Treaty Consistency

From time to time in my practice I get questions regarding the appropriate treatment of a transaction undertaken by a U.S. branch of a foreign bank. Often, the answer differs depending on whether the branch was eligible for, and claiming, benefits under a tax treaty with the United States. For example, a branch claiming treaty benefits can determine its interest expense by viewing itself as a separate entity and applying arm's length pricing norms, and similarly can give effect to interbranch transactions that would otherwise be ignored by domestic U.S. tax law.

Normally, a taxpayer eligible to claim treaty benefits has the choice of whether to claim those benefits, or to rely instead on domestic law without regard to the treaty. But this choice may not be unfettered; and as a result, choosing to apply the treaty to one transaction may restrict one's ability *not* to apply the treaty to another. As a result, it is impossible to advise on the tax treatment of any transaction that is potentially eligible for treaty benefits, without knowing what other transactions may have occurred, or may occur in the future, that might constrain the choice of whether to claim treaty benefits.

Questions of this type crop up in a broad variety of contexts, yet oddly very little had been written about the extent to which taxpayers are subject to a duty of consistency in applying tax treaties. This paper seeks to remedy that gap by providing a comprehensive study of the issue.

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I. INTRODUCTION[1]

Must a taxpayer claiming benefits under a treaty do so consistently? For example, should the treatment of an item of income under a treaty depend on whether treaty benefits are claimed for a separate item of income?

At first blush, the answer appears to be clearly no. A taxpayer might receive an interest payment that qualifies for exemption from withholding under a treaty but not for the portfolio interest exemption, while receiving another interest payment that qualifies for the portfolio interest exemption but is not covered by the treaty.[2] Such a taxpayer should be allowed to pick and choose, using the treaty to avoid tax on the first item of interest, while relying on the portfolio interest exemption to avoid tax on the second. Similarly, a taxpayer who relies on the portfolio interest exemption, rather than a reduced rate under a treaty,[3] should not be obligated to give up other treaty

[1] The author gratefully acknowledges the assistance of David Mitchell.

[2] For example, if the taxpayer is a U.K. bank, the first item might be interest on a bank loan that is ineligible for the portfolio interest exemption under Code Section 881(c)(3), while the second item might be interest on a debt security that is contingent on profits in a way that passes muster under Code Section 871(h)(4) but runs afoul of Article 11(5)(a) of the U.K. treaty. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, July 24, 2001, U.S.-U.K., art. 11(5)(a), T.I.A.S. No. 13,161. (An example of the latter might be interest that is determined by reference to gains from a portfolio of publicly traded property owned by the debtor.)

References herein to the "Code" or "I.R.C." are to the Internal Revenue Code of 1954 or the Internal Revenue Code of 1986, as applicable in the context, and references to "Regulations" are to regulations promulgated under the Code.

[3] Most U.S. treaties apply a zero rate of withholding on interest, consistent with Article 11 of the U.S. Model. United States Model Income Tax Convention of November 15, 2006, art. 11, 1 TAX TREATIES (CCH) ¶ 209, at 10,553 [hereinafter 2006 U.S. Model]. Withholding at a 10% rate, however, is permitted under the OECD Model Tax Convention on Income and on Capital, art. 11 (2010) [hereinafter OECD Model]. A number of U.S. treaties, particularly those with

benefits, such as the right to limit taxation of business profits to those attributable to a permanent establishment.

Yet the Treasury Department has claimed that a duty of consistency exists within the context of determining the profits attributable to a permanent establishment. As a result, in that context the treatment of one item of income may well depend on whether treaty benefits are claimed for another item.

Unfortunately, the Treasury has been inconsistent in articulating the scope of this duty of consistency. For example, in the Technical Explanations of the treaties with Germany and Belgium, the Treasury asserted a "strong" duty of consistency.[4] Under strong consistency, a taxpayer electing to apply the treaty to limit taxation of business profits to those attributable to a permanent establishment must accept U.S. taxation of all of those profits, even if some of those profits would be exempt under domestic law.[5] By contrast, in a subsequent Technical Explanation of the treaty with Canada, the Treasury asserted a "weak" duty of consistency.[6] Under weak consistency, a taxpayer may apply the business profits article selectively to different items of income, except when doing so would defeat the purposes of that article. Yet regardless of whether strong or weak consistency is asserted, the underlying language of the business profits articles of the treaties is essentially the same.

countries in the Far East, allow withholding on interest at a reduced rate. *See, e.g.,* Agreement with Protocol and Exchange of Notes for the Avoidance of Double Taxation and the Prevention of Tax Evasion with Respect to Taxes on Income, Apr. 30, 1984, U.S.-China, art. 10(2), T.I.A.S. No. 12065, 1988-1 C.B. 414 (allowing withholding at a 10% rate).

4 *See infra* note 84 and accompanying text.

5 The term "domestic law" is used here to refer to U.S. tax law before taking into account any modifications that may be required by a treaty.

6 *See infra* notes 93–96 and accompanying text. The terms "strong" and "weak" consistency are used here to distinguish the two approaches, but these terms do not appear in the technical explanations.

Both versions of consistency are problematic. Strong consistency has at least the appearance of clarity, but it demands too much when it requires a taxpayer to forgo an exemption under domestic law in order to apply the treaty. Weak consistency is better targeted towards the objective of ensuring that inconsistent positions are not used to avoid tax on income that is both taxed under domestic law and attributable to a permanent establishment. Unfortunately, the IRS has never specified precisely what is demanded by weak consistency, an omission that is perhaps understandable in light of the difficulties in formulating a coherent expression of this concept.

This article argues that weak consistency is better suited to treaty norms, and seeks to articulate the proper scope of this consistency requirement. The article also explores a variety of applications of treaty consistency outside the branch profits context, including cases where items of income, or entities, are treated differently for treaty purposes than under domestic law.

II. INCOME ATTRIBUTABLE TO A PERMANENT ESTABLISHMENT

A. *The Requirement of a Permanent Establishment*

The United States taxes the income of nonresident aliens and foreign corporations on a net basis if the income is effectively connected with a U.S. trade or business,[7] and on a gross basis if the income is not so connected but is otherwise derived from U.S. sources.[8] Under every U.S. tax treaty, the United States is permitted to tax business profits of a qualifying resident of the treaty partner only if those profits are attributable to a U.S. permanent establishment.[9]

The term "permanent establishment" is defined by each treaty in a broadly similar manner, but the general requirement is that there must be an office or other fixed place of business of the taxpayer or its dependent agent. Since it is possible to be engaged in a U.S. trade or business without such a fixed place of business, the permanent establishment clause generally restricts the ability of the United States to tax some business profits that under domestic law would be treated as effectively connected income. Also, since the permanent establishment of an agent is attributed to its principal only if the agent is a dependent agent, treaties restrict the ability of the United States to tax income that is treated as effectively connected by reason of the activities of an independent agent.[10]

7 I.R.C. §§ 871(b), 882(a).

8 I.R.C. §§ 871(a), 881(a).

9 This principle is enshrined in Article 7(1) of the 2006 U.S. Model and the OECD Model: "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."

10 *See, e.g.,* 2006 U.S. Model art. 5(6) and OECD Model art. 5(6). *See also infra* Part II.C.1 (p. 708).

Most U.S. source income that is not effectively connected with a U.S. trade or business is outside the scope of the treaty clauses dealing with business profits and permanent establishments. This non-business income is typically governed by separate treaty articles dealing with dividends, interest, royalties, or "other" income.

B. *Attributable Income*

Once an enterprise has a permanent establishment in the United States, the United States can tax its business profits, "but only so much of them as are attributable to that permanent establishment."[11] The determination of what business profits are "attributable" to a permanent establishment is essentially a transfer pricing question. Accordingly, the 2006 U.S. Model and the OECD Model currently apply the international norms of arm's length pricing to determine the profits of a permanent establishment.[12] Under those norms, the profits of the permanent establishment are generally determined by

[11] The quoted language is from Article 7(1) of the 2006 U.S. Model; Article 7(1) of the 2005 OECD Model uses identical language.

[12] The 2006 U.S. Model Article 7(3) contains a footnote, which provides that a Protocol or Notes should state, "the principles of the OECD Transfer Pricing Guidelines will apply for purposes of determining the profits attributable to a permanent establishment, taking into account the different economic and legal circumstances of a single entity." The most current version of these guidelines is contained in ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS (2010). Article 7(2) of the OECD Model provides,

> [T]he profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.

treating it as if it were a separate entity dealing on an arm's length basis with its home office and other branches of the enterprise.[13]

A consequence of applying these norms is that interbranch transactions are given effect in determining attributable profits. Interbranch transactions are a legal fiction, since an entity cannot contract with itself. But they routinely appear on the accounting records of a multi-branch enterprise, as a means of allocating profits and risks among branches, for purposes of management and financial accounting as well as taxation. If these records reasonably reflect the functional operations of the branch, and embody arm's length pricing, they will be respected in determining attributable profits.[14]

Most multinational enterprises seek to avoid having permanent establishments, preferring to operate in the United States through subsidiaries that are treated as corporations for U.S. tax purposes. There are many reasons for this, including avoidance of branch profits tax (in cases where it is not eliminated by treaty) and a desire to keep the parent's activities fully out of the U.S. tax net at both federal and state levels. The principal exception is in the banking sector, since banks commonly operate through branches in order to deploy their capital most effectively. As a result, many of the tax issues regarding permanent establishments arise in the context of banks and other financial institutions operating through branches in the United States. For these enterprises, business profits include not only interest from loans made by these branches, but also income from notional principal contracts that results from their dealing activities in the United States or hedges of their lending activities. In some cases, external market hedging may be centralized at the home office, and individual

[13] For the application of these principles to interest deductions, *see infra* notes 20–23 and accompanying text.

[14] *See* United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006 [hereinafter 2006 U.S. Model Technical Explanation], commentary on art. 7(2), 1 TAX TREATIES (CCH) ¶ 215, at 10,617.

branches will hedge with the home office through interbranch transactions. Those transactions will be respected in determining attributable profits if they reflect the way the enterprise actually manages the underlying risk.[15]

Attributable profits are computed taking into account a suitable portion of the overhead of the enterprise, such as head office expenses that benefit the enterprise as a whole.[16] But in the banking context the most important allocable expense is interest on borrowed funds. Given the fungibility of money, and the fact that the entire enterprise stands behind its recourse debt, it would not be tenable to follow blindly the records of the enterprise that indicate where interest expense is booked, particularly if those records include interbranch loans that do not represent legal obligations at all.

The starting point for applying the arm's length standard to interest expense is the allocation of enterprise capital to the permanent establishment. This amount of capital will depend on the value and riskiness of the permanent establishment's assets. Once this capital is determined, the liabilities of the enterprise that are allocable to the permanent establishment can be measured as the difference between the book value of its assets and the amount of its allocable capital. As a matter of recordkeeping, external liabilities booked in another branch may be on-lent to the U.S. branch, but that on-lending has no legal substance and can be seen rather as a way of evidencing the allocation of that external liability to the U.S. branch. The proper arm's length interest rate to apply to the branch's liabilities can be determined by reference to the rate that would be payable by the permanent establishment if it were a separate independent enterprise, but

[15] *Id.* Proposed regulations under Section 482 provide detailed rules for allocating income among controlled taxpayers that are participants in a global dealing operation, and presumably those rules would also be relevant where a U.S. branch participates in such an operation. *See* Prop. Reg. § 1.482-8, 63 Fed. Reg. 11,177 (Mar. 6, 1998).

[16] *See* 2006 U.S. Model Technical Explanation, commentary on art. 7(3).

an adjustment needs to be made to reflect the fact that assets standing behind those liabilities are those of the enterprise as a whole, which would presumably reduce the arm's length rate.

Under domestic law, the regulations allocate liabilities to a U.S. branch by a formula rather than by explicit reference to an arm's length standard.[17] That formula applies a debt-to-assets ratio to the assets of the U.S. branch to determine the amount of the branch's liabilities. The actual debt-to-assets ratio can be used for this purpose, but a bank branch can elect to use a fixed 95% ratio.[18] A formula interest rate reflecting the enterprise's cost of debt capital in the relevant currency is then applied to the liability amount to determine the deductible interest expense.[19]

For many years the Service took the position that this formula was required to be used in computing the interest attributable to a permanent establishment.[20] That position was successfully challenged in the *NatWest* case,[21] and the IRS now accepts that under a tax treaty attributable interest can be determined under arm's length principles rather than the regulatory formula.[22] For ease of administration, however, the IRS continues to permit taxpayers to use the formula to determine branch capital even though it is less precise, as it does not

17 Treas. Reg. § 1.882-5.

18 A taxpayer that is neither a bank nor an insurance company can elect to use a fixed 50% ratio. Treas. Reg. § 1.882-5(c)(4).

19 Treas. Reg. § 1.882-5(d), (e).

20 The regulations still purport to provide the exclusive means of allocating interest expense to a U.S. branch, unless a treaty or accompanying documents expressly provides otherwise. Treas. Reg. § 1.882-5(a)(2).

21 Nat'l Westminster Bank v. United States, 512 F.3d 1347 (Fed. Cir. 2008). For a discussion of the *NatWest* litigation and its implications, *see* Richard L. Reinhold & Catherine A. Harrington, *What* NatWest *Tells Us About Tax Treaty Interpretation*, 119 TAX NOTES 169 (Apr. 15, 2008).

22 *See* 2006 U.S. Model Technical Explanation, commentary on art. 7(3).

take into account the riskiness of the branch's assets in applying the actual or deemed debt-to-assets ratio.[23]

C. *Effectively Connected But Not Attributable Income*

Some business profits that are treated under domestic law as income that is effectively connected with a U.S. trade or business are nonetheless exempt under a treaty because they are not attributable to a permanent establishment. The enterprise will normally seek relief from U.S. tax on those profits if it is eligible for treaty benefits.

1. *No Permanent Establishment*

Business profits will not be attributable to a permanent establishment if there is no such establishment to attribute them to. Yet one can have a U.S. trade or business without a permanent establishment. The most straightforward case would be an enterprise that regularly sends employees into the United States to conduct business, but does not have an office or other fixed place of business that could be regarded as a permanent establishment. Moreover, most treaties provide that a fixed place of business will not be a permanent establishment if it is used for specific purposes, such as storage or display of merchandise, purchasing, or other auxiliary activities.[24]

Differing rules for agents can also cause income to be effectively connected without being attributable to a permanent establishment. Agency concepts are critical in this context, because business entities can act only through agents. The key question is when the activities or place of business of an agent will be attributed to his or her principal.

A permanent establishment of an agent will be attributed to an enterprise as principal only if the agent is a dependent agent and has,

23 *See infra* note 83 and accompanying text.

24 *See* 2006 U.S. Model art. 5(4).

and habitually exercises, an authority to conclude contracts in the name of the enterprise.[25] An employee is the quintessential dependent agent, but the interesting cases involve non-employees. An agent can be viewed as dependent either by being legally dependent (subject to detailed control by the principal) or economically dependent (not bearing significant business risk).[26] These standards may not be easy to apply in practice, but a dependent agent can be seen as one who essentially works for the enterprise rather than being in business for himself or herself. The requirement that the agent have authority to conclude contracts in the name of the enterprise makes it possible in some cases to avoid having a permanent establishment by the simple expedient of requiring contracts to be approved by the head office.[27]

The rules under domestic law for attributing a trade or business of an agent to an enterprise are potentially more far-reaching. While some have argued for conforming the domestic standard more closely to the treaty standard,[28] the existing case law, though sparse, suggests a broader approach.[29] In one case, the activities of various agents were attributed to a Swiss taxpayer under domestic law, even though the

[25] *See* 2006 U.S. Model art. 5(5); OECD Model art. 5(5).

[26] *See* 2006 U.S. Model Technical Explanation, commentary on art. 5(6); Taisei Fire and Marine Ins. Co. v. Comm'r, 104 T.C. 535 (1995). For a fuller historical treatment, *see* J. Ross McDonald, *"Songs of Innocence and Experience": Changes to the Scope and Interpretation of the Permanent Establishment Article in U.S. Income Tax Treaties, 1950–2000*, 63 TAX LAW. 285, 381–409 (2010).

[27] Some caution is needed here, as the IRS has found a permanent establishment to exist when an enterprise opens an office in the United States with its own employees, even if those employees lack authority to conclude contracts. *See* Rev. Rul. 65-263, 1965-2 C.B. 561; Rev. Rul. 62-31, 1962-1 C.B. 367.

