary established abroad who purports to be the employer and hires the labour out to the employer. The worker thus fulfills the usual prima facie conditions for claiming exemption from taxation in the country where he is temporarily working. Noting that the term "employer" is not defined in the Convention, it is understood, however, that the employer is the person having rights on the work produced and bearing the relative responsibility and risks.

The Commentary notes that the Contracting States should agree on the situations in which the intermediary does not fulfill the conditions required for him to be considered as the employer. The commentary notes various circumstances to establish that the real employer is the user of the labour (and not the foreign intermediary):[126]

- the hirer does not bear the responsibility or risk for the results produced by the employee's work;
- the authority to instruct the worker lies with the user;
- the work is performed at a place which is under the control and responsibility of the user;
- the remuneration to the hirer is calculated on the basis of the time utilized, or there is in other ways a connection between this remuneration and wages received by the employee;
- tools and materials are essentially put at the employee's disposal by the user;

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[125] The OECD's Centre for Tax Policy and Administration originally released "Revised Draft Changes to the Commentary on Paragraph 2 of Article 15," a Revised Public Discussion Draft, dated March 12, 2007.

[126] OECD Commentary on Article 15, ¶ 8.

- the number and qualification of the employee are not solely determined by the hirer.

F. Determining Available P.E. Deductions

Article 7(3) of the OECD Model Treaty specifies that in determining the profits of a permanent establishment there shall be allowed as deduction expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere. Article 7(4) provides that insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, the Business Profits article shall not preclude the Contracting State from determining the profits to be taxed by such an apportionment.

The issue of the appropriate allocation of expenses was the focus of the long running dispute between the IRS and National Westminster Bank. NatWest conducted banking operations in the U.S. through several branches. The bank claimed deduction for accrued interest expenses as recorded on its books at the various U.S. branches. However, IRS sought to apply Regs. § 1.882-5 (providing a formulary approach) to recompute (i.e., reduce) the amount of U.S. interest expense. The U.S. Court of Federal Claims found that the plain language of the U.S.-U.K. income tax treaty (1975) using a separate enterprise principle required that the expenses incurred for the benefit of the U.S. branch were deductible, particularly the interest expenses paid to certain foreign branches of NatWest. The court found that Regs. § 1.882-5 was not consistent with the treaty provisions as applied to the U.S. based permanent establishment of an international financial enterprise.[127] The U.S. Court of Appeals for the Federal Circuit affirmed this decision of the lower court.[128]

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[127] National Westminster Bank PLC v. United States, 69 Fed. Cl. 128 (Fed. Cl. 2005).

[128] National Westminster Bank PLC v. United States, 512 F3d 1347 (Fed. Cir. 2008).

After the very long litigation history in this dispute the IRS has determined (during late 2008) that is would not apply to the U.S. Supreme Court for certiorari.[129]

G. Treatment of Royalties

Royalties received are ordinarily taxed only the country of residence, and not at the country of source, unless associated with a permanent establishment in the source country. This treatment of immense significance to certain parties in the transfer of intellectual property including, e.g., the transfer of computer software. The 2008 changes to the Commentary for the OECD Model included various changes for the royalty article (Article 12). One change is that payments made in consideration for the transfer of the full ownership of an element of property as referred to in the definition of royalties cannot be treated as "royalties" under Article 12.[130] The position is that the payments are not made in consideration for the use of, or the right to use, that property.[131] In this context these payments should be treated as subject to the capital gains article (Article 13), providing for taxation only at the residence.

H. Foreign Country Withholding at Source

1. The U.S. "Residency Certificate"

The taxing authorities in many countries insist upon the receipt of a "Residency Certificate" from the Internal Revenue Service before accepting a U.S. taxpayer's position that he is a genuine resident in the United States and, therefore, is entitled

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[129] See BNA Daily Tax Report, August 22, 2008, p. K-1.

[130] OECD Commentary on Article 12, ¶ 8.2

[131] Note that in this context OECD Commentary on Article 12, ¶ 46.1 specifies that the United States (and Mexico) reserve the right to treat as a royalty a gain derived from the alienation of property, provided that the gain is contingent on the productivity, use of disposition of the property. This U.S. position reflects the differentiation made in the sourcing rules in the Internal Revenue Code.

to the tax treaty benefits provided under the applicable income tax treaty to a U.S. resident when that U.S. resident receives income sourced in the treaty partner country.[132] This Certificate (IRS Letter Form 6166) is to be obtained from the Service by filing IRS Form 8802, an application form for this certificate. IRS has been notoriously ineffective in responding to requests to provide such a certificate. Perhaps the process has a possibility of becoming more efficient, but at a cost.

In Rev. Proc. 2006-35, 2006-2 CB 434, the Service announced that a new user fee charge will apply to the processing of all requests for a residency certification on Form 8802. In Notice 2006-90, 2006-2 CB 688, the fee for IRS Form 8802 processing was postponed. In Rev. Proc. 2007-22, 2007-1 CB 675, the IRS indicated that the processing fee now imposed to obtain such a certificate can be paid electronically (for applications filed after April 2, 2007).

