Mysteries of the Model

by H. David Rosenbloom

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In this article, Rosenbloom explores three complex "mysteries" of the 2016 U.S. model income tax convention: derivation, non-aggravation, and justifiable discrimination.

It appears that the Treasury Department is reviewing the United States Model Income Tax Convention of 2016 with a view to updating it and producing an entirely new version. That is good news. There have been significant developments since 2016 — most prominently, enactment of the Tax Cuts and Jobs Act in 2017. Moreover, the 2016 model was not accompanied by a model technical explanation, the most recent version of which dates to 2006. It is to be hoped that a new model technical explanation will be issued when a new model income tax convention is released.

As of this writing, the best public indication of U.S. treaty policy is probably the income tax convention with Croatia, the only treaty negotiated and made available to the public in the years since enactment of the TCJA. That treaty, which of course reflects not only U.S. preferences but the requirements and demands of another country, does not present a clear picture. For the most part it tracks the 2016 model word for word.

It seems timely and worthwhile to identify aspects of the 2016 model that are especially perplexing, and perhaps worthy of further thought and elaboration. If the 2016 model is to be thoroughly reconsidered, some of its odd features cry out for attention.

Many are no doubt attributable to the longstanding Treasury objective of remaining close to the OECD model convention to the extent U.S. law will allow. This is presumably the justification, for example, for a seemingly unnecessary article on directors' fees and for confining the special rules of article 16 (entertainers and sportsmen) to artists and athletes, who are certainly not the only sorts of taxpayers capable of earning large amounts of income in a short span of time without having a permanent establishment in the country in which the income is earned.

Other mysteries of the 2016 model can be identified in a few words, such as the elimination of explicit coverage of taxes of "a political subdivision or local authority" of a contracting state in article 24 (nondiscrimination). Could it have been the intention of the Treasury to narrow application of the nondiscrimination rules? That would have been a dramatic change of policy.

The mysteries on which this article focuses are more complex and require more elaboration. They are:

- the "derivation" principle of paragraph 6 of article 1 (personal scope);
- implications of the "non-aggravation" clause of paragraph 2 of article 1; and
- the concept of "justifiable discrimination" as it emerges from the model technical explanation's discussion of article 24.

Strictly speaking, this last mystery is not "of the model," because it does not stem from the words of article 24 — perhaps the source of the mystery lies there.

Derivation

Paragraph 6 of article 1 reads as follows:

> For the purposes of this Convention, an item of income, profit or gain derived by or through an entity that is treated as wholly or partly fiscally transparent under the taxation laws of either Contracting State shall be considered to be derived by a resident of a Contracting State, but only to the extent that the item is treated for purposes of the taxation laws of such Contracting State as the income, profit or gain of a resident.

This provision is aligned with IRC section 894(c) and reg. section 1.894-1(d). It appears clear. Derivation is determined according to taxation in the country of purported residence of a person claiming treaty benefits. If that country is imposing tax on a residence basis, then the person claiming treaty benefits derives the income on which the tax falls. But so what? The articles on dividends, interest, and royalties (10, 11, and 12) do not contain the words "derived" or "derivation." The word "derived" does appear in article 13 (gains) and in some of the employment articles — 14 (income from employment), 15 (directors' fees), 16 (entertainers and sportsmen), and the paragraph dealing with annuities in 17 (pensions, social security, annuities, alimony, and child support). But the derivation provision in article 1 is designed to address the treaty implications of hybrid and reverse hybrid entities (fiscally transparent entities), and those entities are most commonly associated with investment income. It is not clear how article 1, paragraph 6 meshes with the use of the word "derived" elsewhere in the model. Article 1, paragraph 6, is not even tethered to article 13, an investment article, much less to the employment articles. What is to be made of the derivation rule?