[28] *See* Lawrence Lokken, *Income Effectively Connected with U.S. Trade or Business: A Survey and Appraisal*, 85 TAXES 61, 76 (2008); Richard C. Pugh, *Policy Issues Relating to the U.S. Taxation of Foreign Persons Engaged in Business in the United States Through Agents: Some Proposals for Reform*, 1 SAN DIEGO INT'L L.J. 2, 46 (2000).

[29] For discussions of this case law, *see* Andrew R. Walker, *The Submerged Logic of "Doing Business" and Attribution: Diving Below the Surface of the Offshore Lending "GLAM,"* 64 TAX LAW. 405, 443–45 (2011); W. Kirk Wallace, *Agency: Even Paranoids Have Enemies, Don't They?*, Tax Forum No. 579 (Dec. 6, 2004).

court found that those agents were independent and therefore did not constitute a permanent establishment of the taxpayer under the Swiss treaty.[30] Other cases that attribute activities of an agent are less clear on this point, since they lack an explicit finding of whether the agents were independent.[31] Still other cases show a reluctance to attribute activities of independent agents,[32] although those results can be seen as grounded in the particular facts of those cases rather than stating a general proposition.

Whatever ambiguities may exist in the case law, the IRS has shown no reluctance to assert a broad standard of agency attribution in the domestic law context. Indeed, in a 2009 general legal advice memorandum,[33] the IRS went so far as to attribute the activities of an independent agent without contracting authority. This view has been criticized as inconsistent with the theoretical basis for attributing activities of agents and as lacking support in the regulations and case law.[34] Curiously, the context in which the IRS applied this view was for U.S. source lending income. The regulations under Section 864 make clear that the standard for agency attribution for foreign source lending income is essentially the same as for treaties, in attributing only the activities of a dependent agent with authority to conclude contracts.[35] Although the regulations arguably intend the same standard to apply to U.S.-source lending income, they do not expressly say so, and the

30 De Amodio v Comm'r, 34 T.C. 894 (1960).

31 *See* Inverworld Inc. v. Comm'r, T.C. Memo 1996-301; Handfield v. Comm'r, 23 T.C. 633 (1955); Lewenhaupt v. Comm'r, 20 T.C. 151 (1953), *aff'd*, 221 F.2d 227 (9th Cir. 1955).

32 *See* Di Portanova v. United States, 690 F.2d 169 (Ct. Cl. 1982); Cadwallader v. Comm'r, 13 T.C. 214 (1949); Amalgamated Dental Co. v. Comm'r, 6 T.C. 1009 (1946).

33 I.R.S. Chief Couns. Mem. AM 2009-010 (Sept. 22, 2009), *available at* 2009 TNT 182–13.

34 *See* Walker, *supra* note 29, at 416–18, 436–45.

35 Treas. Reg. § 1.864-7(d).

IRS took advantage of the omission to apply its much broader view.[36] While it remains to be seen whether the IRS position will attract support in the courts, the mere existence of the issue shows how differing standards of agent attribution can lead to effectively connected income that is not attributable to a permanent establishment.

2. *Excess over Arm's Length Amount*

An item of income can be treated in full as effectively connected if it has a sufficient nexus to a U.S. trade or business, even though the home office or other branches may have also played a role. For example, dividends and interest can be treated as effectively connected to a U.S. branch whose activities were a "material factor" in earning the income.[37] But it is possible in such a case that activities of the home office or other branches outside the United States were also a material factor, and under arm's length principles that apply in attributing profits to a permanent establishment, only a portion of the income may be properly attributable to the U.S. branch. The standards for determining effectively connected income do not take into account the norms of arm's length pricing, and therefore can sweep into the U.S. tax net more business profits than would be allowed under a treaty.

3. *Interest Expense*

The regulatory formula for allocating interest expense to a U.S. branch does not purport to use arm's length principles, and therefore may produce results that deviate from the amount of interest that would be taken into account using these principles. Yet a treaty-eligible taxpayer is free to apply the arm's length method for this purpose when provided by the treaty, if it finds that result to be more

36 *See* Walker, *supra* note 29, at 412–14.

37 I.R.C. § 864(c)(2)(B); Treas. Reg. § 1.864-4(c)(1).

favorable than the regulatory formula.[38] Moreover, the IRS will allow a taxpayer that generally uses a treaty for branch profits to compute attributable branch capital using the regulatory formula as a surrogate for the arm's length method.[39] Because the regulatory formula allows a bank to elect to use a fixed 95% debt-to-assets ratio in lieu of its actual ratio, a treaty-eligible bank will generally find it beneficial to use the formula, unless its particular branch operations justify a higher ratio under the arm's length standard.

4. *Limited Force of Attraction Principle*

Domestic law contains a vestige of the "force of attraction" principle, which used to treat all U.S. source income of a taxpayer with a U.S. trade or business as effectively connected with that business. While this rule was repealed in 1966 with respect to dividends, interest, and other "fixed or determinable annual or periodic" income,[40] it persists for other types of income, including business profits.[41] By contrast, except for a couple of older treaties with Greece and Pakistan,[42] all U.S. treaties negate the force of attraction principle by permitting the United States to tax only business profits that are attributable to a permanent establishment.[43]

38 *See* Treas. Reg. § 1.882-5(a)(2).

39 *See infra* note 83 and accompanying text.

40 Foreign Investors Tax Act of 1966, Pub. L. No. 89-809, §§ 103(a), 104(a), 80 Stat. 1539, 1547, 1555.

41 I.R.C. § 864(c)(3).

42 *See* Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, July 1, 1957, U.S.-Pak., art. 3(2), 10 U.S.T. 984, 1960-2 C.B. 646; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Feb. 20, 1950, U.S.-Greece, art. 3(1), 5 U.S.T. 891, 1958-2 C.B. 1054.

43 *See* Rev. Rul. 81-78, 1981-1 C.B. 604, *amplified by* Rev. Rul. 84-17, 1984-1 C.B. 308 (Polish treaty).

D. *Attributable But Not Effectively Connected Income*

There are statutory exclusions that treat some income as not effectively connected, even though the income may be attributable to a permanent establishment and therefore permitted under tax treaties to be taxed by the United States. In addition, interbranch transactions, when they result in net gains to a U.S. branch, can produce income that is attributable to a permanent establishment even though those transactions are disregarded in determining effectively connected income under domestic law.

1. *Safe Harbors for Securities and Commodities*

Taxpayers who earn income from stocks, securities and commodities fall into three broad categories: investors, traders and dealers. Traders and dealers, unlike investors, are engaged in a trade or business, which, if conducted in the United States, could give rise to effectively connected income. The line between investing and trading is not easy to draw; relevant factors include the frequency of trading and length of holding periods. While the distinction between investing and trading in stocks, securities and commodities can be relevant in a variety of tax contexts,[44] it is made moot in the context of determining effectively connected income because of two statutory safe harbors—one covering stocks and securities;[45] the other, commodities[46]—that prevent trading in these types of property for one's own account from being viewed as the conduct of a trade or business. Neither safe harbor is available for dealers, so the distinction between traders and dealers remains relevant in this context.

[44] For example, a trader in securities or commodities can elect to be taxed on a mark to market basis. I.R.C. § 475(f)(1)(A).

[45] I.R.C. § 864(b)(2)(A).

[46] I.R.C. § 864(b)(2)(B).

At one time the safe harbor for stocks and securities generally did not apply if the principal office of the taxpayer was in the United States. The regulations took a somewhat mechanical view of what constituted a "principal office," focusing mainly on back-office functions such as keeping accounts and sending communications to shareholders.[47] It became apparent that this limitation simply had the effect of steering these functions to service providers in tax havens,[48] and accordingly the "principal office" limitation was repealed in 1997.[49] The result of this repeal is that a foreign enterprise such as a hedge fund can have its *only* office in the United States and still not be treated as engaged in a U.S. trade or business, regardless of its level of trading activity. Yet such an office would constitute a permanent establishment of the enterprise, and presumably all of its business profits would be attributable to that office. Such an enterprise would have no need for a treaty in relation to its business profits, and enterprises that are eligible for the safe harbor are often organized in tax havens, where treaty benefits are unavailable.

2. *Foreign Source Income*

Whether income is from domestic or foreign sources is not an explicit factor in determining whether it is attributable to a U.S. permanent establishment,[50] although in practice most attributable income

47 Treas. Reg. §1.864-2(c)(2)(iii). This regulation has not yet been amended to reflect the repeal of the "principal office" limitation.

48 *See* STAFF OF JOINT COMM. ON TAX'N, 105TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997 at 321 (Comm. Print 1997), *reprinted in* 1997 U.S.C.C.A.N. 678; H.R. REP. NO. 105-148, at 541 (1997), *reprinted in* 1997 U.S.C.C.A.N. 935.

49 Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1162(a), 111 Stat. 788, 987.

50 *But see* U.S.-Pak. treaty, *supra* note 42, art. 3(2). The Pakistan treaty permits the United States to tax only U.S. source income of a U.S. permanent establishment. The treaty with Greece contains a similar limitation, but also contains a clause deeming income attributable to a permanent establishment to be sourced in the

can be expected to be U.S. source. The rules for determining effectively connected income, however, do explicitly vary in some respects based on the source of the income. One example is the special treatment of U.S. source income under the limited force of attraction principle discussed in Part II.C.4 above.

Foreign source income is also subject to special rules that can cause it to be excluded from effectively connected income even in circumstances where it would be attributable to a permanent establishment. For taxpayers other than insurance companies, those rules exclude all foreign source income other than income that is attributable to an office or other fixed place of business in the United States (and therefore at least in part attributable to a permanent establishment) and falls in one of the following three categories:

(i) rents or royalties for the use of intangible property that was derived from the trade or business;

(ii) dividends or interest derived from a banking, financing or similar business; or

(iii) gain from the sale or exchange of personal property outside the United States through an office or other fixed place of business if no office or other fixed place of business outside the United States participated materially in the sale.[51]

Moreover, there are exclusions for foreign-source dividends, interest and royalties received from related parties,[52] and for any subpart F income that might otherwise be attributed from a controlled foreign corporation.[53]

host country. U.S.-Greece treaty, *supra* note 42, art. 3(1), (2). *See also* Rev. Rul. 74-63, 1974-1 C.B. 374 (applying a similar limitation under the prior Swiss treaty).

51 I.R.C. § 864(c)(4).

52 I.R.C. § 864(c)(4)(D)(i).

53 I.R.C. § 864(c)(4)(D)(ii). Normally, no subpart F income would be attributed to a foreign corporation, since it could not itself be a "United States shareholder" under I.R.C. § 951(b), but it might be a partner in a domestic partnership that was a United States shareholder.

There are special rules for determining the source of particular types of income that have the effect of treating the income as not effectively connected when the source is determined to be foreign, regardless of its nexus to a United States office or other permanent establishment. For example, income of a non-U.S. person from a telecommunications satellite may be treated as partially or wholly foreign source, even if the satellite was launched in the United States and operated from a domestic tracking station.[54]

3. *Tax-Exempt Income*

A permanent establishment can earn interest income on debt of a state or local government that is tax-exempt under Section 103 of the Code even though it is attributable to the permanent establishment and is therefore income that the United States could tax without violating its treaty obligations. An example would be a loan to a municipality by a U.S. branch of a foreign bank. In cases where the income is exempt on this basis, any related deductions that are disallowed under domestic law will not be allowed under a treaty, even if the treaty generally permits a permanent establishment to claim deductions in computing attributable profits.[55]

4. *Interbranch Transactions*

Interbranch transactions play no role in determining effectively connected income. Transactions among branches of a single legal

[54] I.R.C. § 863(d)(1)(B). For international communications income, which is likely to be the most important category of satellite income, a separate source rule treats the income as United States source if it is attributable to an office or other fixed place of business in the United States. I.R.C. § 863(e)(1)(B)(ii). This rule is likely to closely track attribution to a permanent establishment under a treaty. This income, however, may benefit from a statutory exclusion under I.R.C. § 883(b), even though the income is attributable to a permanent establishment.

[55] *See infra* Part III.B.1 (p. 741).

entity have no legal effect, and are therefore disregarded under domestic tax law.[56] The tax law goes a step further in also ignoring transactions between an entity and its sole owner if the entity is treated as a disregarded entity under the check the box regulations, even though those transactions do have legal effects, and may have foreign tax effects as well. Thus, a subsidiary, whether domestic or foreign, that is wholly owned by a foreign parent and elects to be treated as transparent, will, in its dealings with the parent, create genuine legal rights and obligations that are largely ignored by domestic tax law.[57]

On the other hand, interbranch transactions are given effect in determining the amount of business profits that are attributable to a permanent establishment under arm's length pricing norms. This is not to say that these transactions are thought to have actual legal effect simply because their tax treatment is being determined in a treaty context. Rather, the fiction of an intercompany transaction, which may be evidenced only by accounting entries, is simply a heuristic

[56] The regulations containing the formulas for allocating interest expense expressly state that interbranch transactions will not be considered to create an asset or liability that can be taken into account under those formulas. Treas. Reg. § 1.882-5(c)(2)(viii). However, an interbranch transfer of a nonfunctional currency, or an asset denominated in a nonfunctional currency, can give rise to exchange gain or loss if the currency or asset is, or is denominated in, the functional currency of the receiving branch. Treas. Reg. § 1.988-1(a)(10). Also, branch remittances can have foreign exchange consequences under the rules governing qualified business units. Treas. Reg. § 1.987-2(c)(2).

[57] In a few contexts, the separate existence of a disregarded entity is given effect for tax purposes. For example, in determining the extent to which a partner bears the economic risk of loss for a partnership liability, the amount borne by a partner that is a disregarded entity is limited to the entity's net worth, even though the "partner" for tax purposes is the entity's owner. Treas. Reg. §1.752-2(k)(1). Also, a disregarded entity is treated as separate for purposes of liability for corporate taxes for periods in which it, or a predecessor in interest, was treated as a corporation, as well as for some employment and excise tax purposes. Temp. Reg. § 301.7701-2T. And a disregarded entity can be a qualified business unit for purposes of foreign currency accounting, and may be treated as a dual resident under the dual consolidated loss rules. Treas. Reg. §§ 1.989(a)-1(b), 1.1503-2(c)(3)(A), (c)(4).

device for determining what the profits of the permanent establishment would be if it were an independent legal entity.[58]

Interbranch transactions are commonly used to allocate interest rate, currency exchange, and other financial risks among branches of a financial enterprise. A U.S. branch may wish to hedge its exposure to these risks through a notional principal contract with its home office, which then amalgamates the assumed risks with similar risks throughout the enterprise to determine the extent, if any, to which it wishes to hedge these risks in the external market. In these circumstances, only the external hedges have any economic reality. Interbranch hedges do nothing to shift risks as an economic matter, even if some of the branches involved are separate legal entities that are disregarded for U.S. tax purposes. These interbranch transactions do, however, work to allocate responsibility for managing these risks. If the resulting allocation reflects the way the enterprise is actually managed in this regard, then it is proper to give effect to these transactions as a means of implementing the arm's length standard.

Interbranch transactions can cause attributable business profits to be greater or less than effectively connected income, depending on whether they produce a gain or a loss. Taxpayers will therefore want to recognize these transactions only when they produce a loss, but their ability to do so will likely be restricted by a treaty consistency rule.[59]

58 *See supra* notes 14–15 and accompanying text.

59 *See infra* Part III.B.4 (p. 748).

III. STRONG AND WEAK CONSISTENCY

As devices to avoid double taxation, treaties are intended to reduce tax, not increase it. This principle is enshrined in Article 1(2) of the 2006 U.S. Model: "This Convention shall not restrict in any manner any benefit now or hereafter accorded…by the laws of either Contracting State…" Similar language appears in all U.S. tax treaties. The 2006 U.S. Model Technical Explanation points out that this means that a treaty cannot take away a deduction that is allowed under domestic law.[60] Moreover, a treaty itself does not impose any tax; rather, each country must exercise, under its domestic law, any right to tax that is granted by the treaty, before an actual tax liability can arise.[61]

This principle is qualified, however, by a duty of consistency. While a taxpayer can choose whether to apply the treaty or to rely on domestic law, "[a] taxpayer may not, however, choose among the provisions of the Code and the Convention in an inconsistent manner in order to minimize tax."[62] This language is not new to the 2006 U.S. Model Technical Explanation; identical language appears in the Technical Explanation of the prior 1996 U.S. Model.[63] This consistency principle is explained by reference to a 1984 Revenue Ruling[64] inter-

60 2006 U.S. Model Technical Explanation, commentary on art. 1(2).