I. Pension Plan Contributions and Benefits

A particularly complicated issue for employees in the cross border context is the tax treatment of both contributions to deferred compensation plans and the treatment of subsequent distributions. The OECD Model Treaty (Article 18) specifies that, except for government service pension, "pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment shall be taxable only in that State." This model treaty Article does not deal with the tax treatment of contributions where cross-border situations arise, but the OECD Treaty Commentary seeks to address this issue.[133]

The objective of this discussion is to suggest a provision which countries can include in bilateral treaties to provide relief for pension contributions made by or for

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[132] In the U.S. eligibility status for reduced withholding is established by filing the appropriate IRS W-8 form.

[133] See OECD Commentary on Article 18, paragraphs 31 through 65.

individuals working outside their home country.[134] As noted, the aim of this provision is to ensure that, as far as is possible, individuals are not discouraged from taking up "overseas" work by the tax treatment of their contributions to a home country pension scheme. This provision seeks, first, to determine the general equivalence of pension plans in the two countries and then to establish limits to the contributions to which the tax relief applies based on the limits in the laws of both countries.

The U.S. Model includes a specific provision which would deal with deductibility during the contributions phase when cross-border employment is occurring.[135] Significant flexibility is included in this context.[136] Few current U.S.

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[134] The suggested provision (included in OECD Article 18 Commentary, Paragraph 18) is as follows:
"1. Contributions to a pension scheme established in and recognized for tax purposes in a Contracting State that are made by or on behalf of an individual who renders services in the other Contracting State shall, for the purposes of determining the individual's tax payable and the profits of an enterprise which may be taxed in that State, be treated in that State in the same way and subject to the same conditions and limitations as contributions made to a pension scheme that is recognized for tax purposes in that State, provided that:
a) the individual was not a resident of that State, and was participating in the pension scheme, immediately before beginning to provide services in that State, and,
b) the pension scheme is accepted by the competent authority of that State as generally corresponding to a pension scheme recognized as such for tax purposes by that State."

[135] See U.S. Model, paragraph 18(2).

[136] Note the U.S. Model Treaty Technical Explanation for Article 18: "Subparagraph (a) of paragraph 2 allows an individual who exercises employment or self-employment in a Contracting State to deduct or exclude from income in that Contracting State contributions made by or on behalf of the individual during the period of employment or self-employment to a pension fund established in the other Contracting State. Thus, for example, if a participant in a U.S. qualified plan goes to work in the other Contracting State, the participant may deduct or exclude from income in the other Contracting State contributions to the U.S. qualified plan made while the participant works in the other Contracting State. Subparagraph (a), however, applies only to the extent of the relief allowed by the host State (e.g., the other Contracting State in the example) for contributions to a pension fund established in that State.

income tax treaties include such expansive language. However, the IRS seems to exercise an expansive approach in this context - if a taxpayer asks for a private letter ruling. See PLRs 200602045-046 concerning contributions and benefits arising from the continued application of a foreign pension plan during U.S. employment. In these rulings both the employer and employee were granted favorable treatment. The U.S. income tax treaty involved in these rulings was expansive (like the U.S. Model) but the Service also noted an "Exchange of Diplomatic Notes" when the treaty was implemented to assure applicability to the particular foreign deferred compensation plans involved. See, also, PLR 200604027 where the Service allowed taxpayers (Canadian citizens, resident in the U.S.) to make a late election to defer income taxation on the income contributed to a Canadian Registered Retirement Savings Plan.[137]

The Service has not been so forthcoming in other contexts. See AM 2008-009 (IRS Generic Legal Advice) involving the applicability of Article 18(1) of the U.K.-U.S. Income Tax Treaty (2001) where a U.S. resident who has worked in the United Kingdom returns to the United States and wishes to make a transfer from a U.K. pension scheme to a U.S. retirement plan. Interpreting that Article the Service noted that the U.S. could not tax a U.S. resident's U.K. pension plan if the U.S. resident transferred his account to another U.K. pension plan. However, if the U.S. resident transferred his account to a U.S. plan, Article 18(1) would not apply because this transfer is not an "eligible rollover distribution" under IRC §402(c)(4). Consequently, the accumulated income transferred to the U.S. plan, and the pretax

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"Subparagraph (b) of paragraph 2 provides that, in the case of employment, accrued benefits and contributions by or on behalf of the individual's employer, during the period of employment in the host State, will not be treated as taxable income to the employee in that State. Subparagraph (b) also allows the employer a deduction in computing its taxable income in the host State for contributions to the plan. For example, if a participant in a U.S. qualified plan goes to work in the other Contracting State, the participant's employer may deduct from its taxable income in the other Contracting State contributions to the U.S. qualified plan for the benefit of the employee while the employee renders services in the other Contracting State."