The discussion of paragraph 2 of article 10 (dividends) in the 2006 model technical explanation provides an explanation of sorts. A distinction is made there between derivation and beneficial ownership. Derivation is determined by the country of residence, while beneficial ownership, a phrase not defined in the model but employed in articles 10, 11, and 12, is left to the country of source. It is to be interpreted in accordance with paragraph 2 of article 3 (general definitions), which generally looks to the law of the jurisdiction applying the convention for interpretative guidance. The discussion in the model technical explanation makes clear that both the derivation and beneficial ownership requirements must be satisfied for a person to enjoy the benefits of a treaty.

The model technical explanation discusses the two tests as if there were no problem. What could go wrong with the residence country calling the shots on derivation while the source country applies its law in determining beneficial ownership? It's all for the best in the best of all possible worlds. A bit of reflection, however, suggests that the technical explanation may be a bit disingenuous and that a problem or two may be lurking.

The technical explanation focuses solely on hybrid entities — transparent in the United States, nontransparent abroad — and the discussion suggests there generally is, or might be, a happy ending in these cases, with treaty benefits awarded to the party that claims them. That may indeed be the case in many instances. Not all, however.

In Announcement 2003-21, the IRS stated that it had reached a mutual agreement with the Netherlands with respect to the treatment of certain exempt pension funds. Some Dutch funds are wont to make cross-border investments through entities organized and treated as fiscally transparent in the United States but nontransparent in the Netherlands, the country of the funds' residence. The mutual agreement is to the effect that such a fund will be considered to have derived the resulting income even though it cannot meet the prescribed derivation test because the intermediate entity is nontransparent in the Netherlands. (This point is described from the viewpoint of an investment in the United States; the provision is, of course, reciprocal.)

The rule articulated in the announcement was subsequently adopted by protocol in paragraph 4 of article 24 of the convention with the

Netherlands. It has thus far been limited to the Netherlands and apparently applies only when the fiscally transparent entity is or would be a resident of the source jurisdiction (and thus, by definition, not a taxpayer in any country). The situation demonstrates that a mechanical application of the derivation rule can produce results lacking in policy rationale.

More problems emerge when a reverse hybrid situation is in question — that is, transparent abroad but nontransparent under U.S. rules. There is a good chance here that treaty benefits will be more frequently unavailable because the owner of the reverse hybrid may be taxed on the income on a residence basis but the beneficial owner for U.S. purposes is going to be the reverse hybrid entity itself. A problem may exist even if the owner and the entity are residents of the same treaty partner country, with derivation satisfied because of the owner and beneficial ownership satisfied by the entity. Who is required to file the U.S. tax return in these circumstances?

The model technical explanation says nothing about the fact that the derivation concept does not appear in article 10 at all. What, exactly, justifies a denial of treaty benefits for dividends that the putative taxpayer, a beneficial owner, has not derived? The text of article 1, paragraph 6, is not capable of producing this result by itself. It may be worth observing in this context that courts have sometimes taken a dim view of technical explanations that expand upon the words of a treaty.[1]

Stepping back from this muddled state of affairs, it is not clear why two entirely separate sets of rules are needed. The derivation concept developed because a beneficial ownership approach to fiscally transparent entities led to the award of source-country treaty benefits when there was no residence country imposing tax. Granting these benefits only when there is a treaty partner imposing tax on the basis of residence makes considerable sense. It is, after all, a bedrock tax treaty notion that the source country reduces or eliminates its tax and the residence country taxes and undertakes to avoid double international taxation. Regarding fiscally transparent entities, however, it is hard to see why there should be continued insistence on beneficial ownership if the derivation rule is in place and the person claiming treaty benefits is subject to tax on the basis of residence. The beneficial ownership requirement is intended to preclude the possibility of benefits flowing to a party that is not the true economic owner of the income in question. Yet once it is determined that there is a residence-basis tax on the claimant, as a slightly modified derivation rule would guarantee, the policy rationale for an additional inquiry into economic ownership of the income is less than compelling. The residence country's tax is sufficient to ensure that the income is not flowing to a mere nominee.[2]

To be clear, the suggestion here is to equate derivation with beneficial ownership only in the case of fiscally transparent entities. It is not feasible, or desirable, to dispense entirely with beneficial ownership, a concept that appears in the investment articles of most tax treaties. The idea would be, rather, to establish a treaty rule that derivation, with its focus on the country of residence, itself satisfies the beneficial ownership standard when fiscally transparent entities are concerned.[3]

Non-Aggravation

The non-aggravation provision appears in paragraph 2 of article 1 of the model and states (in part):

> This Convention shall not restrict in any manner any benefit now or hereafter accorded . . . by the laws of either Contracting State.