61 *Id.*

62 *Id.*

63 Technical Explanation of the United States Model Income Tax Convention (Sept. 20, 1996), 1 TAX TREATIES (CCH) ¶ 216, [hereinafter 1996 U.S. Model Technical Explanation].

64 Rev. Rul. 84-17, 1984-1 C.B. 308 [hereinafter the "1984 Ruling"].

preting the business profits article of the Polish treaty.[65] In that ruling, a taxpayer was engaged in three separate lines of business in the United States:

(i) the first business constituted a permanent establishment, and operated at a net profit;

(ii) the second business did not constitute a permanent establishment, and also operated at a net profit; and

(iii) the third business did not constitute a permanent establishment, and operated at a net loss.

The income from all three business was effectively connected under domestic law.

According to the ruling, the taxpayer could apply the treaty, and pay tax only on the income from the first business, since that was the only business that had income attributable to a permanent establishment. Alternatively, the taxpayer could ignore the treaty completely, and pay tax on the net income from all three businesses, allowing the net loss from the third business to offset the profits from the other two. What the taxpayer could not do, according to the ruling, was apply the treaty to avoid tax on the second business only, while ignoring the treaty so as to take into account the net loss from the third business in order to offset the profits from the first.

It is difficult to quarrel with the conclusion reached by this ruling. If the taxpayer had instead been allowed to apply the treaty to the second business only, the result would have been a selective use of the treaty to achieve a reduction in the tax on the income from the first business, which the treaty expressly permits the United States to tax. This is a classic case of "weak" consistency, where consistent treatment is required in order to ensure that the tax on income that the

[65] Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Oct. 8, 1974, U.S.-Pol., art. 8(1), 28 U.S.T. 891, 1977-1 C.B. 416.

United States is entitled to tax, and does tax, is not avoided by selective application of the treaty.

In articulating this duty of consistency, both the 1996 and 2006 U.S. Model Technical Explanations take care to point out that there is no global duty of consistency; that is, a taxpayer is not required to forgo all treaty benefits just because it forgoes some of them. Thus, if the taxpayer in the ruling had decided not to apply the treaty to its effectively connected income (in order to use the loss from the third business), it would not be precluded from applying, say, the dividend article of the treaty to reduce withholding tax on non-effectively connected dividend income that it might happen to receive in the same year.[66]

A. *Strong Consistency*

The 2006 U.S. Model Technical Explanation expanded the duty of consistency in the business profits context by introducing the notion of "strong" consistency. Strong consistency views treaty limitations on the U.S. taxation of business profits as simply providing an overall cap on the amount of these profits that can be taxed. As a result, the taxpayer claiming treaty benefits is taxed on the lesser of two amounts: (i) profits attributable to a permanent establishment in the United States, and (ii) effectively connected income as determined without regard to the treaty. Superficially, strong consistency might be seen as just another way of articulating the non-controversial conclusion of the 1984 Ruling. But it operates with broader scope, allowing U.S. taxation in situations that are not critical to protecting the ability of the United States to apply its tax laws to income that is attributable to a permanent establishment.

[66] 1996 and 2006 U.S. Model Technical Explanations, commentaries on art. 1(2).

1. *Origins in Older Treaties*

The 2006 U.S. Model is not the first occasion on which the Treasury asserted a duty of strong consistency. Article 1 of the prior Maltese treaty, signed in 1980, contains the typical statement that the treaty shall not restrict any benefit provided by domestic law.[67] The Technical Explanation of that article states,

> Paragraph (2) provides that the Treaty shall not restrict any benefit provided by the laws of either Contracting State or by any other agreement between the Contracting States. Thus, if a deduction would be allowed in computing the taxable income of a Malta resident under the Internal Revenue Code of 1954 ("Code"), such a deduction is generally available to him in computing taxable income under the Treaty. A taxpayer, however, may not make inconsistent choices between Code and Treaty rules. For example, if a resident of Malta claims the benefits of the "attributable to" rule of paragraph (1) of Article 7 (Business Profits) with respect to the taxation of business profits of a permanent establishment, he must use the "attributable to" concept [consistently] for all items of income and deductions and may not rely upon the "effectively connected" rules of the Code with respect to other items of income otherwise attributable to a permanent establishment. In no event, however, are the rules of the Treaty to increase overall U.S. tax liability from what it would be if there were no treaty. It follows that a right to tax under the Treaty cannot be exercised unless the right also exists under the Code.[68]

[67] Agreement with Respect to Taxes on Income, Mar. 21, 1980, U.S.-Malta, art. 1, 34 U.S.T. 3527. On November 16, 1995, the United States informed Malta that it was terminating its treaty with Malta effective January 1, 1997. A successor treaty went into effect on November 23, 2010. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Aug. 8, 2008, U.S.-Malta, Hein's No. KAV 8388.

[68] Technical Explanation of the Agreement Between the United States of America and the Republic of Malta with Respect to Taxes on Income Signed at Valletta on March 21, 1980, commentary on art. 1, 1984-2 C.B. 366.

Essentially the same language appears in the 1984 Technical Explanation of the Canadian treaty[69] and the 1990 Technical Explanation of the Spanish treaty.[70]

As discussed in Part II above, a taxpayer can have some income that is attributable to a permanent establishment but not effectively connected, and other income that is effectively connected but not attributable. These Technical Explanations make clear that a taxpayer that uses the treaty to avoid U.S. tax on income that is effectively connected but not attributable to a permanent establishment must pay U.S. tax on other income that is attributable to a permanent establishment but is not effectively connected. This requirement is the essence of strong consistency.

At the end of the paragraph quoted above, there is an acknowledgement that a right to tax under the treaty cannot be exercised unless the right exists under the Code.[71] It might appear that in light of the acknowledgement, no U.S. tax can be imposed under current law on business profits that are not effectively connected. Yet the Maltese Technical Explanation justifies imposing such a tax in the immediately preceding sentence, which points out that in no case will the overall U.S. tax be greater than it would be in the absence of the treaty.

69 Technical Explanation of the Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital Signed at Washington, D.C. on September 26, 1980, as amended by the Protocol Signed at Ottawa on June 14, 1983 and the Protocol Signed at Washington on March 28, 1984, commentary on art. 29, 2 TAX TREATIES (CCH) ¶ 1950, at 41,359.

70 Technical Explanation of the Convention Between the United States of America and the Kingdom of Spain for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income Signed at Madrid on February 22, 1990, commentary on art. 1, 6 TAX TREATIES (CCH) ¶ 8425, at 177,202.

71 The Technical Explanations of the Canadian and Spanish treaties omit this acknowledgement.

These Technical Explanations are the exception for the pre-2006 period; the descriptions of the duty of consistency in other Technical Explanations cite the 1984 Ruling but do not appear to go further than weak consistency. This has not deterred the Treasury Department from attempting some revisionist history: a 2006 preamble to regulations on branch interest expense[72] asserts that the Technical Explanations of the Japan[73] and United Kingdom[74] treaties require strong consistency, but the texts of those Technical Explanations do not support this assertion.

2. *2006 U.S. Model*

According to the 2006 U.S. Model Technical Explanation, strong consistency is currently the opening position of the United States in treaty negotiations.[75] In describing paragraph 2 of the business profits article, which provides for attribution of profits to a permanent establishment on an arm's length basis, the Technical Explanation states,

> The "attributable to" concept of paragraph 2 provides an alternative to the analogous but somewhat different "effectively

[72] T.D. 9281, 71 Fed. Reg. 47,443, 47,444 (Aug. 17, 2006) ("The Treasury Department and the IRS believe that [the U.S.-U.K. and U.S.-Japan income tax treaties] provide that a taxpayer must apply either the domestic law or the alternative rules expressly provided in the treaty in their entirety…").

[73] Technical Explanation of the Convention Between the Government of the United States of America and the Government of Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, Signed at Washington on November 6, 2003, commentary on art. 1(2), 4 TAX TREATIES (CCH) ¶ 5233, at 113,295.

[74] Technical Explanation of the Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland, as Amended by the Protocol Between the United States and the United Kingdom of Great Britain and Northern Ireland, Signed on July 22, 2002, commentary on art. 1(2), 7 TAX TREATIES (CCH) ¶ 10,911, at 201,279.

[75] *See* 2006 U.S. Model Technical Explanation, commentary on art. 7(2).

> connected" concept in Code section 864(c). In effect, paragraph 2 allows the United States to tax the lesser of two amounts of income: the amount determined by applying U.S. rules regarding the calculation of effectively connected income and the amount determined under Article 7 of the Convention. That is, a taxpayer may choose the set of rules that results in the lowest amount of taxable income, but may not mix and match.[76]

The Technical Explanation amplifies the discussion of strong consistency that appeared in prior Technical Explanations by providing examples of how strong consistency can work in practice:

> In some cases, the amount of income "attributable to" a permanent establishment under Article 7 may be greater than the amount of income that would be treated as "effectively connected" to a U.S. trade or business under section 864. For example, a taxpayer that has a significant amount of foreign source royalty income attributable to a U.S. branch may find that it will pay less tax in the United States by applying Section 864(c) of the Code, rather than the rules of Article 7, if the foreign source royalties are not derived in the active conduct of a trade or business and thus would not be effectively connected income. But, as described in the Technical Explanation of Article 1(2), if it does so, it may not then use Article 7 principles to exempt other income that would be effectively connected to the U.S. trade or business. Conversely, if it uses Article 7 principles to exempt other effectively connected income that is not attributable to its U.S. permanent establishment, then it must include the foreign source royalties in its net taxable income even though such royalties would not constitute effectively connected income.[77]

The Technical Explanation even brings separate lines of business within the scope of strong consistency:

[76] *Id.*

[77] *Id.*

> In the case of financial institutions, the use of internal dealings to allocate income within an enterprise may produce results under Article 7 that are significantly different than the results under the effectively connected income rules. For example, income from interbranch notional principal contracts may be taken into account under Article 7, notwithstanding that such transactions may be ignored for purposes of U.S. domestic law. Under the consistency rule described above, a financial institution that conducts different lines of business through its U.S. permanent establishment may not choose to apply the rules of the Code with respect to some lines of business and Article 7 of the Convention with respect to others. If it chooses to use the rules of Article 7 to allocate its income from its trading book, it may not then use U.S. domestic rules to allocate income from its loan portfolio.[78]

This approach goes much further than the 1984 Ruling in its requirement of consistency for separate lines of business. For example, a bank might want to use a treaty to determine income from its U.S. branch's trading book, in order to take into account interest rate or foreign exchange hedges with the home office; otherwise, its pre-tax hedges would not work as after-tax hedges. At the same time, it might want to use domestic rules for the branch's loan portfolio, in order to exclude income from loans to foreign affiliates that might be attributable to the branch under treaty principles, but are treated as not effectively connected under domestic law.[79] Such a bank would not be guilty of the abuse addressed by the 1984 Ruling, since its use of domestic law to calculate the income from its loan portfolio would not undermine the ability of the United States to tax the income attributable to the branch's trading book.

The 2006 U.S. Model did not change the language of the model treaty text dealing with attribution of profits, but its Technical Expla-

78 *Id.*

79 *See supra* note 52 and accompanying text.

nation stated that OECD transfer pricing guidelines, including recognition of interbranch transactions and risk-based allocation of capital, would apply in determining profits attributable to a permanent establishment.[80] Shortly after the 2006 U.S. Model was published, a Treasury official commented that the adoption of these OECD principles, which diverge substantially from the rules for determining effectively connected income, motivated the addition of the strong consistency requirement.[81]

Even under strong consistency, there is one respect in which the United States will allow a taxpayer to "mix and match" a treaty and domestic law. In the wake of *NatWest*, a bank that computes its U.S. branch income under a treaty is not required to use the interest expense allocation formula under the regulations.[82] But the IRS will permit a bank to use the formula to determine its branch capital, even if the bank otherwise uses a treaty to determine the tax liability of its U.S. branch. The formula departs from otherwise applicable arm's length principles, because it fails to take into account the riskiness of the branch's assets compared with those of the bank as a whole. If the branch's assets were relatively less risky, the branch would in principle require a smaller share of the bank's equity capital, and could therefore bear a larger share of the bank's debt. The availability of the formula in this circumstance is justified by administrative convenience, since assessing the relative riskiness of branch assets may not be an easy task.[83]

80 *See supra* note 12.

81 *See* Lee A. Sheppard, *Treasury's Kissel Explains New Model Treaty*, 115 TAX NOTES 1294 (June 25, 2007).

82 *See supra* Parts II.B (p. 704) and III.A.1 (p. 722).

83 *See* T.D. 9281, 71 Fed. Reg. 47,443, 47,444 (Aug. 17, 2006); 2006 U.S. Model Technical Explanation, commentary on art. 7(3); Technical Explanation of the U.S.-Japan treaty, *supra* note 73, commentary on art. 7(3); Technical Explanation of the U.S.-U.K. treaty, *supra* note 74, commentary on art. 7(3).

3. *Application to Recent Treaties*

The U.S. Model is itself just a negotiating template, not an agreed treaty. Yet the Technical Explanations of protocols to the treaties with Belgium and Germany, signed in 2006, include language identical to that in the 2006 U.S. Model Technical Explanation.[84] In each of these cases, the protocols did not amend the text of the Business Profits article in the treaty,[85] but did refer to the application of OECD transfer pricing guidelines. The Technical Explanations of the prior ver-versions of these treaties did not allude to strong consistency, as those treaties were negotiated long before the 2006 U.S. Model.[86]

[84] Technical Explanation of the Convention Between the Government of the United States of America and the Government of the Kingdom of Belgium for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income Signed at Brussels on November 27, 2006, commentary on art. 7(2), 2 TAX TREATIES (CCH) ¶ 1352, at 31,303; Technical Explanation of the Protocol Signed at Berlin on June 1, 2006 Amending the Convention Between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes Signed on 29th August 1989, commentary on art. 3 of the Protocol *amending* art. 7(2) of the Treaty, 3 TAX TREATIES (CCH) ¶ 3229B, at 77,199-59.

[85] Given that the treaty language did not change, one might wonder whether the Treasury thought that strong consistency applied under the prior treaty as well. *See* Willard B. Taylor, *U.S. Model Income Tax Treaty and the Concept of "Consistency"*, 36 TAX MGMT. INT'L J. 524–525 (2007). *But see supra* note 81 and accompanying text.

[86] *See* Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income, July 9, 1970, U.S.-Belg., 23 U.S.T. 2687; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes, Aug. 29, 1989, U.S.-Ger., Hein's No. KAV 713; Technical Explanation on the Convention Between the United States and Belgium for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Signed July 9, 1970, 2 TAX TREATIES (CCH) ¶ 1359G, at 31,530; Technical Explanation of the Convention and Protocol Between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes Signed at Bonn on August 29, 1989, 3 TAX TREATIES (CCH) ¶ 3230, at 77,207.

The texts of these protocols do not discuss consistency, and the recognition of OECD transfer pricing guidelines would not necessarily have signaled to our treaty partners a need to strengthen demands of treaty consistency. Moreover, the German protocol was signed on June 1, 2006, well before the release of the 2006 U.S. Model, which did not occur until November 15, 2006. The Belgian protocol was signed, along with an updated treaty, on November 27, 2006, but the negotiations were in all likelihood substantially complete before the 2006 U.S. Model was released. In these circumstances, it is hard to see how the negotiators for Belgium and Germany could have been expected to be on notice that the United States was about to articulate a new standard for strong consistency. On the Belgian and German side, the negotiators would be unlikely to even be aware of the issue, since both Belgian[87] and German[88] domestic tax laws are closely aligned with treaty standards in attributing branch profits, and therefore these questions of consistency do not arise in those countries. Worse still, the Technical Explanations of these treaties, which incorporate strong consistency, were not issued until July 17, 2007, well after the treaties were signed.