[137] Rev. Proc. 2002-23, 2002-1 C.B. 744, providing procedures for applying for relief in this context.

contribution to the U.K. plan, would be a taxable distribution in the United States. See, also, CCA 200604023 involving dual citizens resident in Australia. The Australia - U.S. treaty (Article 18) provides that a pension shall only be subject to tax in the state of residence (Australia), but the Service applied the "savings clause" to specify that U.S. income tax liability also arose. After the taxpayer received information that the Service would rule adversely the taxpayer withdrew its private letter ruling request. Consequently, this CCA consists of a "Notice of Withdrawal of Ruling Request to IRS International Examination" of a tentative adverse position.

J. FTC Limitation for AMT

Many taxpayers with foreign sourced income have litigated the issue of the applicability of the (now repealed) alternative minimum tax provision that limited their ALTMIN foreign tax credit to 90 percent of the foreign tax paid. Many taxpayers have continued to lose on this issue. See, e.g., Peter M. Haver v. Commissioner, 444 F.3d 656 (C.A. D.C. 2006). This taxpayer, who had lived and worked in Germany, challenged a ruling that he was liable for AMT despite the fact that his German tax payments had exceeded his U.S. tax liability. In imposing AMT liability, the IRS relied on provisions in Code §59(a)(2)(A) which then provided that foreign tax credits extinguished no more than 90% of a U.S. citizen's AMT liability. On de novo review, the court rejected the taxpayer's claim that Code §59 and the treaty were inconsistent and that the treaty should control under the "last in time" doctrine. The court instead concluded that there was no need to invoke the "last in time" analysis because there in fact was no conflict between the treaty and the statute. That was because the language of the treaty expressly conditioned the tax credits available to a U.S. citizen in the taxpayer's position on "the limitations" of U.S. law at the time in question. Here, because Code §59 was an existing "limitation" on the tax credits that might be available to a U.S. citizen at the time the tax treaty was adopted, the parties had every reason to know that the treaty would not afford a 100% tax credit and, therefore, that taxpayers would remain liable for an AMT of at least 10%. Thus, the court affirmed the judgment of the Tax Court holding that the taxpayer still owed a percentage of his AMT notwithstanding the provisions of the tax treaty. Similarly, see (as noted earlier) Jamieson v. Commr., T.C. Memo 2008-118, where the Tax Court determined that the ALTMIN provision limiting the available foreign tax credit was the later in time and eliminated applicability of a contrary Canada-U.S. income tax treaty provision.

This issue has now been solved prospectively by the elimination of this limitation. See former Code §59(a)(2), repealed in the American Jobs Creation Act of 2004, effective for years after 2004, § 421(a)(1). But, for prior years the litigation on this issue has obviously continued.

K. The Canada-U.S. Income Tax Treaty

1. Fiscally Transparent Entities

The Canada-U.S. income tax treaty, as amended by the Fifth Protocol, provides general rules for the treatment of amounts of income, profit or gain derived through or paid by fiscally transparent entities, i.e., "hybrids," including limitations on the use of hybrids.[138] The joint objectives of these rules are to (1) enable a flow-through of benefits to ultimate owners but (2) deny treaty benefits in some situations where double benefits are sought to be achieved.[139]

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[138] See Canada-U.S. Treaty, Article IV(6) & (7), as added by this protocol. See the extensive analysis of this provision in Joint Committee on Taxation, "Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Canada," JCX-57-08, July 8, 2008, p. 100, Part VI (entitled "Issues"), Segment B (entitled "Payments Derived Through or Made by Fiscally Transparent Entities").

[139] The Canada-U.S. Tax Treaty Joint Committee Explanation of this amendment by the protocol notes that Paragraph 6 sets forth the "positive" rule that an amount of income, profit, or gain is considered to be derived by a resident of a treaty country if (1) that person is considered under the tax law of that country to have derived the amount through an entity, other than an entity that is a resident of the other treaty country, and (2) by reason of that entity being treated as fiscally transparent under the laws of the first treaty country, the treatment of the amount under the tax law of the country of residence is the same as its treatment would be if that amount had been derived directly by that person. The rule of paragraph 6 is similar in scope and effect to the rule of Article 1, paragraph 6 of the U.S. Model treaty, which provides "[a]n item of income, profit or gain derived through an entity that is fiscally transparent under the laws of either Contracting State shall be considered to be derived by a resident of a State to the extent that the item is treated for purposes

2. The "Services P.E."

This treaty also has special rules for determining the status of a services activity in the other country as being a services permanent establishment when certain levels of presence in the other country are met and certain other conditions are satisfied.[140] A enterprise of one country may have a permanent establishment in the other country merely because a single individual is present in the other country. That occurs when the individual is present in the other country for a period (or periods) aggregating 183 days or more in any twelve month period and during that period more than 50 percent of the gross active business revenues of the enterprise consists of income derived from the services performed in that other country by that individual.