This seems clear on its face. A taxpayer is always free, insofar as a U.S. tax treaty is concerned, to take the position that it does not wish to invoke the treaty and will instead rely on the IRC. A problem arises, however, when a

[1] *See, e.g., Xerox v. United States*, 41 F.3d 647 (Fed. Cir. 1994).

[2] If it is deemed necessary to accommodate exempt entities with a special rule such as the one adopted for the Netherlands, that can be accomplished by a treaty provision overriding the derivation concept in such circumstances.

[3] In adopting this suggestion, the derivation rule should be adjusted so that it applies not to "a resident of a Contracting State" but to a "resident of a Contracting State claiming benefits under this Convention."

taxpayer seeks benefits under both the code and a treaty.

Rev. Rul. 84-17, 1984-1 C.B. 308, declared 40 years ago that there were (should be?) limits to a taxpayer's ability to "pick and choose" among benefits made available by the code and those afforded by a tax treaty. The ruling seems reasonable, although it has never received judicial scrutiny. It deals with a taxpayer with a U.S. PE electing the code to claim losses of a different U.S. trade or business not amounting to a PE, while invoking a treaty to exempt income from a third U.S. trade or business not amounting to a PE. That would seem to be an easy case. The ruling demands that the taxpayer be, at least to some extent, consistent: It may proceed under either the code or the treaty but not under both at the same time with respect to the same subject matter. How far does this implicit consistency rule carry? The model technical explanation states, in discussing the provision, that a taxpayer may invoke the code for all trades or businesses not constituting a PE but can rely upon the convention "with respect, for example, to dividend income he may receive from the United States that is not effectively connected with any of his business activities in the United States." This is helpful as far as it goes, which is not very far.

In discussing the attribution rule that appears in paragraph 2 of article 7 (business profits), the model technical explanation states that if a taxpayer:

> uses Article 7 principles to exempt . . . effectively connected income that is not attributable to its U.S. permanent establishment, then it must include . . . foreign source royalties [attributable to the permanent establishment] in its net taxable income even though such royalties would not constitute effectively connected income.

This may go *too* far. Can it be correct that the consistency principle — or anything else — permits U.S. taxation of income not reached by the IRC?

In the *National Westminster Bank* case,[4] a U.S. branch of a foreign bank was authorized to claim U.S. deductions for interest paid by the branch to the head office in London. Such intra-entity payments are generally disregarded under the IRC. The result in *Natwest* was based on a careful parsing of the language of the business profits article of the treaty between the United States and the United Kingdom, as well as the commentaries of the OECD. The courts never considered the obverse situation, which was apparently not presented by the facts in the case: If interest had flowed in the opposite direction, from the head office to the branch, would that interest have been taxable in the United States? If not taxable, might it have been an offset to the interest that was deductible? It is difficult to identify the legal authority for either of those conclusions, apart from the non-aggravation rule.

Treaties do not generally contain rules of taxation. Rather, they establish outer limits within which domestic taxation rules of the treaty partners are allowed to operate. It is not necessarily the case that the domestic rules occupy the entire space afforded by the treaties. The United States especially, with its peculiar rules for determining effectively connected income of a U.S. trade or business, finds itself leaving empty a fair amount of the territory within which the treaties would permit taxation. The question presented by the hypothetical intra-entity income flow mirroring the *Natwest* facts is whether the consistency supposedly mandated by the non-aggravation rule can extend U.S. taxation beyond what has been enacted into U.S. law and up to the bounds set by a treaty. This question arises more frequently than might be supposed.