[87] Income of a Belgian nonresident subject to Belgian tax includes profits realized through the intermediary of a Belgian establishment. *Code des impôts sur les revenues/Wetboek van de Inkomstenbelastingen* [Income Tax Code], art. 228, §2, 3°. The definition of a Belgian establishment is slightly broader than the definition of permanent establishment found in tax treaties. *See* J. KIRKPATRICK & D. GARABEDIAN, LE RÉGIME FISCAL DES SOCIÉTÉS EN BELGIQUE 475 (3rd ed. 2003). One difference between Belgian domestic law and most of its treaties is that those treaties, unlike domestic law, allow a Belgian permanent establishment to deduct an appropriate share of headquarters expenses. *See Commentaire du Code des impôts sur les revenues/Commentaar op het Wetboek van de Inkomstenbelastingen* [Administrative Commentary on the Income Tax Code], n°235/38.

[88] German nonresidents are subject to German tax on income from a trade or business for which a German permanent establishment is maintained. *Körperschaftsteuergesetz* [Corporation Tax Act] §§ 2(1), 8(1); *Einkommensteuergesetz* [Income Tax Act] §§ 1(4), 49. The German domestic law definition of permanent establishment closely follows that found in tax treaties. *Abgabenordnung* [General Fiscal Code] § 12.

It is therefore doubtful that in these cases strong consistency represents an agreed view between both of the relevant Contracting States. As a matter of contract interpretation, therefore, it would be difficult to conclude that strong consistency is needed to give effect to the shared intentions of the parties. In this context, the interpretation of the duty of consistency offered by the Technical Explanation deserves no more respect than necessary to give proper effect to the agreed treaty language.

A treaty, however, is unlike an ordinary contract in that there is no ultimate authority to interpret and enforce its provisions. Instead, each party is itself a sovereign, and the treaty forms part of its own law. This feature of treaties requires the use of standards of statutory interpretation that can be at odds with a pure contractual analysis.[89] The weight given to Technical Explanations is a good example of this. A Technical Explanation forms part of the formal record of the Senate's deliberations in approving the treaty, and is therefore a valuable tool in interpreting treaty language.[90] Yet it is drafted unilaterally by the United States, and the other treaty party has nothing to do with its preparation and cannot be presumed to have agreed to its contents.[91]

89 *See* Lewenhaupt, *supra* note 31, at 160 ("A tax convention or treaty is construed by the courts in the same manner as is a taxing statute."). *See also* Robert Thornton Smith, *Tax Treaty Interpretation by the Judiciary*, 49 TAX LAW. 845, 888 (1996).

90 *See* Xerox Corp. v. United States, 14 Cl. Ct. 455, 463 (1988)

91 A treaty party might be said to be on notice of a Technical Explanation when it subsequently ratifies a treaty. *See id.* at 463–464. It is difficult, however, to presume assent on that basis. S*ee* Snap-On Tools, Inc. v. United States, 26 Cl. Ct. 1045, 1072 (1992). To put the shoe on the other foot, one cannot imagine that the United States would feel bound by documents prepared unilaterally by the other side as part of its ratification process.

A noteworthy exception is Canada. In a 2008 press release dated July 10, 2008, the Canadian Ministry of Finance stated in relation to the Fifth Protocol to the U.S.-Canada treaty:

> It is the usual practice of the U.S. Treasury Department to prepare a technical explanation of tax treaties and protocols subject to formal ratification. While it is not customary for Canada to issue such an explanation, Canada

The relevance of a Technical Explanation is like that of any other legislative history: it stands as a record of what the Senate thought it was doing when it approved the treaty. As such, a Technical Explanation is a legitimate source of interpretation of treaty issues where the text of the treaty is silent or ambiguous, notwithstanding the absence of input from the treaty partner.

The introduction of strong consistency in the 2006 U.S. Model attracted criticism from foreign banks, who are the taxpayers most likely to be affected.[92] Since then, the United States has signed protocols with Canada[93] and Iceland,[94] in which it agreed to apply OECD trans-

> was given an opportunity to review and comment on the U.S. document. The Minister indicated that Canada agrees that the Technical Explanation accurately reflects understandings reached in the course of negotiations with respect to the interpretation and application of the various provisions in the Protocol.

News Release 2008-052 (July 10, 2008). Similar statements were issued for prior Protocols. *See, e.g.,* News Release 1997-122 (Dec. 18, 1997) (Fourth Protocol); News Release 1995-048 (June 13, 1995) (Third Protocol).

These Technical Explanations may be accepted as guidance and used by the Canadian courts. *See, e.g.,* Coblentz v. R., [1996] 3 C.T.C. 295 (FCA); TD Securities (USA) LLC v. R., 2010 TCC 186. However, the Federal Court of Appeal stated in Kubicek Estate, [1997] 3 C.T.C. 435, para. 10:

> The Technical Explanation is a domestic American document. True, it is stated to have the endorsation of the Canadian Minister of Finance, but in order to bind Canada it would have to amount to another convention, which it does not. From the Canadian viewpoint, it has about the same status as a Revenue Canada interpretation bulletin, of interest to a Court but not necessarily decisive of an issue.

92 *See* Letter of Lawrence R. Uhlick, on behalf of the Institute of International Bankers, to Eric Solomon, Assistant Secretary (Tax Policy) (Oct. 1, 2007), 2007 TAX NOTES TODAY 194-29. *See also* N.Y. ST. BA. ASS'N TAX SEC., *Report on the Model Income Tax Convention Released by the Treasury on November 15, 2006* (Apr. 11, 2007).

93 Protocol Amending the Convention with Respect to Taxes on Income and on Capital, Sept. 21, 2007, U.S.-Can., Hein's No. KAV 8086, attached Diplomatic Note No. JLAB-0112, para. 9.

94 Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, and accompanying Protocol, Oct. 23, 2007, U.S.-Ice., Protocol art. 2, Hein's No. KAV 8166.

fer pricing standards in determining business profits attributable to a permanent establishment, just as it did in its protocols with Belgium and Germany. The accompanying Technical Explanations, issued in 2008, contain similar discussions of the issues relating to those transfer pricing standards, but omit the language relating to strong consistency.[95] This omission is particularly striking in the case of Canada, since the Technical Explanation of the prior treaty contained an early articulation of strong consistency.[96]

When these protocols were signed in 2007, the most recently issued Technical Explanations on this issue were those for the Belgian and German protocols, which contained strong consistency language. Given that now the most recent Technical Explanations addressing business profits lack strong consistency language, one can legitimately wonder whether strong consistency still represents the position of the United States in negotiating other treaties. There is nothing in the language of the business profits articles, or any accompanying protocols or diplomatic notes, to indicate when the United States is intending to apply strong consistency, which leaves treaty partners with no official way of knowing what they have agreed to on behalf of their residents at the time a treaty is signed.

95 Technical Explanation of the Protocol done at Chelsea on September 21, 2007 Amending the Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital done at Washington on September 26, 1980, as Amended by the Protocols done on June 14, 1983, March 28, 1994, March 17, 1995, and July 29, 1997, commentary on art. 4 of the Protocol *amending* art. VII(2) of the Treaty, 2 TAX TREATIES (CCH) ¶ 1939, at 41,191; Technical Explanation of the Convention Between the Government of the United States of America and the Government of Iceland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, commentary on art. 7(3) of the Treaty and para. 2 of the contemporaneous Protocol, 4 TAX TREATIES (CCH) ¶ 4041, 97,189.

96 *See supra* note 69 and accompanying text; s*ee also* Letter of Lawrence R. Uhlick, *supra* note 92, at 16 n.6.

4. ***Non-Fungibility of Profits***

As a matter of textual interpretation, the question of strong consistency can be seen as an interpretation of the words "so much of them" in the limiting phrase of paragraph 1 of the Business Profits articles of the 2006 U.S. Model and the Belgian and German treaties, which permit a Contracting State to tax business profits of an enterprise that has a permanent establishment, "but only so much of them as are attributable to that permanent establishment." Under strong consistency, the United States takes a purely quantitative view of "so much" of the profits that can be taxed. Those attributable profits represent a number, and that number is the amount of business profits that the United States can tax. It does not matter whether the actu-actual profits taxed are attributable or not, so long as the total amount of these taxable profits is no more than this number.

A competing view takes a more qualitative approach to this limitation. An enterprise can have business profits, some of which are attributable to a permanent establishment, some of which are not. Under this competing view, the United States can tax only those particular profits that are attributable. Here, "so much of them" refers to particular elements of profit, not just some number representing total attributable profit.[97]

This qualitative view can be seen through an analogy with partnership allocations. One view of the tax system is to see the government as a silent partner, taking its share of net profits.[98] If an allocation of profits to the government is to have economic effect, it

[97] Ambiguities of this type pervade ordinary language. In Professor Quine's example, if I say "I want a sloop," I might want a particular sloop, or I might seek mere relief from slooplessness. W.V. Quine, *Quantifiers and Propositional Attitudes*, 53 J. PHIL. 177 (1956), *reprinted in* W.V. QUINE, THE WAYS OF PARADOX AND OTHER ESSAYS 183 (1966).

[98] *Cf.* Stephen B. Land, *Defeating Deferral: A Proposal for Retrospective Taxation*, 52 TAX L. REV. 45, 83–84 (1996), *reprinted in* STEPHEN B. LAND, I PAPERS ON TAXATION 273, 328–30 (2013).

matters which profits are being allocated.[99] Under this view, the Business Profits article entitles the government to be allocated a share of attributable profits. It can claim that share by taxing those profits under its domestic law, but it does not have to. If, however, the government chooses not to tax some attributable profits, it cannot offset the revenue loss by taxing other non-attributable profits of an equal or lesser amount.

5. *Clarity of Strong Consistency*

One virtue that might be claimed for strong consistency is its clarity. Unlike weak consistency, which requires an inquiry into whether an inconsistent position undermines the intent of a treaty clause, strong consistency purports to be mechanical. A taxpayer can choose to have its business profits taxed under the treaty, or under domestic law; all it has to do is choose consistently.

Such a view, however, presupposes that there is some free-standing notion of "profits" that exists independent of domestic tax law. In a 1992 study, the American Law Institute addressed the question of treaty consistency for business profits, and asserted, "In the case of business income, the statute and the treaty each sets forth a self-contained and internally consistent set of rules governing the taxation at source of business income, and these differ in important respects."[100] Based on this premise, the ALI Study proposes a consistency requirement that sounds much like strong consistency, but its proposal is softened by an exception that allows domestic-law exclusions to continue to apply.[101]

99 *Cf.* Treas. Reg. § 1.704-1(b)(2)(ii)(*a*).

100 AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT, INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION II: PROPOSALS ON UNITED STATES INCOME TAX TREATIES 85 (1992) (hereinafter, "ALI Study").

101 The ALI proposals are discussed further *infra* in Part III.B.3 (p. 746).

As discussed in Part II above, there are treaty-based rules for attributing profits between a home office and its branches, and the arm's length approach might be seen as a "self-contained and internally consistent set of rules," as the ALI put it. But ultimately what is attributed are the profits of the enterprise, and there is no clearly defined alternative to domestic tax law in defining what those profits are. For example, the tax exemption for municipal bond interest is a benefit offered by domestic tax law that is not mandated by any treaty. If that interest is attributable to a permanent establishment, strong consistency might require a taxpayer that avails itself of a treaty in computing its business profits to forgo the benefit of that exclusion, on the grounds that the interest is includible in business profits even though it is excludible from gross income.[102]

Domestic tax law contains numerous other provisions that affect the computation of taxable income in ways that arguably depart from a conception of "business profits" that the United States is entitled to tax under a treaty.[103] Perhaps the most important, from a tax expenditure standpoint, are the benefits of accelerated depreciation and first-year write-offs of equipment cost.[104] An expansive view of strong consistency that would require taxpayers to forgo benefits such as these in order to claim treaty benefits would require a wholly independent methodology for calculating business profits, including a methodology for computing depreciation deductions. Whatever the merits of such a view might be, they do not include simplicity or clarity.

102 Weak consistency would not require such a choice, as is illustrated by the Technical Explanation for the Icelandic treaty, discussed *infra* in Part III.B.1 (p. 741).. That Technical Explanation plainly permits a taxpayer computing its business profits under a treaty to claim the municipal bond exemption as well, but makes the point, amply justified by weak consistency, that such a taxpayer must accept a corresponding disallowance of interest expense under I.R.C. § 265.

103 *See* Uhlick, *supra* note 92, at 11–14.

104 *See infra* notes 241–242.

The Commentary to Article 7 of the OECD Model states that the profits attributable to a permanent establishment are subject to provisions of domestic law governing the deductibility of expenses (such as restrictions on the deductibility of entertainment expenses) or on the timing of expenses (such as depreciation).[105] Thus, the Commentary rejects the idea that attributable profits can be measured independently from the rules of domestic law, and acknowledges that issues of timing and deductibility may be dealt with differently by the domestic law of each of the parties to a treaty.[106]

A less expansive version of strong consistency would deprive a treaty claimant only of those provisions of domestic tax law that specifically pertain to the determination of when income is effectively connected. These provisions, however, vary in how they operate:

> (i) some exclude activities from the definition of a U.S. trade or business, such as the safe harbor for trading in stocks and securities;
>
> (ii) some treat income as not effectively connected, such as the rules governing dividends, interest, and royalties from related parties;
>
> (iii) some ignore the transaction giving rise to the income, as is the case with interbranch transactions and transactions between a disregarded entity and its owner;
>
> (iv) some govern the source of the income, such as the rules for space and ocean activities; and
>
> (v) some provide exclusions from gross income, such as the rules for international transportation and communications income.

To bring clarity to the concept of strong consistency, some guidance would need to be issued regarding whether all, or only some, of these rules fall within its scope. That exercise would likely look to the pur-

[105] OECD Model, commentary on art. 7, ¶ 31, at 139.

[106] OECD Model, commentary on art. 7, ¶ 32, at 139.

pose of the business profits article, and end up incorporating principles of weak consistency.

6. *Implementation under Domestic Law*

In assessing the legitimacy of strong consistency, one can distinguish between whether the United States *can* require strong consistency under the relevant treaties and, if so, whether the United States *does* in fact implement that requirement under its domestic law. Although these treaties state that they cannot be used to increase tax, the IRS could reply, in seeking to apply strong consistency, that these treaties do not increase tax since strong consistency only allows the United States to tax the lesser of the treaty amount of attributable business profits and the amount of effectively connected income under domestic law. Such a reply, of course, would implicitly reject the arguments in Part II.D.4.4 above regarding the non-fungibility of profits.

But would our treaty partners really care? Nothing is stopping the United States from amending its domestic law to tax substantially all attributable profits, just as Belgium and Germany do.[107] A treaty partner may view the various benefits offered by domestic law as a purely internal matter, so long as the overall tax on business profits is no more than the amount permitted under the treaty. In that sense, those benefits do not constitute part of the *quid pro quo* that was achieved by the treaty partner in the course of the treaty negotiations. Yet in another sense, strong consistency does undermine the value of the benefit offered by the Business Profits article, in that residents of the treaty partner may have to give up a domestic law benefit in order to get the treaty benefit.

Even if the treaties with Belgium and Germany allow the United States to require strong consistency, there remains the question as to

[107] *See supra* note 88.

whether this requirement is in fact implemented in domestic law. Domestic law contains the provisions described above that cause some attributable profits to go untaxed. The treaty itself cannot impose a tax on those profits, and indeed disclaims any intent to do so. Moreover, as a tax-raising measure, a treaty would be unconstitutional, since all revenue-raising bills must originate in the House of Representatives,[108] whereas a treaty is subject to Senate approval only.[109]

As it turns out, domestic law is not silent on this matter. As part of the international tax reforms of the Foreign Investors Tax Act of 1966, including the curtailment of the force of attraction principle, Congress enacted Section 894(b), which provides, in pertinent part:

> (b) PERMANENT ESTABLISHMENT IN UNITED STATES.
>
> For purposes of applying any exemption from, or reduction of, any tax provided by any treaty to which the United States is a party with respect to income which is not effectively connected with the conduct of a trade or business within the United States, a nonresident alien individual or a foreign corporation shall be deemed not to have a permanent establishment in the United States at any time during the taxable year.[110]

Here is a clear direction from Congress, in the very section of the Code that purports to state how the Code will be administered in light of treaty obligations. By treating a person claiming treaty benefits as not having a permanent establishment with respect to income that is not effectively connected under domestic law, the Code is treating that income as not attributable to a permanent establishment.