The Joint Committee on Taxation explanation of this treaty notes that the Senate Foreign Relations Committee might inquire about the appropriateness of this services P.E. provision. The explanation indicated that the U.S. has negotiated several tax treaties containing a similar rule, but noted that the Canada-U.S. treaty would be the first U.S. treaty with a developed country containing such a provision. The implication is that this is a "developing country," not a "developed country" issue.

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of the taxation law of such Contracting State as the income, profit or gain of a resident." The Technical Explanation to the U.S. Model treaty states that the two goals of that provision are (1) to eliminate technical problems that would have prevented investors using such entities from claiming treaty benefits, and (2) to prevent the use of such entities to claim treaty benefits where the investors are not subject to tax on the income in their state of residence. The rule of paragraph 6 is consistent with the first goal stated above. Similarly, the "negative" rule of paragraph 7(a) is consistent with the second goal stated above. Under subparagraph 7(a), an amount of income, profit, or gain is considered not to be paid to or derived by a person who is a resident of a treaty country if (1) that person is considered under the taxation law of the other treaty country as deriving the amount through an entity that is not a resident of the first treaty country, but (2) by reason of the entity being treated as not fiscally transparent under the laws of that treaty country, the treatment of the amount under the taxation law of that country is not the same as its treatment would be if that amount had been derived directly by the person.

[140] Treaty Article V, Paragraph 9 (as added by the protocol).

VI. Certain Reporting/Structural Requirements

A. Disclosing Tax Treaty Benefits Claimed

A taxpayer claiming tax treaty benefits (i.e., more liberal treatment than a provision of the Internal Revenue Code) is often required to disclose this reporting position to the IRS.[141] This is accomplished by attaching IRS Form 8833, "Treaty-Based Return Position Disclosure," to the taxpayer's income tax return.[142]

A number of exceptions exist to the required filing of this form, e.g., where withholding rates at source on fixed or determinable annual or periodical income are reduced.[143] An important situation where a tax treaty might be relied upon is where a foreign entity which is engaged in a trade or business in the U.S. asserts that it is not subject to U.S. income tax because it does not have a permanent establishment in the U.S., as determined under the applicable bilateral U.S. income tax treaty.[144]

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[141] Code §6114. A useful place to start for the identification of the existence of these tax treaty benefits (other than examining the particular tax treaty itself) might be the IRS Publication 901, "U.S. Tax Treaties," ordinarily revised annually. This publication provides useful charts summarizing the withholding tax rates in the treaties, and other information. Note, however, that for this purpose Code §6114 includes "any treaty of the United States (including, but not limited to, an income tax treaty, estate and gift tax treaty, or friendship, commerce and navigation treaty)." See Reg. §301.6114-1(a)(1).

[142] Note that the filing of this IRS Form 8833 did not help a U.S. Indian tribe taxpayer claiming that he was exempt from taxation under an 1815 treaty between the United States and the Potawatomi tribe, 6 Treaty with the Potawatomies, Sept. 8, 1815, art. 2, 7 Stat. 131. Accompanying his unsuccessful assertion of his tax-exempt status was a cover letter and a summary of purported legal arguments for his treaty-based return position. Green v. Commissioner, T.C. Memo 2008-130.

[143] See Reg. §301.6114-1(c)(1).

[144] See, e.g., Priv. Ltr. Rul. 200815016 noting a situation where Entity X, a resident of a Country A with which the United States has an income tax treaty, was formed as a general partnership under the laws of Country A. Entity X was eligible to make an election to be treated as a corporation for federal tax purposes. However, IRS Form 8832, Entity Classification Election, was not timely filed. Entity X represented that it was engaged in a U.S. trade or business but that

B. The Limitation on Tax Treaty Benefits

For several decades the U.S. Department of the Treasury has been pursuing the inclusion of a "limitation on benefits" provision in new and renegotiated tax treaties. The objective of the U.S. Treasury in this context is to not enter into or maintain in existence an income tax treaty which, practically, can be transformed through adroit tax planning, into a "treaty with the world." The tax planning objective sought to be achieved would be to enable the use of an entity in the treaty partner country which, however, facilitates conduit tax treatment in that country in investing under favorable tax conditions into the United States.

The important objective of income tax treaty provisions reducing source country taxation is to cause a shifting of a taxpayer's tax burden to the residence state, but this is to be facilitated only if the beneficiary is actually a tax resident of the other state (and, therefore, subject to tax in that other state). "Those reductions and benefits are not intended to flow to residents of a third country."[145] For example, the provisions of this income tax treaty would be significantly frustrated if (a) a resident (including a corporation) in a Middle -Eastern or South American country not having an income tax treaty with the United States could organize a controlled entity in a third jurisdiction (e.g., the Netherlands), (b) that Netherlands entity would have the benefits of the U.S. income tax treaty upon the receipt of profits derived from U.S. corporate investments, and (c) under the applicable internal Dutch tax law (e.g., the "participation exemption" provisions) the taxation of that income in the Netherlands could be eliminated or significantly moderated when received and then transmitted to the owner's jurisdiction,

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it did not have a U.S. permanent establishment. Entity X was granted an extension of time to elect to be classified as an association taxable as a corporation for federal income tax purposes. The Service noted that the election should be made by filing IRS Form 8832 with the appropriate service center. A copy of this letter should be attached to the election. Because X is relying on a treaty-based return position. Entity X was also required to file IRS Form 8833, Treaty-Based Return Position Disclosure under §§ 6114 or 7701(b) attached to Form 1120-F, U.S. Income Tax Return of a Foreign Corporation for each year during the applicable period.