Nondiscrimination

The word "discrimination" means differentiation or distinction and, notably, does not appear in the text of article 24 of the model. The article is intended to ensure that taxpayers who are resident in, or nationals of, a treaty partner jurisdiction will not be treated differently to their detriment in the other jurisdiction. Four types of

[4] *National Westminster Bank v. United States*, 512 F.3d 1347 (Fed. Cir. 2008).

discrimination are covered by the article. The model technical explanation states that although the wording of the four types may be different, all of them provide that "two persons that are comparably situated must be treated similarly."

The technical explanation also stakes out the position that "the common underlying premise is that if the difference in treatment is directly related to a tax-relevant difference in the situations of the domestic and foreign persons being compared, the difference is not to be treated as discriminatory." In other words, a tax-relevant difference — discrimination — does not violate the principles of article 24.

This is a far-reaching proposition. It adopts the concept of "justifiable discrimination" — discrimination in taxation that is acceptable notwithstanding the rules of article 24. Foreign persons are almost never in the same situation as domestic persons, so a tax-relevant defense of a discriminatory provision is frequently available. It is doubtful that justifiable discrimination was an original facet of the nondiscrimination principle, or that U.S. tax authorities or Congress embraced this point in the past, especially when the focus was on other countries' tax rules.[5]

In enacting section 897 of the code — the substantive foreign investment in real property tax act rules — Congress deemed it necessary to include section 897(i), giving foreign corporations the option to elect to be taxed as domestic if they have a treaty right to nondiscriminatory treatment. Yet surely the discriminatory aspects of section 897 — for example, the restricted availability of tax-free reorganizations — were based on tax-relevant differences between foreign and domestic corporations. A similar point can be made about the efforts of Congress to justify the now-repealed interest stripping rule of section 163(e), by denying deductions not only for interest paid to foreign persons but also for interest paid to U.S. tax-exempt entities. Why were these heroic efforts needed if tax-relevant differences between U.S. and foreign persons were sufficient to ward off a nondiscrimination challenge?

The closest the IRS has ever come to expressing a concept of justifiable discrimination was in Rev. Rul. 89-80, 1989-1 C.B. 273, dealing with the excess interest tax of section 884. The ruling explained the basis for differentiating between a foreign corporation with a U.S. trade or business and a U.S. corporation. The explanation is presented as a defense of the excess interest tax, which is levied only on foreign corporations.

Countries are not normally in the business of establishing distinctions in their tax laws based on pure xenophobia. They are very much in the business of trying to protect their tax base, and that often requires rules for foreign persons that are different from the rules for domestic persons. If tax-relevant differences justify discrimination, the reach of article 24 is narrow indeed. That may be what is desired, because the rationale for including any nondiscrimination rule in a tax treaty is itself questionable.[6] However, the text of the article contains no such broad limiting principle. If it is to be adopted, perhaps it should be explained clearly, and with more attention to detail than a few sentences in a model technical explanation.

Conclusion

There is more to think about and discuss in the 2016 model, including whether U.S. treaties grant a foreign tax credit independent of the credit granted by the code (a question being litigated in the Court of Claims and the Federal Circuit), and whether article 18 (pension funds) should contain a paragraph like the one in the fifth protocol to the treaty with Canada, dealing with U.S. residents working in the treaty partner jurisdiction and participating in a pension fund there. However, the three points discussed above, pertaining to the meaning and implications of "derivation," the reach of the non-aggravation clause, and the concept of justifiable discrimination, furnish plenty to consider as work on a new model income tax convention proceeds. ■

[5]The only admission of tax discrimination by the United States is found in a series of revenue rulings dealing with the availability of the foreign earned income exclusion to resident aliens. Rev. Rul. 91-58, 1992-2 C.B. 340, replacing Rev. Rul. 72-330, 1972-2 C.B. 444, and Rev. Rul. 72-598, 1972-2 C.B. 451.

[6]Nondiscrimination is something of an interloper in an agreement aimed at double international taxation or nontaxation because it is concerned with neither. On the other hand, it seems odd to include a nondiscrimination guarantee in treaties and then proceed to develop an interpretation that undermines it.