The regulations under Section 894(b) contain an example that illustrates this rule.[111] In the example, a foreign corporation has a

108 U.S. CONST. art. I, § 7, cl. 1.

109 U.S. CONST. art. II, § 2, cl. 2.

110 I.R.C. § 894(b), *added by* Foreign Investors Tax Act of 1966, Pub. L. No. 89-809, § 105, 80 Stat. 1539, 1563.

111 Treas. Reg. § 1.894-1(b)(2), Ex. (1).

permanent establishment in the United States and receives dividend income from a domestic corporation. The dividends are not, under domestic law, effectively connected with a U.S. trade or business. The example concludes that, under Section 894(b), the corporation will be deemed not to have a permanent establishment with respect to the dividends. While the example does not expressly state that the dividends would otherwise be attributable to the permanent establishment, that appears to be the intention, since only in that circumstance would the deeming rule be relevant. A separate example points out that the deeming rule does not apply to dividends that do constitute effectively connected income.[112]

This provision of domestic law undermines strong consistency. Strong consistency seeks to indirectly tax income that is attributable but not effectively connected, by taxing other income that is effectively connected but not attributable. But Section 894(b) causes this other income to be exempt from tax under domestic law when a treaty applies. To implement strong consistency, changes to domestic law would be required, including an amendment to Section 894(b).

Treaties and statutes have equal weight under federal law; when they conflict, a "later in time" rule governs.[113] Since the treaties that purport to assert strong consistency were ratified long after Section 894(b) was enacted, it might be argued that these strong consistency requirements take precedence over prior conflicting rules in the Code. Yet such a statutory override is likely to be found only if there is evidence of a clear intent to do so. Such evidence is lacking: the Technical Explanations that assert a duty of strong consistency make no reference to Section 894(b), nor do the relevant treaty texts indicate any such intent. Faced with a purported conflict, a court would be far more likely to seek a harmonious interpretation of Section

112 Treas. Reg. § 1.894-1(b)(2), Ex. (2).

113 *See* Lindsey v. Comm'r, 98 T.C. 672 (1992) (*citing* Whitney v. Robertson, 124 U.S. 190 (1888)), *aff'd* 15 F.3d 1160 (D.C. Cir. 1994).

894(b) and the treaty that avoids such a conflict. Such an interpretation would preclude a finding of strong consistency under the treaty, but Section 894(b) might have to flex as well. For example, the implementation of arm's length norms of profit attribution, including the recognition of interbranch transactions, would require the recognition of interbranch transactions even though those transactions do not generate effectively connected income. Since the treaties that adopt OECD transfer pricing guidelines manifest an intent to recognize these transactions, Section 894(b) will need to be interpreted in a manner that accommodates the application of these guidelines. Such an interpretation would have to incorporate a consistency requirement in order to give effect to the purpose of the relevant treaty rules. This is the domain of "weak" consistency, which is discussed in the next Part.

B. *Weak Consistency*

Weak consistency requires consistent treatment only where necessary to give effect to the purpose of the Business Profits article. The Technical Explanations that assert a weak consistency requirement illustrate the operation of weak consistency by reference to the 1984 Ruling.[114] That ruling precludes selective use of a treaty where doing so would limit the ability of the United States to tax income that is attributable to a permanent establishment. Two plausible purposes of the Business Profits article can be seen to be at work here: one is ensuring that the United States does not tax business profits that are not attributable to a permanent establishment; the other is ensuring that the United States is not prevented from taxing business profits that are attributable to a permanent establishment if it chooses to. Weak consistency seeks to balance these purposes; the following discussion

114 *See supra* note 64 and accompanying text.

considers the scope that weak consistency needs to have in order to achieve this balance.

1. *Deductions against Exempt Income*

Some commentators have sought to explain the result in the 1984 Ruling by asserting that it simply precludes the use of a deduction (in this case, a non-attributable loss) that is allocable to a class of exempt income (i.e., non-attributable income) to shelter other income that is not exempt.[115] The domestic law rules for computing effectively connected income require deductions that are definitely related to a class of income to be allocated to that class,[116] and for this purpose exempt income is taken into account as a class of income.[117] In this context, the consistency requirement can thus be seen as analogous to Section 265 of the Code, which disallows deductions for interest and other expenses that are allocable to tax-exempt income. Indeed, Section 265 can itself be relevant in the treaty context, when a permanent establishment holds municipal obligations that are tax-exempt under Section 103 even though interest on the obligations may constitute attributable income that the United States could tax under the Business Profits article of a treaty.

Under strong consistency, a permanent establishment might end up paying tax on interest from municipal obligations, since it is required to ignore domestic-law exclusions if it chooses to apply a treaty to its business profits, which it presumably would do if the treaty offered other benefits of greater value. Such a choice would not be forced by weak consistency, and a permanent establishment whose

[115] *See* N.Y. ST. BA. ASS'N TAX SEC., *Report on Guidance under U.S. Income Tax Treaties* 13–14 (May 28, 2010); N.Y. ST. BA. ASS'N TAX SEC., *Report on the Model Income Tax Convention Released by the Treasury on November 15, 2006* 12–13 (Apr. 11, 2007); Taylor, *supra* note 85.

[116] Treas. Reg. § 1.861-8(b)(1).

[117] Treas. Reg. § 1.861-8T(d)(2)(i)(A).

profits included some interest on municipal obligations could exclude that interest while otherwise calculating its taxable income by reference to its attributable profits under the treaty.

Weak consistency would, however, subject the permanent establishment to the limitations of Section 265, even where the treaty generally allows a permanent establishment to claim domestic-law deductions in computing its attributable income. The Technical Explanation of the treaty with Iceland offers the example of a permanent establishment that borrows $100 to purchase tax-exempt bonds, and points out that both the income from the bonds and the related interest expense would be excluded in calculating attributable profits.[118]

In the 1984 Ruling, the third business was the only one that operated at a loss. Because it did not constitute a permanent establishment, the gross income from the business was excludable from income under the treaty, at least if the taxpayer chose to apply the treaty. In that case, since gross income from the business would be exempt from tax, the deductions attributable to that income would be disallowed under Section 265(a). On that basis, it might be argued that the net loss from this business could not be claimed as a deduction to offset income from the first business.

The difficulty with this argument is that the income from the third business is exempt only if the taxpayer claims the benefits of the treaty. But the precise question addressed by the 1984 Ruling is whether the taxpayer can choose to forgo the benefits of the treaty, in

[118] Technical Explanation of the U.S.-Ice. treaty, *supra* note 95, commentary on art. 7(3), at 97,190. The example refers to a "Bulgarian" rather than an "Icelandic" taxpayer, presumably the result of hasty copying of text from a Technical Explanation that was prepared for the Bulgarian treaty at the same time. Department of the Treasury Technical Explanation of the Convention Between the United States of America and the Republic of Bulgaria for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Signed at Washington on February 23, 2007, commentary on art. 7(3), 2 TAX TREATIES (CCH) ¶ 1841, at 40,845.

order to use the resulting net loss to shelter the income from the first business, which is attributable to a permanent establishment. The ruling does permit the taxpayer to forgo the benefits of the treaty, but only on the condition that it also do so with respect to the second business, which did not constitute a permanent establishment but earned a net profit. If the second business did not exist, the taxpayer would have been free to use the net loss from the third business to offset the profits from the first, even though under the treaty it could have exempted the income of the third business from U.S. tax had it been profitable.[119] Even with the second business in the picture, the taxpayer can do the same thing, provided it is also willing to forgo treaty benefits on the second business.[120]

Thus, the 1984 Ruling, and weak consistency generally, is about more than simply disallowing deductions attributable to exempt income. It is the *inconsistent* application of the treaty to the second and third businesses in the ruling that is proscribed by weak consistency. To allow otherwise would be to permit the taxpayer to avoid tax on income from the first business, which the United States is entitled to tax under the treaty and does tax under its domestic law.

This point can be further illustrated by the selective application of a treaty in the context of sales of loans that are effectively connected with a U.S. trade or business, but not attributable to a permanent establishment.[121] Any gains from these sales are treated as U.S. source if

119 *See* KLAUS VOGEL, HARRY A. SHANNON III, RICHARD L. DOERNBERG & KEES VAN RAAD, UNITED STATES INCOME TAX TREATIES, Part II (Commentary) 315 (1995).

120 For example, in Rev. Rul. 80-147, 1980-1 C.B. 168, a Canadian taxpayer's effectively connected income included interest as well as income from a transportation business that ran at a net loss. Income from the transportation business was exempt under Article V of the U.S.-Canada treaty, but the IRS ruled that the taxpayer could elect not to apply the treaty in order to use the net loss against its interest income. This ruling is discussed further in the multi-year context *infra* in the text accompanying note 236.

121 The differing standards that may be applied by the IRS in these contexts are discussed *supra* in Part II.C.1 (p. 708).

attributable to a U.S. office.[122] It is possible, however, that such an office would not be a permanent establishment if maintained by an agent whose activities were attributed to the taxpayer under domestic law but not under the treaty, and therefore those gains could be exempted by the treaty. The sourcing of losses is governed by reference to how the gain would have been sourced had the property been sold at a gain.[123] Since any such gain would be U.S. source, any losses are U.S. source as well. In a 1995 Field Service Advice Memorandum[124] dealing with an analogous situation under the former Irish treaty, the taxpayer sought to ignore the treaty in regard to loan losses, and use those losses to shelter other U.S. source income that was attributable to its permanent establishment. At the same time, the taxpayer was using the treaty to exempt interest income from these loans. Had the taxpayer not sought treaty protection for the interest, then nothing would have prevented the taxpayer from applying domestic law rather than the treaty so that the losses would be taken into account in determining its U.S. taxable income. The losses were disallowed not because a treaty exemption was available for gains, but rather on account of the selective use of the treaty to exclude interest income but not losses.

2. *The Best of Both Worlds*

The goal of the taxpayer in the 1984 Ruling was to achieve a better result than could be obtained either purely under domestic law or purely under the treaty if the United States taxed all attributable profits. Denying the taxpayer the best of both worlds is the hallmark of strong consistency. Under weak consistency, the taxpayer can indeed have a better result than provided under domestic law or the treaty

[122] I.R.C. § 865(e)(2).

[123] Treas. Reg. § 1.865-1(a)(1).

[124] I.R.S. Field Serv. Adv. Mem. 1995-202 (Sept. 7, 1995).

alone. For example, consider a taxpayer who earns some municipal bond interest that is attributable to a permanent establishment, and some other effectively connected income that is not so attributable. Under weak consistency, the taxpayer can claim benefits of the treaty to avoid tax on the non-attributable income, while also claiming the benefits of domestic law to avoid tax on the municipal bond interest. While such a taxpayer would have to forgo deductions for interest or other expenses that were attributable to the tax-exempt interest under Section 265, the taxpayer would nonetheless have achieved a better result than domestic law (which would tax the non-attributable income) or the treaty (which would tax the municipal bond interest) alone would provide.

If under weak consistency a taxpayer can indeed have the best of both worlds, some other means is needed to define the scope of weak consistency. In the case of the 1984 Ruling, what was objectionable was not that the taxpayer wanted a better result than could be obtained purely under domestic law or the treaty. It was the selective use of the treaty to shelter income from the first business that was attributable to a permanent establishment. Since the treaty was intended to permit the United States to tax that income, it cannot be used to prevent the United States from doing so. Articulating the rule in this fashion makes clear why the taxpayer is free to shelter income from that first business under domestic law with other losses, if it can do so without recourse to the treaty, as it would be able to do if the second business did not exist or also incurred a net loss. But if the taxpayer cannot reach that result under domestic law, it cannot selectively use the treaty to hinder the United States from taxing income that the treaty expressly permits the United States to tax.

Under weak consistency, therefore, a taxpayer can have the best of both worlds unless the allowance of benefits under both domestic law and the treaty would enable the taxpayer to avoid tax on income that the United States is permitted to tax under the treaty, and does seek to tax under its domestic law. Where no such avoidance potential

is present, the IRS has been willing to grant a domestic law exclusion for income that is attributable to a permanent establishment. For example, in a 1996 private letter ruling issued under the Spanish treaty, a bank was permitted to exclude foreign-source letter of credit acceptance and confirmation fees under the domestic-law rules that tax only narrow categories of foreign-source income,[125] even though the income was attributable to a permanent establishment and therefore permitted to be taxed under the Spanish treaty.[126] That ruling was not conditioned on the taxpayer's forbearance from using the treaty to avoid tax on other effectively connected income, as would have been required under strong consistency.

3. *Categories of Income*

One approach to treaty consistency is to look to whether the items that a taxpayer seeks to treat inconsistently are in the same category of income for treaty purposes. This is the approach taken by the ALI Study, which proposes a modified form of strong consistency for items in the same category, but weak consistency for items in different categories. Those proposals state:

> (a) A taxpayer electing to claim treaty benefits with respect to any item of income must treat all income derived during the taxable year in the same treaty category as provided in the treaty. To the extent that the treaty permits the imposition of a tax which is not imposed under internal law, the internal law exemption continues to apply.
>
> (b) A taxpayer claiming statutory treatment with respect to one category of income may nevertheless claim treaty benefits with respect to another category of income derived in the same taxable year when the relation between the treaty provisions and the Code

125 *See supra* Part II.D.2 (p. 714).

126 I.R.S. Priv. Ltr. Rul. 1996-51-052 (Dec. 20, 1996).

> rules is such that they can be applied independently without distorting the application of either system to the items of income involved.[127]

Where different categories are involved, these proposals essentially embody the principle of weak consistency, allowing inconsistent treatment where doing so would not "distort" the application of the Code or treaty rules.

Business profits, however, constitute a single treaty category of income. Here the ALI Study proposes to require consistency without regard to whether inconsistent treatment would lead to any distortion. Presumably, this means that a bank would not be permitted to use a treaty to compute income from its trading book while using domestic law to compute income from its loan portfolio, just as was stated in the Technical Explanations that articulate strong consistency.[128] Yet the ALI Study departs from strong consistency in allowing a taxpayer that uses the treaty to compute business profits to also benefit from domestic law exemptions. Thus, the ALI Study would permit a taxpayer that uses a treaty to exempt effectively connected income that is not attributable to a permanent establishment to also exclude foreign source royalties that are so attributable, if those royalties are exempt under domestic law. This result is contrary to the Technical Explanations that articulate strong consistency.[129]

While the ALI Study rejects strong consistency in its strictest form, it is unclear why its proposals on treaty consistency turn on whether the items under consideration are in the same treaty category. The ALI is evidently content with inconsistencies between some items in different categories if no distortion occurs, but in the absence of distortion there is no evident reason not to permit inconsistencies between items in the same category. It may turn out that opportunities

[127] ALI Study, at 92.

[128] *See supra* note 78 and accompanying text.

[129] *See supra* note 77 and accompanying text.

for distortion occur more readily for items within the same category, but that just means that a consistency requirement will operate more frequently in that case even if the same standard is applied regardless of the categories of the affected items.

4. *Interbranch Transactions*

Interbranch transactions pose a challenge for weak consistency. As discussed in Part II.D.4 above, they are disregarded under domestic law but given effect in determining attributable profits under a treaty. Under strong consistency, the taxpayer must recognize all of them or none of them, depending on whether it is computing branch profits under a treaty or under domestic law. Weak consistency potentially allows greater latitude, but how much is difficult to say.

Clearly some form of consistency is needed. Absent any consistency requirement, a taxpayer would simply recognize only those interbranch transactions that produced a loss. The resulting losses would then be used to offset other attributable income that the United States is permitted to tax under a treaty, and does seek to tax under its domestic law. Such an outcome would be in direct conflict with the principles of the 1984 Ruling, and should be prevented under weak consistency.

For a possibly more sympathetic case, consider a non-U.S. taxpayer with two functionally unrelated branches in the United States, each of which has some interbranch transactions with the head office. Such a taxpayer might seek to make independent choices for each branch, even if it were required to adopt an all-or-nothing approach towards recognizing the interbranch transactions entered into by each branch.[130] Yet even here, the taxpayer would presumably recognize the

[130] Distinguishing when a U.S. branch is a "separate" branch rather than part of another U.S. branch is itself fraught with difficulties, as there is a wide range of functional relationships that might exist between them. In the NatWest litigation, the court was dealing with a group of U.S. branches, but it treated them as one. Nat'l Westminster Bank, PLC v. United States, 44 Fed. Cl. 120, 121 (1999).

interbranch transactions of each branch only if those transactions, in the aggregate, produced a net loss. If the interbranch transactions of the first branch produced a net gain and those of the second produced a net loss, the taxpayer would seek to recognize only those of the second branch. Yet even here, the potential for abuse persists, since the interbranch net loss of the second branch would be used generally to offset other income of these branches, while the interbranch net gain of the first branch would escape taxation. Such an outcome would again conflict with the principles of the 1984 Ruling.