[145] Brown Testimony, p. 4.

Every new U.S. income tax treaty (and particularly every revision of previously existing U.S. income tax treaties with large trading partner countries) produces a strengthening of these limitations on the available treaty benefits.[146] The nuances of the applicable limitations in this context are many, with the variables often depending upon business investment conditions in the treaty partner country.[147] The objective

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[146] See Joint Committee on Taxation, "Testimony of the Staff of the Joint Committee on Taxation Before the Senate Committee on Foreign Relations Hearing on the Proposed Protocol to the Income Tax Treaty with Canada and the Proposed Income Tax Treaties with Iceland and Bulgaria," JCX-60-08, p. 2, July 10, 2008 (testimony of Emily McMahon, Deputy Chief of Staff of the Joint Committee on Taxation), describing the recent Bulgaria & Iceland Treaties and the Canada Protocol as being consistent with the objective to limit tax treaty benefits. This testimony indicates that the (now prior) treaty between the U.S. and Iceland was one of only eight remaining U.S. income tax treaties that did not include any limitation-on benefits rules. Three of those eight treaties, including treaties with Iceland (prior treaty), Hungary and Poland provide for a complete exemption from withholding on interest payments from one treaty country to the other treaty country. "Consequently, those three treaties present particularly attractive opportunities for treaty-shopping. In fact, a November 2007 report prepared by the Treasury Department at the request of the U.S. Congress suggests that the income tax treaties with Hungary and Iceland have increasingly been used for treaty-shopping purposes in recent years as the United States adopted modern limitation-on-benefits provisions in its other treaties. [See Department of the Treasury, 'Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties' (Nov. 28, 2007)]. The proposed treaty with Iceland, including its modern limitation-on-benefits provisions rules, would thus eliminate a significant treaty-shopping opportunity. Nevertheless, the Committee may wish to inquire of the Treasury Department regarding its plans to address the remaining U.S. income tax treaties that do not include limitation-on-benefits provisions, and in particular the treaties with Hungary and Poland."

[147] For a useful example of the limitation on treaty benefits in a particular context see Venuti, Poms and Manasuev, "Eligibility for Treaty Benefits Under the Luxembourg-U.S. Income Tax Treaty," Tax Notes International, July 21, 2008, p. 285. The Luxembourg-U.S. treaty was signed in 1996 so it does not include a zero percent dividend withholding tax rate. This article includes seven flowcharts facilitating a review concerning whether the limitation on benefits provision might apply to preclude tax treaty benefits. Similarly, see Venuti, Dabrowski, Poms & Manasuev, "Eligibility for Treaty Benefits Under U.K.-U.S. Income Tax Treaty," Tax Notes International, March 23, 2009, p. 1095. Similarly, this article includes useful flowcharts concerning eligibility for the zero withholding tax rate on dividends.

of the U.S. Treasury in limiting the perceived abuse of U.S. tax treaties in the outbound profits distribution context is quite clear.[148]

This analysis does identify a tax planning opportunity which can often be exploited by U.S. enterprises investing outbound through a third jurisdiction (as contrasted to inbound investment where the U.S. will apply its limitation on benefits rules to preclude inappropriate treaty benefits). Other countries are often not concerned about the back-to-back linkage of transactions through their jurisdictions (as long as the country can realize some minimal processing fee).[149] Therefore, in the outbound context a U.S. enterprise could use a tax treaty (e.g., the U.S.-Netherlands treaty) to link through another Netherlands treaty into a third destination country.[150] Interestingly, in this context, however, in the Protocol to the Canada-U.S. Income Tax Treaty Canada has agreed to the reciprocal application of the limitation on benefits provision, reflecting a perspective that other countries may be moving towards a similar limitation on benefits rule.[151]

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[148] In the Department of the Treasury's "Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties" (Nov. 28, 2007), Section D includes an extensive discussion of the development of the anti-abuse provisions of U.S. tax treaties, including the limitation-on-benefit concept..

[149] Note that in the Department of the Treasury's "Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties" (Nov. 28, 2007), p. 87, the statement is made that "[a] growing consensus is developing among tax authorities worldwide about the need to prevent third country residents from inappropriately obtaining the benefits of bilateral income tax treaties."

[150] The Netherlands is noted as an example because it has a much more expansive tax treaty network than does the United States. This is attributable to several factors, including that the Netherlands have been interested in these bilateral arrangements for an extended period and because a bilateral agreement with the Netherlands is, for many countries, not politically intimidating (unlike a treaty with the United States).