Indeed, if there are any groups of interbranch transactions that can be treated inconsistently, there is potential for abuse, regardless of whether there is any functional connection between the groups. In each case, the taxpayer will recognize a group that produces a net loss, and ignore a group that produces a net gain. This reasoning suggests that for interbranch transactions the requirements of weak consistency resemble those of strong consistency.

Yet an all-or-nothing approach could be applied to interbranch transactions without the full rigor of strong consistency. Instead, in cases where the taxpayer chooses to apply the treaty, all interbranch transactions would be taken into account, but domestic law exclusions would continue to apply to the extent not otherwise proscribed by weak consistency. Those exclusions could even apply to income recognized on an interbranch transaction, to the extent that the exclusions would apply had the transaction been with a separate entity. For example, interest earned on an interbranch loan to the head office or another non-U.S. branch could be excluded under the statutory rule that exempts interest received from a foreign affiliate.[131] Allowing these exclusions would be consistent with the approach taken by the ALI Study.[132]

131 *See supra* note 52 and accompanying text.

132 *See supra* note 127 and accompanying text.

Further easing of consistency requirements could be justified in the case of interbranch transactions entered into as hedges. For example, it would not be unusual for a branch making loans in the ordinary course of its business to hedge interest rate or currency risks on those loans through swaps with its head office, which can manage those risks on a global basis. Ideally, the branch would be able to integrate the loan with the hedge, treating the combined cash flows as a synthetic debt instrument that is taxed as such in lieu of separate treatment for the loan and the hedge.[133] However, the integration rules apply to a foreign taxpayer only if all items relating to the hedge and the hedged item are effectively connected with its U.S. trade or business,[134] which will not be the case if the hedge is a disregarded interbranch transaction. Moreover, these integration rules would likely be unavailable even if the interbranch swap were given effect under a treaty, since the branch and its head office would be seen as related parties. The rules for integrating currency swaps do not apply to related-party hedges,[135] and the rules for integrating interest rate swaps apply to related parties only if the counterparty uses the mark to market method of accounting for U.S. federal income tax purposes.[136] Since in this context the head office is being treated as distinct from its U.S. branch, it may not be in a position to adopt such a mark to market method of accounting, and therefore an interest rate swap with the parent might not be eligible for integration even if it were given effect under a treaty.

Even if the requirements for integration were not relaxed in this regard, one could imagine allowing branches to elect to apply a treaty to recognize particular interbranch hedges, without regard to whether

[133] *See* Treas. Reg. §§ 1.988-5(a)(9) (foreign exchange risk), 1.1275-6(f) (interest rate risk).

[134] *See* Treas. Reg. §§ 1.988-5(a)(5)(vi), 1.1275-6(c)(1)(iv).

[135] Treas. Reg. § 1.988-5(a)(5)(iii).

[136] Treas. Reg. § 1.1275-6(c)(1)(ii).

other interbranch transactions are given effect. A requirement that any such elections be made at the time the hedge is entered into would eliminate the potential for selective recognition of transactions that, with hindsight, are seen to generate a loss.[137] There is accordingly no reason to restrict elections of this sort on consistency grounds.

An interbranch payment that reduces branch profits could, if respected under domestic law, also give rise to U.S. source income of the home office or another non-U.S. branch, which might be subject to withholding tax. This issue would not arise for payments under notional principal contracts, as these are generally sourced by the residence of the recipient and therefore would not attract withholding tax when received by a non-U.S. person. On the other hand, a payment of interest on a deemed or actual interbranch loan can give rise to withholding under the branch profits interest tax, as discussed in the next Part. In the case of other interbranch payments that give rise to U.S. source income, the question arises whether the taxpayer can rely on a treaty to obtain a deduction for the payment, and then rely on domestic law to ignore the payment for withholding tax purposes.

An example of such a payment would be a guarantee fee. A new source rule enacted in 2010 assigns U.S. source to a fee paid, directly or indirectly, by a U.S. person for guaranteeing its debt.[138] Suppose a U.S. branch of a foreign bank receives a fee for guaranteeing the debt of one of its U.S. customers. That fee would be U.S. source, but would not be subject to withholding tax because it is effectively connected income of the branch.[139] The branch might then pay most of

[137] *See* Treas. Reg. §§ 1.988-5(a)(8)(i), 1.1275-6(e).

[138] I.R.C. § 861(a)(9). This rule was intended to override the decision earlier that year in Container Corp. v. Comm'r, 134 T.C. 122 (2010), *aff'd* 107 AFTR 2d 2011-1831 (5th Cir. 2011). *See* STAFF OF JOINT COMM. ON TAX'N, 111TH CONG., TECHNICAL EXPLANATION OF THE TAX PROVISIONS IN S, AMENDMENT 4594 TO H.R. 5297, THE SMALL BUSINESS JOBS ACT OF 2010, at 50 (Comm. Print 2010).

[139] I.R.C. §§ 871(a)(1), 881(a).

that fee to its home office in recognition of the fact that most of the capital supporting the guarantee is in the home office. Although that further payment to the home office would be an interbranch transaction that is generally disregarded under U.S. tax law, the branch might apply a treaty to reduce its attributable profits by the amount of that payment. If the branch had instead been a subsidiary, an actual payment of that amount to its parent might have been U.S. source, and subject to withholding tax unless exempted by treaty.[140] The payment would have likely been exempt as business profits that were not attributable to a permanent establishment if the parent had been in the business of providing guarantees.[141] Otherwise, the payment would have been "other income" for treaty purposes;[142] and unless the relevant treaty contained a provision exempting "other income" without regard to its source,[143] no treaty exemption would have been available

[140] U.S. source treatment would apply to such a payment if it were viewed as an indirect payment from the U.S. customer. I.R.C. § 861(a)(9)(A).

[141] *Cf.* I.R.S. Field Serv. Adv. Mem. 2001-47-033 (Aug. 14, 2001).

[142] In commenting on Article 21, the "Other Income" article of the 2006 US Model, the 2006 US Model Technical Explanation states, "in most cases guarantee fees paid within an intercompany group would be covered by Article 21, unless the guarantor were engaged in the business of providing such guarantees to unrelated parties." Similar language appears in the Technical Explanations to the recent treaties and protocols with Belgium, Bulgaria, France and Iceland. *See* Technical Explanation of the U.S.-Belg. treaty, *supra* note 84, commentary on art. 20, at 31,340; Technical Explanation of the U.S.-Bulg. treaty, *supra* note 118, commentary on art. 20, at 40,870; Technical Explanation of the 2009 Protocol to the 1994 U.S. France Income Tax Treaty, commentary on Protocol art. 7, 2 TAX TREATIES (CCH) ¶ 3039B, at 75-175-83; Technical Explanation of the U.S.-Ice. treaty, *supra* note 95, commentary on art. 20, at 97,199-14.

[143] For treaties containing a provision exempting "other income" without regard to its source, *see, e.g.*, U.S.-Ger. treaty, *supra* note 86, art. 21; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Dec. 18, 1992, U.S.-Neth., art. 23, Hein's No. KAV 3507; U.S.-U.K. treaty, *supra* note 2, art. 22; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Nov. 27, 2006, U.S.-Belg., art. 30, Hein's No. KAV 7908; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion

for such an actual payment. The branch, however, would argue that no withholding tax can be imposed on an interbranch guarantee fee, since that fee is disregarded under domestic law.

The combination of a deduction under the treaty and the avoidance of withholding under domestic law is the result of inconsistent treatment of the interbranch fee for treaty and domestic law purposes. It would be improper to deny the treaty deduction, however, if it complies with the arm's length norms that apply in determining the profits attributable to a permanent establishment. Furthermore, there is no basis under domestic law or a treaty for imposing a withholding tax on an interbranch transaction that creates a deduction under a treaty but is otherwise not recognized under domestic law. Yet the end result is avoidance of U.S. tax on a large portion of the fee paid by the domestic customer, which is presumably intended to fall within the U.S. tax net.

The remedy would be to amend domestic law to impose a withholding tax on interbranch payments that are deducted pursuant to a treaty and that, had they been actual payments from a subsidiary, would have been U.S. source income subject to withholding, except to the extent that the tax on any such actual payment would have been reduced or eliminated by treaty. The prototype for such a tax would be the branch profits interest tax. Shortly after that tax was enacted, the IRS considered whether the branch profits interest tax violated the nondiscrimination clause of any treaty, or amounted to an implicit

with Respect to Taxes on Income, Nov. 6, 2003, U.S.-Japan, art. 21, Hein's No. KAV 6401. *See also* 2006 U.S. Model art. 21.

For treaties without such an exemption, *see, e.g.*, U.S.-China treaty, *supra* note 3, art. 21; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Aug. 6, 1982, U.S.-Austl., art. 21, 35 U.S.T. 1999, 1986-2 C.B. 220, *as amended by* Protocol, Sept. 27, 2001, art. 11, T.I.A.S. 13,164; U.S.-Malta 2008 treaty, *supra* note 67, art. 21; Convention with Respect to Taxes on Income and on Capital, Sept. 26, 1980, U.S.-Can., art. 22, T.I.A.S. 11,087, 1986-2 C.B. 258; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Jan. 15, 1998, U.S.-Est., art. 21, T.I.A.S. No. 12,919.

denial of an interest deduction that was required to be allowed under the business profits article.[144] The IRS concluded that the tax did not violate any treaty obligations, since it put the branch in no worse a position than a comparably situated subsidiary. A similar argument would justify a tax on recognized interbranch guarantee fees or other U.S. source payments.

5. ***Branch Profits Tax***

Where there is a branch, there is potential for branch profits tax. Absent a treaty, a 30% tax is imposed on the repatriation of effectively connected income, whether to the home office or another branch outside the United States.[145] Mechanically, the statute measures repatriation by comparing the branch's assets, net of liabilities, at the end of the year with the net assets at the end of the preceding year. The tax base for the branch profits tax is the "dividend equivalent amount," defined as effectively connected earnings and profits, plus any decrease in branch net assets, and minus any increase in branch net assets.[146] The effectively connected earnings and profits are earnings and profits that are attributable to effectively connected income, and are therefore reduced by any federal income tax due on that income.[147] For example, if a branch starts the year with 100 in net assets from retained earnings in prior years, earns another 100, pays 35 of U.S. tax, and has 50 in the branch at the end of the year, then the branch profits tax will be imposed on the 65 of after-tax profit plus the 50 reduction in branch net assets, for a total of 115. Thus, under these facts, the branch can be seen to have repatriated all of the cur-

[144] Notice 89-80, 1989-2 C.B. 394, Part II.

[145] I.R.C. § 884(a).

[146] I.R.C. § 884(b).

[147] I.R.C. § 884(d).

rent year's after-tax earnings plus 50 of the previously accumulated earnings.

The 30% branch profits tax rate mirrors the withholding tax rate on dividends. The intent is to broadly equalize the tax treatment of operating in the United States through a branch or through a U.S. subsidiary. Where a treaty applies, the branch profits tax rate is conformed to the reduced rate on dividends from a subsidiary to its parparent. This rate is 5% in many treaties, but in the handful of more recent treaties and protocols that provide to qualifying residents a complete exemption from withholding tax on those dividends, a branch profits tax exemption is available as well.[148]

Treaties affect more than the branch profits tax rate. They also limit the branch profits tax base to branch profits that are attributable to a permanent establishment.[149] Moreover, only repatriations of earnings from a permanent establishment are included in the branch profits tax base; repatriations of other earnings are disregarded.[150] Thus, in computing branch profits tax under a treaty, the starting point is the effectively connected earnings and profits of the permanent establishment, which is then adjusted up or down by any decrease or increase in its net assets. This formulation protects tax-

148 U.S.-Austl. treaty, supra note 143, art. 10(8), *as amended by* the U.S. Austl. Protocol, *supra* note 143; U.S.-Ger. treaty, *supra* note 86, art.10(10), *as amended by* Protocol, June 1, 2006, art. 4, Hein's No. KAV 7646; Convention for Avoidance of Double Taxation and Prevention of Fiscal Evasion with Respect to Income Taxes, Sept. 18, 1992, U.S.-Mex., art. 11A(3), Hein's No. KAV 3508, *as amended by* Second Additional Protocol, Nov. 26, 2002, art. 3, Hein's No. KAV 6264; U.S.-Neth. treaty, *supra* note 143, art. 11(3), *as amended by* Protocol, Mar. 8, 2004, art. 4, Hein's No. KAV 6475; U.S.-U.K. treaty, *supra* note 143, art. 10(7); U.S.-Belg. treaty, *supra* note 143, art. 10(11); Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Aug. 19, 1999, U.S.-Den., art.10(9), T.I.A.S. 13,056; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Sept. 1, 1994, U.S.-Swed., art. 10(10), Hein's No. KAV 3979, *as amended by* Protocol, Sept. 30, 2005, art. 4, Hein's No. KAV 7442.

149 Treas. Reg. § 1.884-1(g)(4)(ii)(B).

150 Treas. Reg. § 1.884-1(g)(4)(iii).

payers, since it removes from the branch profits tax base any repatriations of branch net assets outside the permanent establishment. But it also protects the revenue, since any branch profits tax on the permanent establishment cannot be sheltered by reinvesting earnings in U.S. assets that are not attributable to the permanent establishment.[151]

This rule for computation of branch profits tax in the treaty context is essentially a consistency requirement: if the taxpayer is using the treaty to limit the branch profits tax on earnings and profits attributable to a permanent establishment, then it must be consistent in looking only to the permanent establishment in measuring changes in U.S. net assets. Moreover, the regulation appears to have been drafted with weak consistency in mind:

> To determine the dividend equivalent amount of a foreign corporation out of ECEP [effectively connected earnings and profits] that is attributable to a permanent establishment, the foreign corporation may only take into account its U.S. assets, U.S. liabilities, U.S. net equity and ECEP attributable to its permanent establishment.[152]

Under strong consistency, a taxpayer claiming treaty benefits on business profits is subject to U.S. tax on all profits that are attributable to a permanent establishment, including profits that do not constitute effectively connected income. But those profits do not appear to constitute "effectively connected earnings and profits" for purposes of the branch profits tax. Consequently, branch profits that are attributable to a permanent establishment but do not constitute effectively connected income could be included in the income tax base under strong consistency, but not the branch profits tax base.

That sort of tax base discrepancy potentially conflicts with a number of Technical Explanations, which assert that a taxpayer that

151 *But see infra* Part IV.B.3 (p. 798).

152 Treas. Reg. § 1.884-1(g)(4)(iii).

uses a treaty for its business profits generally must also use the treaty for branch profits tax purposes as well.[153] For example, the Technical Explanation of the Belgian treaty states,

> As discussed in the Technical Explanations to Articles 1(2) and 7(2), consistency principles require that a taxpayer may not mix and match the rules of the Code and the Convention in an inconsistent manner. In the context of the branch profits tax, the consistency requirement means that an enterprise that uses the principles of Article 7 to determine its net taxable income also must use those principles in determining the dividend equivalent amount. Similarly, an enterprise that uses U.S. domestic law to determine its net taxable income must also use U.S. domestic law in complying with the branch profits tax. As in the case of Article 7, if an enterprise switches between domestic law and treaty principles from year to

[153] Technical Explanation of the U.S.-Belg. treaty, *supra* note 84, commentary on art. 10(10), at 31,318. Technical Explanations with similar language include Technical Explanation of the U.S.-Bulg. treaty, *supra* note 118, commentary on art. 10(8), at 40,855; Technical Explanation of U.S.-Ger. protocol, *supra* note 84, commentary on art. 4 of the Protocol *amending* art. 10 of the Treaty, at 77,199-69; Technical Explanation of the U.S.-Ice. treaty, *supra* note 95, commentary on art. 10(8), at 97,199; Technical Explanation of the 2009 Protocol to the 1994 U.S.-France Income Tax Treaty, commentary on art. 2 of the Protocol *amending* art. 10 of the Treaty, 3 TAX TREATIES (CCH) ¶ 3039B, at 75,175-79; Technical Explanation of the Convention between the Government of the United States of America and the Government of Malta for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income Signed at Valletta on August 8, 2008, commentary on art. 10(8), 5 Tax Treaties (CCH) ¶ 5839C, at 133,515-116; Technical Explanation of the Protocol Between the United States of America and New Zealand, Signed at Washington on December 1, 2008, Amending the Convention and Protocol Between the United States of America and New Zealand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income, Signed at Wellington on July 23, 1982, commentary on art. 6 of the Protocol *amending* art. 10 of the Treaty, 5 TAX TREATIES (CCH) ¶ 6849C, at 145,201-73. This language also appears in the 2006 U.S. Model Technical Explanation, commentary on art. 10(8).