[151] Article XXIXA of the protocol. See Joint Committee on Taxation, "Testimony of the Staff of the Joint Committee on Taxation Before the Senate Committee on Foreign Relations Hearing on the Proposed Protocol to the Income Tax Treaty with Canada and the Proposed Income Tax Treaties with Iceland and Bulgaria," JCX-60-08, p. 3, July 10, 2008 (testimony of Emily

VII. Resolving Tax Treaty Disputes

A. Perspectives on Facilitating Tax Treaty Dispute Resolution

A continual dilemma concerning the resolution of cross border tax disputes is that often adequate mechanisms do not exist to facilitate their expeditious resolutions. This can be quite frustrating to the taxpayer, and even to the several government Competent Authorities, when these disputes drag on for years. Over the last several years many tax authorities (including in the U.S.) have recognized that the dispute resolutions process must be made more efficient.[152] Even the U.S. has been moving towards a dispute resolution process to be accomplished through binding arbitration. But, from the U.S. perspective, this is treacherous ground, since it involves agreeing that the U.S. Government can be bound by the decision of some "foreign arbitrators."

B. The OECD Position

The OECD's Centre for Tax Policy and Administration on February 7, 2007 published a report addressing various issues relating to the tax treaty "mutual agreement procedure" or "Competent Authority" process.[153] This report notes that

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McMahon, Deputy Chief of Staff of the Joint Committee on Taxation), noting that "[u]nlike the rules in the present treaty (which may be applied only by the United States), the new rules are reciprocal and are intended to prevent the indirect use of the treaty by persons who are not entitled to its benefits by reason of residence in Canada or the United States."

[152] The OECD is beginning to consider whether a separate multilateral dispute resolution treaty to resolve tax controversies might be appropriate. See Tax Notes, September 15, 2008, p. 1039.

[153] See "OECD Publishes Report on Resolution of Tax Treaty Disputes," 2007 TNT 27-19 (February 8, 2007), providing the text of the report entitled "Improving the Resolution of Tax Treaty Disputes," adopted by the OECD Committee on Fiscal Affairs, January 30, 2007. This report, "Improving the Resolution of Tax Treaty Disputes," is located at http://www.oec.org/dataoecd/17/59/38055311.pdf The OECD has also posted on its web site the final version of its "Manual on Effective Mutual Agreement Procedures (MEMAP)" which is intended as a guide to increase awareness of the mutual agreement procedure process and how it

the existing mutual agreement procedure implemented through OECD model treaty based agreements provides a generally effective and efficient method of resolving international tax disputes.[154] However, the report notes, cases will arise in which the mutual agreement procedure is not able to reach a satisfactory result. These cases will typically arise when the countries involved cannot agree in a particular situation that the taxation by both countries is in accordance with the treaty. Since the mutual agreement procedure as currently structured does not require the countries to come to a common understanding of the treaty, but only that they "endeavor to agree," the result can be double taxation or "taxation not in accordance with the Convention" where the countries cannot agree. Consequently, the OECD model tax treaty is being revised to include a mandatory arbitration provision.[155]

The arbitration process can be mandated by the affected taxpayer when the several competent authorities are unable to reach an agreement within two years of

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should function.
See http://www.oecd.org/document/26/0.2340.en_2649_33753_36197402_1_1_1_1.00.html

[154] OECD 2007 Tax Treaty Report, paragraph 10.

[155] OECD 2007 Tax Treaty Report, paragraph 10, provides for the following new paragraph 5 to Article 25:

"5. Where,

a) under paragraph 1, a person has presented a case to the competent authority of a Contracting State on the basis that the actions of one or both of the Contracting States have resulted for that person in taxation not in accordance with the provisions of this Convention, and

b) the competent authorities are unable to reach an agreement to resolve that case pursuant to paragraph 2 within two years from the presentation of the case to the competent authority of the other Contracting State, any unresolved issues arising from the case shall be submitted to arbitration if the person so requests. These unresolved issues shall not, however, be submitted to arbitration if a decision on these issues has already been rendered by a court or administrative tribunal of either State. Unless a person directly affected by the case does not accept the mutual agreement that implements the arbitration decision, that decision shall be binding on both contracting States and shall be implemented notwithstanding any time limits in the domestic laws of these States. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this paragraph."

the commencement of the competent authority proceeding. The process is not dependent on a prior authorization by the competent authorities. The objective of this provision is to expand the mutual agreement procedure to assure that where the competent authorities cannot reach an agreement on one or more issues that prevent the resolution of a case, a resolution of the issues will still be possible by submitting those issues to arbitration.[156] The OECD report does state that in some countries (e.g., the U.S.?) national law, policy, or administrative consideration may not allow or justify the type of arbitration process provided for in this provision. Constitutional barriers may prevent arbitrators from deciding tax issues. In addition, some countries may only be in a position to include this paragraph in treaties with particular countries. Therefore, the OECD report concludes that the binding arbitration provision should only be included in a bilateral treaty where each country concludes that the process is capable of effective implementation.[157]

In adopting binding arbitration in a tax treaty the parties could adopt either the "independent opinion" approach or the "last best offer" approach to arbitration. Countries could prescribe when one of the two approaches is applied or decide on a case-by-case basis. Under the "independent opinion" approach the competent authorities present their arguments to a panel of arbitrators who issue their own opinion (that could ignore the proposals by each side). Under the "last best offer" approach (often referred to as "baseball arbitration") the arbitrators would be required to choose between the two settlements proposed by the several competent authorities.[158]

This OECD report includes an Annex to the OECD Model Treaty Commentary to provide for a "Sample Mutual Agreement on Arbitration."[159] This "Mutual

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[156] OECD 2007 Tax Treaty Report, paragraph 46.

[157] OECD 2007 Tax Treaty Report, paragraph 47.

[158] See "OECD Issues Revised Arbitration Procedure; Taxpayers Retain Right to Litigate Disputes," Daily Tax Report, February 8, 2007.

[159] OECD 2007 Tax Treaty Report, paragraph 69.

Agreement on the Implementation of Paragraph 5 of Article 25" would provide the details concerning the procedures in dealing with the submission of a case to arbitration under this provision.

C. U.S. Perspectives

1. Arbitration of Tax Treaty Disputes

Binding arbitration has been included in the protocols to the German-U.S., the Belgium - U.S., the Canada-U.S. and the France-U.S. income tax treaties.[160] Will binding arbitration be extended to other U.S. income tax treaties?[161] Note that prior to 2007no binding arbitration provision had been included in a tax treaty or protocol submitted to the U.S. Senate for ratification.[162] However, members of the Senate Foreign Relations Committee were apparently receptive to this idea at the July 17, 2007 hearings on several protocols and the Belgium treaty.[163] Subsequently, in approving the Fifth Protocol to the U.S.-Canada income tax treaty (which includes an arbitration provision), the Senate Foreign Relations Committee directed the U.S. Treasury to develop rules for the arbitration process and to submit reports on cases

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160 The France-U.S. Treaty, 2nd Protocol, including this binding arbitration was signed in 2009 and is not yet in force.

161 Note that voluntary arbitration provisions are included in treaties with Mexico, Switzerland, France, Ireland, Kazakhstan, the Netherlands and Germany (prior to the 2007 protocol).

162 See "Tax Officials Talk Up Treaty Arbitration," 2006 TNT 241-5 (December 15, 2006), noting that binding arbitration may play a role in future U.S. tax treaty practice, but taxpayers should not expect a standardized mechanism. This article notes that "[g]iven the patriotic murmuring one hears about how arbitration could result in the loss of sovereignty, the ratification process for the German and Belgian agreements will hardly be a rubber stamp."

163 See "Testimony of the Staff of the Joint Committee on Taxation Before the Senate Committee on Foreign Relations hearing on the Proposed Tax Treaty with Belgium and the Proposed Tax Protocols with Denmark, Finland and Germany," Joint Committee on Taxation, JCX-51-07 (July 17, 2007); electronic citation: 2007 TNT 138-16. See, further, Goulder, "U.S. Lawmakers Warm to Mandatory Arbitration," Tax Notes International, Vol. 47, No. 4, p. 314 (July 23, 2007).

submitted and resolved.[164] In the explanation of this provision in the Canada-U.S. treaty the Joint Committee on Taxation explanation notes that proponents of mandatory arbitration believe that incorporating into the mutual agreement process a mechanism that would ensure the resolution of disputes would be useful for several reasons.[165] First, disputes that could not be resolved by the competent authorities within a prescribed time frame would be finally and completely resolved through the arbitration process. More fundamentally, however, proponents argue that the existence of a mandatory arbitration process will impel the competent authorities to reach mutual agreement, so as to avoid any arbitration proceedings. This argument is premised on the belief that the competent authorities would prefer to negotiate their own settlement to having an outcome imposed by an arbitration board. Proponents further believe that, if a competent authority believes that an arbitration board may determine the matter adversely to that competent authority, mutual agreement on reasonable and moderate grounds will be more likely. These proponents hold the view, therefore, that while few, if any, actual arbitrations will occur, many more cases will be resolved promptly and appropriately through the mutual agreement procedure.

Certain additional observations concerning arbitration proceedings are noted here. The Belgium-U.S. treaty utilizes a "baseball" form of arbitration, i.e., requirement that the last best offer be accepted by the arbitrators. In contrast, the OECD provision allows the competent authorities to adapt the form of arbitration to each case. As specified in the Canada-U.S. treaty the taxpayers must sign a

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[164] See, "Senate Ratifies Tax Treaty Instruments, Canada Protocol," 120 Tax Notes 1269 (Sept. 29, 2008). A detailed report to the Senate Finance Committee and the Joint Committee on Taxation is required after the tenth arbitration conducted under all three of the treaties facilitating binding arbitration. This is to include information about the number of pending cases by treaty article, the number resolved without arbitration, the number of initiated arbitrations and which competent authority initiated the case. Following the first arbitration report an annual report with similar information is to be prepared and provided for each of the next five years.