> year, it will need to make appropriate adjustments or recapture amounts that otherwise might go untaxed.[154]

On the face of it, forcing a taxpayer to use the treaty for both income and branch profits tax purposes, or for neither, is a sensible consistency requirement. The structure of the branch profits tax relates to a defined pool of earnings, adjusted to reflect changes in the net assets that generate those earnings. If a treaty is being used to define that pool for regular tax purposes, it makes sense for it to be used for branch profits tax purposes as well. But if strong consistency seeks to impose the regular tax on attributable earnings that are not effectively connected, it cannot be faithful both to the regulations (which exclude those earnings from the branch profits tax base) and also to this further consistency requirement between the income and branch profits taxes. Yet this further consistency requirement appears in the same Technical Explanations that assert strong consistency (as well as several others).[155]

Profits accumulated in one year may be repatriated in a later year. If there is to be consistency in applying treaties to the regular tax and the branch profits tax, that consistency might have to apply among different years as well as within a particular year. The potential requirement of consistency over time raises additional issues, which are discussed in Part IV.B.3 below.

The branch profits tax rules also include the branch profits interest tax,[156] which is intended to preclude, for interest expense, the benefits seen in the preceding Part for guarantee fees: a deduction for a deemed or actual interbranch transaction without a corresponding U.S. source payment on which withholding tax can potentially be imposed. The starting point is interest that is paid or accrued by the

[154] Technical Explanation of the U.S.-Belg. treaty, *supra* note 84, commentary on art. 10(10), at 31,318.

[155] *See* Technical Explanations cited in note 153 *supra*.

[156] I.R.C. § 884(f).

branch on its books. That interest is treated as U.S. source, and is therefore subject to U.S. withholding tax unless a statutory or treaty exemption applies, even though it is paid by a non-U.S. person.[157] In practice, the amount of interest recorded on the books of the branch will normally differ from the amount of interest allocated to the branch under the regulatory formula or a treaty-based allocation. If the branch's book interest expense exceeds the amount that the branch is entitled to deduct, then the branch can designate an amount of interest equal to the excess as foreign source, and can specify which interest it is.[158] Conversely, if the branch's interest deductions exceed its book interest expense, then the excess is treated as interest paid to the home office, as if the branch were a domestic subsidiary of the home office.[159] That interest will not qualify for the portfolio interest exemption (since the "lender" is a greater than 10% shareholder),[160] but the withholding tax may be reduced or eliminated by treaty.

The amount of branch interest subject to these rules will depend on whether the branch computes its interest expense under domestic law rules or a treaty. Even if the branch claims treaty benefits for its business profits and uses the regulatory formula to compute its branch capital, the resulting amount of interest expense could differ from a pure application of domestic law, since the amount of U.S. assets taken into account under the regulatory formula will, in the treaty case, be limited to assets of the U.S. permanent establishment. This circumstance gives rise to some treaty consistency issues.

First, the taxpayer may or may not prefer to claim treaty benefits on branch profits, particularly if the relevant treaty is with Belgium or Germany and strong consistency is required. But if the taxpayer com-

[157] I.R.C. § 884(f)(1)(A).

[158] Treas. Reg. § 1.884-4(b)(6).

[159] I.R.C. § 884(f)(1)(B).

[160] I.R.C. § 881(c)(3)(B).

putes its interest expense under domestic law rules rather than the treaty, can treaty rates be applied to the resulting branch interest? Where the branch interest is paid to a third party, the answer should be clearly yes. Indeed, it is doubtful that it would ever occur to a recipient of such interest that its own treaty benefits might be conditioned on how the debtor computes its branch profits. The answer is not as clear when the tax is applied to the excess interest that is deemed paid to the home office, since in this case it would be the same taxpayer claiming treaty benefits on its deemed receipt of the interest but applying domestic law to determine its branch interest deductions. Yet even here, it seems unnecessarily harsh to require the taxpayer to suffer 30% withholding tax on this excess interest merely because it uses domestic law to determine its taxable business profits. Such a taxpayer is being consistent in the *amount* of interest subject to the branch interest rules; it merely wants to apply the treaty to the tax rate only. A selective use of the treaty to this limited degree does not appear to raise any consistency concerns.

A more serious consistency problem arises if the taxpayer seeks to use domestic law to determine its branch profits, but to use a treaty to determine the amount of interest subject to the branch interest rules. Such a taxpayer might have smaller interest deductions under the treaty (and therefore less interest covered by the branch interest rules), since there would be fewer U.S.-connected assets taken into account. However, the taxpayer might wish to use domestic law for its business profits, in order to use losses from a U.S. trade or business that are not attributable to a permanent establishment. Here, the consistency problem is that the branch interest rules are intended to treat as U.S. source precisely the amount of interest that the branch is claiming as a deduction. It should therefore be proper on consistency grounds to prevent a taxpayer from using a treaty selectively in order to subject a smaller amount of interest to the branch profits rules than it is claiming as a deduction. The Treasury Decision implement-

ing the branch profits tax regulations indicated that the Treasury Department and the IRS are considering this issue.[161]

[161] T.D. 9281, 71 Fed. Reg. 47,443, 47,444 (Aug. 17, 2006).

IV. OTHER TYPES OF CONSISTENCY

The foregoing discussion of consistency has focused on branch profits, and whether treaty protection for one item of branch profits affects the taxation of other branch items in the same year. But considerations of treaty consistency arise in other contexts as well. For example, a claim of treaty benefits for a particular item of income may be inconsistent with the way that same item is treated for other domestic law purposes. Also, in some contexts a duty of consistency may extend over time, so that a claim of treaty benefits in one year affects the choices that may be available to the taxpayer in other years.

Treaty consistency can extend as well to the status of the taxpayer as an entity. Inconsistencies can arise for a taxpayer that is treated as a foreign resident under a treaty but as a U.S. resident under domestic law. Also, a hybrid entity that is a corporation for U.S. tax purposes may be transparent under the tax law of the jurisdiction where its owners reside. Consistency issues arise if those owners treat the entity as transparent in order to claim treaty benefits for some purposes, while relying for other purposes on the opaque status of the entity under domestic law.

In most of these contexts,[162] the distinction between strong and weak consistency disappears. Instead, there is simply the principle that a taxpayer may not take inconsistent positions under a treaty and domestic law where doing so would frustrate the intent of the relevant treaty provision. This is essentially the standard for weak consistency, which in the branch profits context can be viewed as a particular instance of this more general principle.

[162] Exceptions include the selective use of treaty-based sourcing for multiple items of income, discussed *infra* in Part IV.A.4 (p. 779), and the treatment of dual residents, discussed *infra* in Part IV.C (808)..

A. *Character and Source of Income*

1. *Domestic-Law Exemption and Treaty Credit*

Although the United States generally taxes the worldwide income of its citizens regardless of where they reside, U.S. citizens working abroad are entitled under Section 911 to an exclusion of their earned income,[163] up to a maximum amount that is indexed for inflation ($92,900 for 2011).[164] When the services are performed in a treaty country, that country is generally permitted to tax the income, subject to *de minimis* rules.[165] However, Section 911 denies a credit for those foreign taxes, in order to prevent taxpayers from claiming the double benefit of an exclusion for the income plus a credit for the foreign taxes paid on that income, which might be used to shelter U.S. tax on other foreign source income, including earned income in excess of the Section 911 exclusion ceiling.[166]

The treaty consistency question arises when a treaty requires the United States to provide a credit for taxes that the treaty partner is permitted to impose on U.S. persons.[167] Such a requirement is one of the few exceptions to the "savings clause" in U.S. treaties that generally gives each country the unrestricted right to tax its own residents and

[163] I.R.C. § 911(a).

[164] I.R.C. § 911(b)(2)(D); Rev. Proc. 2010-40, 2010-46 I.R.B. 663, § 3.19.

[165] For example, art. 14(2) of the 2006 U.S. Model and art. 15(2) of the OECD Model permit a Contracting State to tax remuneration derived in respect of an employment exercised in that State, unless (i) the employee is present for no more than 183 days in any 12-month period beginning or ending in the taxable year concerned and (ii) the employer is neither a resident nor a permanent establishment in that State.

[166] I.R.C. § 911(d)(6). This limitation was added to Section 911(a) by the Tax Reform Act of 1976, Pub. L. No. 94-455, § 1011(b)(1), 90 Stat. 1520, 1610.

[167] *See, e.g.,* 2006 U.S. Model art. 23(2). The OECD Model contains a similar provision in art. 23B(1), but contains an alternate provision in art 23A(1) that would require the residence country to provide an exemption rather than a credit.

citizens.[168] A taxpayer eligible for the exclusion for income earned in such a country might seek to claim, in addition to the exclusion, a credit under the treaty for foreign taxes on that income, notwithstanding the domestic rule that disallows the credit in such a case.

The IRS considered this issue in Revenue Ruling 79-199;[169] not surprisingly, it refused to allow the credit. For U.S. treaties generally, one could say that there is no conflict between the treaty and domestic law, since the obligation of the United States to provide the credit is expressly made subject to limitations of domestic law in effect from time to time, so long as those limitations do not change the general principle of creditability.[170] However, the OECD Model does not contain such a limitation.[171] If the obligation to provide the credit were not limited by the express terms of the treaty, then the question would arise whether the taxpayer could fairly be required, on treaty consistency grounds, to choose between the benefits of the treaty credit or the domestic law exemption. Since the treaty provision is intended to provide relief from double taxation, it could be argued that requiring a foreign tax credit for income that is exempt from residence country tax goes beyond the purposes of that provision.

Yet a treaty provision that requires the residence country to grant a credit for tax imposed by the source country is different from a provision that requires the residence country to grant an exemption. The

[168] *See, e.g.,* 2006 U.S. Model art. 1(4): "Except to the extent provided in paragraph 5, this Convention shall not affect the taxation by a Contracting State of its residents…and its citizens." The American Law Institute concluded that, in this context, it should be possible under most treaties to construe the treaty and domestic law in a manner that avoids a direct conflict. ALI Study, at 82 n.249.

[169] 1979-1 C.B. 246.

[170] Art. 23(2) of the 2006 U.S. Model, like many current treaties, states, "In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof), the United States shall allow to a resident or citizen of the United States as a credit…"

[171] *See, e.g.,* OECD Model art. 23B(1).

OECD Model offers both possibilities, but a particular treaty will contain only one of these provisions, depending on whether the country to whom it applies has an exemption or credit system in its domestic law for relieving double taxation of foreign income. So when the United States obligates itself to provide a credit, it cannot fairly say in a particular case that it is just as good to offer an exemption instead. The treaty expressly requires a credit, and that is what the United States should provide.

Domestic law conveniently avoids these difficult issues by making the Section 911 exclusion elective. This allows the IRS to say, as it did in Revenue Ruling 79-199, that the United States has not breached its treaty obligations by denying the credit. Any taxpayer is free to claim the credit, by electing to forgo the exclusion. Moreover, the treaty does not take away any benefit under domestic law, as the taxpayer is free to forgo the treaty and claim the exclusion instead.[172] The ruling does not mention any particular treaty, but the elective nature of Section 911 allows the IRS to apply the domestic-law disallowance of the foreign tax credit without regard to the particular terms of the relevant treaty article.

This same reasoning would prevent a bold taxpayer from claiming a deduction for foreign taxes under domestic law and simultaneously claiming a credit for those same taxes under a treaty. The domestic-law rules permitting either a deduction or a credit, but not both,[173] do not contravene a treaty, since the credit is always an option; nor does the treaty take away any right that exists under domestic law in the absence of the treaty.[174]

172 *See* ALI Study, at 82.

173 I.R.C. §§ 164(a)(3), 275(a)(4), 901(a).

174 For a discussion of this same issue from a Canadian-law perspective, *see* Brian J. Arnold, *The Relationship Between Tax Treaties and the Income Tax Act: Cherry Picking*, 43 CAN. TAX J. 869, 884–85 (1995).

2. *Treaty Exemption and Domestic-Law Source*

Most treaties contain sourcing rules, where the treaty partners agree on the source of particular items of income. The approach by which this is done, however, has varied over time. Some older treaties contain a detailed list of sourcing rules, consistent with the 1977 U.S. model.[175] Those rules, however, did not necessarily line up with taxing rights under the treaty. That lack of alignment was corrected in the 1981 U.S. Model, which contained a general source rule as part of the article requiring the United States to provide a credit for taxes that the treaty partner is permitted to impose.[176] That source rule treats income as foreign source if the treaty partner is entitled to tax it; otherwise, the income is treated as U.S. source. This rule ensures that whenever the United States is required to provide a foreign tax credit, it is also required to treat the income as foreign source for purposes of the foreign tax credit limitation provisions. A number of treaties embody this approach, including those with Austria,[177] Canada,[178] India,[179] and Sweden.[180]

[175] United States Model Income Tax Convention, May 17, 1977, art. 23(3), 1 TAX TREATIES (CCH) ¶ 212.23; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Mar. 19, 1984, U.S.-Cyprus, art. 6, 35.4 U.S.T. 4737, 1989-2 C.B. 280; Convention with respect to Taxes on Income, Nov. 20, 1975, U.S.-Isr., art. 4, Hein's No. KAV 971; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, May 21, 1980, U.S.-Jam., art. 24(3), 33 U.S.T. 2903, 1982-1 C.B. 257; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and the Encouragement of International Trade and Investment, June 4, 1976, U.S.-S. Kor., art. 3, 30 U.S.T. 5253, 1979-2 C.B. 435; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and Property, Dec. 3, 1971, U.S.-Nor., art. 24, 23 U.S.T. 2832, 1973-1 C.B. 669.

[176] United States Model Income Tax Convention, June 16, 1981, art. 23(3), 1 TAX TREATIES (CCH) ¶ 211, at 10,567 [hereinafter 1981 U.S. Model].

[177] Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, May 31, 1996, U.S.-Austria, art. 22(4), Hein's No. KAV 4685.

A sourcing rule that requires the United States to treat an item of income as foreign source makes sense when the treaty partner is allowed to tax the income. But it is less clear why the United States should be required to treat income as U.S. source when the treaty partner is not allowed to tax it. Curiously, such a rule has the effect of assigning different sources to the same item of income for purposes of different articles of the treaty. For example, Article 11 of the Canadian treaty, which deals with interest, contains a sourcing rule that assigns the source of income to the country where the payor is resident, or to the country where the payor has a permanent establishment that is paying the interest.[181] So interest paid by a Canadian borrower to a U.S. lender is treated as Canadian source, consistent with U.S. domestic law.[182] By contrast, Article 24 of the treaty, which deals with foreign tax credits, provides that income shall be sourced in the country of residence if the source country is not allowed to tax it.[183] Since the Canadian treaty provides a zero rate of withholding on interest, this means that interest paid by a Canadian borrower must be treated as U.S. source for purposes of the foreign tax credit rules. This inconsistent sourcing of the same item of income is not an outright contradiction, however, since each source rule applies only for purposes of its own article.

The real consistency issue arises when a U.S. lender seeks to use the treaty to claim an exemption from Canadian withholding tax on interest paid by a Canadian borrower, but also seeks to ignore the

[178] U.S.-Can. treaty, *supra* note 143, art. 24(3)(b).

[179] Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Sept. 12, 1989, U.S.-India, art. 25(3), Hein's No. KAV 880.

[180] U.S.-Swed. treaty, *supra* note 148, art. 23(4).

[181] U.S.-Can. treaty, *supra* note 143, art. 11(4).

[182] I.R.C. § 861(a)(1).