[165] See Joint Committee on Taxation, "Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Canada," JCX-57-08, July 8, 2008, p. 106.

confidentiality agreement precluding the release of any information about the arbitration proceedings, except the result.[166]

The German and U.S. tax authorities seem to be proceeding with the implementation of rules for the creation and management of arbitration panels. The tax authorities have implemented a detailed Memorandum of Understanding concerning how the competent authorities will proceed with the arbitration of disputes. Further, the tax authorities have adopted detailed "Arbitration Board Operating Guidelines" concerning how the mechanics of the arbitration panels will function.[167] When the France-U.S. tax treaty protocol was signed on January 13, 2009 an MOU was signed on the same day that details the rules and procedures for implementing the arbitration provision, including the appointment of an arbitration board, the timeline for submitting a proposed resolution and position paper, the handling of confidential information, and the splitting of arbitrator's fees and expenses.[168] This MOU says an arbitration board must deliver a determination within six months from referral.

2. Competent Authority Relief

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[166] See the JCT explanation of the Canada- U.S. treaty, particularly concerning Article 21, "Mutual Agreement Procedure, specifying that all concerned persons and their authorized representatives or agents must agree (in a "confidentiality agreement") before the arbitration proceedings not to disclose to any other person any information, other than the determination of the arbitration board, received during the course of the arbitration proceeding from either treaty country or the arbitration board. This is part of quite extensive notes to the proposed protocol which include additional rules and procedures governing the mandatory binding arbitration.

[167] See IRS Announcement 2008-124, "German Arbitration Memorandum of Understanding Announcement."

[168] See 2009 TNT 8-52, January 14, 2009.

The Service appears to currently have significant competent authority case activity.[169] During 2006 the Service updated the Revenue Procedure describing how competent authority relief can be requested under the provisions of a tax treaty to which the United States is a party.[170] The Service has separate Competent Authority procedures for dealing with the tax agencies in U.S. possessions, i.e., American Samoa, Guam, Northern Mariana Islands, U.S. Virgin Islands, and Puerto Rico.[171]

During 2006 the IRS has also indicated that for certain discretionary qualification decisions by the competent authority concerning the applicability of the "limitation on benefits" provision a "user fee" would be required.[172] Effective May 4, 2006, a user fee of $15,000 is now charged for each entity requesting a discretionary "limitation on benefits determination." If a request is submitted that requires the competent authority to make a discretionary determination for more than one entity, a separate fee will be charged for each entity. In, the Service indicated that no user fees are required with respect to a request for U.S. competent authority assistance pursuant to this revenue procedure, except (superseding Rev. Proc. 2006-

[169] See "Tax Officials Talk Up Treaty Arbitration," 2006 TNT 241-5 (December 15, 2006), indicating that the year-end inventory of competent authority cases numbered 430, a slight increase from the year 2005. These cases involved allocation and nonallocation matters, limitations on benefits cases, and advance pricing agreements. During 2006 IRS had 240 new competent authority cases and disposed of 234 cases. Apparently much of this increased activity is derived from Advance Price Agreement (APA) matters. Foreign initiated cases apparently represent about 70 percent of the total volume of these disputes. The average processing time is "down" from 770 days (more than two years!) to 646 days. For foreign initiated cases the average processing time has declined from 851 days to 756 days (still more than two years!).

[170] See Rev. Proc. 2006-54, 2006-2 CB 1035, superseding Rev. Proc. 2002-52, 2002-2 CB 242.

[171] See Rev. Proc. 2006-23, 2006-1 CB 900.

[172] Rev. Proc. 2006-26, 2006-1 CB 936.

26) the Service reiterated (in Section 14.02) the applicability of a $15,000 fee to "limitation of benefits" determinations.[173]

VIII. Concluding Observations

The U.S. Treasury Department and the IRS have obviously been active on many issues in addressing cross border federal income tax concerns in the context of bilateral income tax treaties. The 2006 Model Income Tax Treaty is evidence that the U.S. Treasury and the IRS may be increasingly serious about the U.S. bilateral tax treaty network, and the resolution of significant, continuing cross-border tax disputes. Presumably this impetus will not be accelerated, not impeded, by Obama Administration Treasury Department appointees. On an even more fundamental basis, the OECD tax group (now including various capable individuals carrying U.S. passports!) has been quite active in examining cross border tax policy issues relevant under bilateral income tax treaties and has been encouraging serious reconsideration of many tax treaty concepts. As a result, many OECD model tax treaty (and related Commentary) refinements can be anticipated in the near future that will affect the continuing worldwide evolution of income tax treaties, including for the United States.

[173] Rev. Proc. 2006-54, 2006-2 CB 1035.