[183] U.S.-Can. treaty, *supra* note 143, art. 24(3).

treaty rule treating the income as U.S. source for foreign tax credit purposes, and apply U.S. domestic sourcing rules instead.[184] Treating the income as foreign source, even though not subject to foreign tax, would potentially enable the lender to shelter the U.S. tax on that income by "cross crediting" foreign taxes on other income that exceed the U.S. tax imposed on that other income. A similar issue can arise under the Canadian treaty for copyright royalties (other than for films), since the Canadian treaty also provides an exemption from withholding tax for those royalties.[185]

This consistency issue is unusual in that it involves the tax systems of both countries. The other consistency issues discussed so far have involved a taxpayer seeking to apply U.S. tax rules differently under a treaty and under U.S. domestic law. Here, the consistency issue pertains to a U.S. taxpayer that is seeking to apply the treaty in the foreign country to eliminate foreign taxes, while applying U.S. domestic law in computing the foreign tax credit.

In requiring this income to be treated as U.S. source, the treaty purports to affect the tax treatment of U.S. citizens and residents. Although the savings clause generally permits the United States to tax its own citizens and residents without regard to the treaty, the savings clause does not apply to the foreign tax credit article, which contains the re-sourcing rule.[186] Such a re-sourcing rule, however, deprives the taxpayer of a benefit under domestic law, which runs contrary to the general rule that treaties do not restrict the availability of domestic law

184 The same issue arises for interest under the treaties with Austria and Sweden, since these also provide an exemption from source-country withholding. U.S.-Austria treaty, *supra* note 177, art. 11(1); U.S.-Swed. treaty, *supra* note 148, art. 11(1).

185 U.S.-Can. treaty, *supra* note 143, art. 12(3). The Austrian treaty also exempts these royalties, and the Swedish treaty has an even broader exemption. U.S.-Austria treaty, *supra* note 177, art. 12(1); U.S.-Swed. treaty, *supra* note 180, art. 12(1).

186 U.S.-Can. treaty, *supra* note 143, art. 29(2); *see also supra* note 168 and accompanying text.

tax benefits.[187] Consequently, the only basis for depriving a U.S. taxpayer of the domestic law benefit of treating the affected income as foreign source would be considerations of treaty consistency.

When the ALI Study was published, the United States was in the process of negotiating some of the treaties that contain this U.S. source rule. The ALI Study expressly addresses whether treaty consistency should prevent a U.S. taxpayer from simultaneously claiming an exemption from foreign withholding under such a treaty while also applying domestic law in determining the source of the underlying income.[188] Two reasons are cited to support its conclusion that treaty consistency should not restrict the taxpayer's choices in this regard. The first reason is that such a rule creates a "cliff effect," where even a small amount of permissible foreign withholding tax would be sufficient to switch the sourcing of the income from U.S. to foreign. Yet such a cliff effect is the inevitable, and presumably intended, result of assigning the source of income in accordance with the assignment of primary taxing power on that income. No one disputes that U.S. domestic law could assign a domestic source to those items of income that the treaty partner is not allowed to tax, in which case the cliff effect would arise wholly apart from any requirement of treaty consistency.

The second reason cited by the ALI Study is that a requirement of treaty consistency in this context would be difficult to administer, because taxpayers would then "be required to examine all applicable treaties to ascertain whether the treaty changes the statutory source rule."[189] Yet such a broad examination would not result from a treaty consistency requirement, which would apply only where a taxpayer was affirmatively using a treaty to avoid foreign tax.

[187] U.S.-Can. treaty, *supra* note 143, art. 29(1).

[188] ALI Study, at 83.

[189] ALI Study, at 84.

While these particular reasons are unpersuasive, a more troubling aspect of applying treaty consistency in this context is that the taxpayer does not have a real choice between a pure application of the treaty or domestic law. On the one hand, the taxpayer could claim the foreign exemption and accept U.S. sourcing of the income under the treaty. Conversely, the taxpayer could forgo treaty benefits, pay the foreign tax, and treat the income as foreign source under domestic law. But in the latter case the taxpayer would be unable to ignore the treaty completely in applying domestic law. Since the taxpayer has the right under the treaty not to pay the foreign tax, the tax would likely be non-creditable as a "voluntary" tax if the taxpayer chose to pay it.[190]

An argument in favor of a consistency requirement is that, in the absence of such a requirement, the U.S. source rule in the treaty would be a dead letter, since taxpayers could, and presumably would, freely ignore it. In effect, the U.S. sourcing rule in the treaty would then become nothing more than an affirmation of the right of the United States to treat the income as U.S. source if it chooses to do so in its domestic law. Such an affirmation is really no different from silence, since the savings clause gives the United States the unrestricted right to tax its own citizens and residents, except as expressly provided in the double taxation article and the handful of other provisions that are not subject to the savings clause.

Perhaps in recognition of the fact that the U.S. sourcing rule was serving no essential purpose, the United States opted for silence on this point in the 1996 and 2006 U.S. Models. Indeed the 1996 U.S. Model has no sourcing rule at all in its double taxation article, which is consistent with the OECD Model. The 2006 U.S. Model has a foreign re-sourcing rule for income that the treaty partner is permitted to

[190] *See* Treas. Reg. § 1.901-2(e)(5). This point is also made by the ALI Study, at 84 n.251, and by Arnold, *supra* note 174, at 887.

tax,[191] but does not say that income that the treaty partner cannot tax must be U.S. source. This approach was taken in a number of older treaties as well,[192] and newer treaties also tend to follow the 2006 Model in this regard.[193]

Given the abandonment in these treaties of any rule that treats exempt foreign income as U.S. source, it is difficult to see a compelling treaty policy reason to impose a consistency requirement in the older treaties that do contain such a rule. Yet regardless of whether the relevant treaty contains such a rule, the combination of foreign source treatment under domestic law with an exemption from foreign tax under the treaty creates a cross-crediting opportunity, since the U.S. tax on that income could be sheltered by excess credits for foreign taxes on other income in the same basket.[194] Those opportunities were

[191] 2006 U.S. Model art. 23(3).

[192] *See, e.g.,* U.S.-Austl. treaty, *supra* note 143, art. 27(1); U.S.-China treaty, *supra* note 3, art. 22(3); U.S.-Est. treaty, *supra* note 143, art. 23(3); Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, July 28, 1997, U.S.-Ir., art. 24(5), Hein's No. KAV 5082; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, Apr. 3, 1996, U.S.-Lux., art. 25(4), Hein's No. KAV 4687; U.S.-Mex. treaty, *supra* note 148, art. 24(3); Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, July 23, 1982, U.S.-N.Z., art. 22(4), 35 U.S.T. 1949, 1990-2 C.B. 274; Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Mar. 28, 1996, U.S.-Turk., art. 23(3), Hein's No. KAV 4684; U.S.-U.K. treaty, *supra* note 143, art. 24(2).

[193] *See, e.g.,* U.S.-Belg. treaty, *supra* note 143, art. 22(3); Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Feb. 23, 2007, U.S.-Bulg., art. 22(3), Hein's No. KAV 8050; U.S.-Ger. treaty, *supra* note 86, art. 23(2), *as amended by* protocol, *supra* note 148, art. 22; U.S.-Japan treaty, *supra* note 143, art. 23(2); U.S.-Malta 2008 treaty, *supra* note 67, art. 23(3).

[194] Credits for foreign taxes are generally limited to the percentage of U.S. tax equal to the percentage of taxable income derived from foreign sources. I.R.C. § 904(a). For this purpose, foreign source income is divided into categories commonly referred to (although not by the statute) as "baskets," and the limita-

enhanced by the reduction in the number of baskets to two for taxable years beginning after 2006.[195]

If cross-crediting is seen as a problem, then one answer might be to change domestic law so that treaty-exempt income is classified as US source. Such a change would not violate treaty obligations, since it would only affect income that the treaty partner has agreed not to tax, except perhaps in the handful of older treaties that contain detailed source rules.[196] The treaty consistency issue would disappear, as there would be no opportunity to play domestic source rules against the treaty exemption.

Such a domestic US source rule would cause complications, however, when income that is exempt under a treaty from tax by one country is subject to tax by another foreign country. For example, suppose a resident of Country *X* pays rent to a U.S. person for the use of personal property in Country *Y*. Suppose further that Country *Y*, like the United States, sources rent by reference to the location of the leased property, but Country *X* sources rent by reference to the residence of the lessee. If the treaty with Country *Y* exempts the rent from tax, but there is no treaty with Country *X*, then Country *X* could tax this income. If domestic law were to reclassify the rent as U.S. source by reason of the treaty with Country *Y*, then no U.S. tax credit would be allowed on the tax imposed by Country *X*, which would be a harsh, and presumably unintended, consequence of the treaty with Country *Y*. The alternative of treating the income as U.S. source for purposes of the credit for Country *Y* tax, but foreign source for purposes of the credit for Country *X* tax, is problematic because the foreign tax credit limitation works on an overall basis for each basket.

tion is applied separately to foreign taxes and income attributable to each basket. I.R.C. § 904(d)(1).

195 American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 404, 118 Stat. 1418, 1494. The "passive" basket contains passive income; the "general category" basket contains everything else. I.R.C. § 904(d)(2)(A).

196 *See supra* note 175.

Yet a similar instance of inconsistent sourcing is evidently contemplated by some treaties, as discussed in the next Part.

A different approach would put treaty-exempt income in its own basket. This separate-basket treatment would make the treaty consistency point essentially moot even for those treaties that still contain a U.S. sourcing rule, as no cross-crediting would be allowed even if the taxpayer treated the income as foreign source.[197] The principal drawback of creating such a basket would be complexity, and the considerations that led to the recent reduction in the number of baskets might justify allowing this potential for cross-crediting on the grounds of simplicity.

3. *Treaty Re-Sourcing Limited to Treaty Partner's Taxes*

Some treaties expressly state that the re-sourcing of income applies only for purposes of crediting taxes imposed by the treaty partner.[198] As a result, the same income may be treated as U.S. source

[197] This approach would be analogous to the rule enacted in 2010, discussed in the next Part, that creates a separate basket for income that is treated as foreign source under a treaty. *See infra* note 204 and accompanying text.

[198] *See, e.g.,* 1981 U.S. Model art. 23(3):

> The rules of this paragraph shall not apply in determining credits against United States tax for foreign taxes other than the taxes referred to in paragraphs 1(b) and 2 of Article 2 (Taxes Covered).

Treaties with similar language include: U.S.-Austl. treaty, *supra* note 143, art. 22(1); U.S.-Austria treaty, *supra* note 177, art. 22(4); Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, Aug. 31, 1994, U.S.-Fr., art. 22(b)(2), Hein's No. KAV 3989; U.S.-India treaty, *supra* note 179, art. 25(3); U.S.-N.Z. treaty, *supra* note 192, art. 22(5), *as amended by* Protocol, Dec. 1, 2008, art. 12(5), Hein's No. KAV 8652; U.S.-Swed. treaty, *supra* note 180, art. 23(4)(b); Convention for the Avoidance of Double Taxation with Respect to Taxes on Income, Oct. 2, 1996, U.S.-Switz., art. 23(3)(c), Hein's No. 4915; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Nov. 26, 1996, U.S.-Thai., art. 25(3), Hein's No. KAV 4911; U.S.-Turk. treaty, *supra* note 192, art. 23(3).

under domestic law for purposes of crediting taxes imposed by other countries. This inconsistent application of a treaty rule and a domestic law rule, unlike the inconsistent choices discussed earlier, potentially favors the government rather than the taxpayer.

Puzzling questions remain about how such a rule can work mechanically. The foreign tax credit limitation for each basket is the percentage of U.S. tax on that basket equal to the percentage of income in that basket that is derived from foreign sources.[199] Since the abandonment in 1976 of the per-country limitation,[200] this limitation is applied by looking at taxes imposed by all foreign countries in the aggregate. If an item of income is to have different sources for purposes of the taxes imposed by different countries, conundrums quickly arise.

Consider again the example in the preceding Part, where a resident of Country *X* pays rent to a U.S. person for the use of personal property in Country *Y*. As before, Country *Y* sources rent by reference to the location of the leased property, but Country *X* sources rent by reference to the residence of the lessee. Under U.S. domestic law, the rent would ordinarily be sourced to Country *Y*, but suppose it is instead treated as U.S. source because of the recapture of an overall foreign loss.[201] In this case, moreover, there are treaties with both Country *X* and Country *Y* that each permit the treaty partner to tax the rent, and also re-source income to the treaty partner if that coun-

The Foreign Relations Committee report for the Chinese treaty states:

> The proposed treaty also omits the U.S. model provision stating that this source rule does not apply in determining foreign tax credits for foreign taxes paid by U.S. residents to third countries, although Treasury's Technical Explanation states that this limitation does apply.

STAFF OF S. COMM. ON FOREIGN RELATIONS, 98TH CONG., REP. ON INCOME TAX 99-7, at 39 (Comm. Print 1985).

199 I.R.C. § 904(a), (d).

200 Tax Reform Act of 1976, Pub. L. No. 94-455, § 1031, 90 Stat. 1520, 1620.

201 *See* I.R.C. § 904(f).

try is entitled to tax it, but only for purposes of that country's taxes. The taxpayer earns 100 of rental income in year 1, and pays 20 of tax to each of Country *X* and Country *Y*, as shown in the "Year 1" column of the table below:

	Year 1	*Year 2*
Income	100	100
Country *X* tax	20	20
Country *Y* tax	20	0
U.S. tax	35	35
Code source	U.S.	U.S.
Treaty source	Country *X*/*Y*	Country *X*

The income is re-sourced to Country *X* for purposes of Country *X* taxes, and to Country *Y* for purposes of Country *Y* taxes. The result is that both taxes are creditable, although the amount of the credit usable in year 1 is constrained by the foreign tax credit limitation for the relevant basket. Assuming that there is no other income or foreign tax in that basket, then 35 of the combined 40 in foreign taxes is creditable, and the remaining 5 is carried forward.[202] At this point, it does not matter which country's taxes are being carried forward rather than used currently, and neither treaty partner can object to the routine application of U.S. foreign tax credit limitation.

The difficulty arises in year 2. Assume that in year 2 the leased property is moved to Country *X*, so that only Country *X* taxes the 100 of rent earned in that year. There is another 20 in Country *X* tax, all of which is creditable, leaving 15 of residual U.S. tax. That residual tax could be sheltered in part by the carryforward of 5 from year 1, but only if the year 2 rent is treated as foreign source for purposes of the carried forward tax. Since only Country *X* can tax the year 2 rent, that rent is treated as foreign source for purposes of Country *X* taxes only. That leaves the question whether the taxes carried forward were

202 *See* I.R.C. § 904(c).

Country *X* taxes or Country *Y* taxes, or some of each. There is no well-defined answer to this question. Further uncertainties arise if taxes of yet a third country are also carried forward, or if the carryforward includes foreign taxes deemed paid out of the earnings and profits of a foreign subsidiary, which may have been subject to the taxes of various countries over an extended period of time.[203] Given the absence of a per-country limitation, there is generally no reason to track which country's taxes are being utilized as a credit an a particular year, but a re-sourcing rule that applies only for purposes of a particular country's taxes would require some sort of tracking mechanism. It is hard to see the policy benefit that would make this additional complexity worthwhile.

Difficulties can arise even within a single year if multiple items of income are involved. Suppose a taxpayer earns three items of 100 in income, each subject to 20 of foreign tax in a separate country. All three items are in the same basket for foreign tax credit limitation purposes. The first two items are U.S. source under domestic law, but the third is foreign source. The first item is re-sourced as foreign under a treaty with Country *X*, but only for purposes of Country *X* taxes. The table below summarizes these facts:

[203] I.R.C. § 902(a) allows an "indirect" credit to a 10% shareholder for taxes paid by a foreign corporation on income distributed to that shareholder as a dividend. The amount of the credit is determined by reference to a pool of undistributed earnings and profits and a pool of foreign taxes, in each case accumulated after 1986, when the current rules took effect. Foreign taxes are added to the foreign tax pool when paid or accrued, and withdrawn from the pool when allowed as a credit, but the taxes of various foreign countries may be blended in a single pool. *See* I.R.C. § 902(c)(2).

	Item 1	*Item 2*	*Item 3*
Income	100	100	100
Foreign tax	20	20	20
Country	*X*	*Y*	*Z*
U.S. tax	35	35	35
Code source	U.S.	U.S.	foreign
Treaty source	Country *X*	—	—

The question is the foreign tax credit limitation for that year. Under domestic law, only the third item is foreign source income, so the foreign tax credit limitation is 35. Since the foreign tax on the third item is only 20, an additional 15 of tax on the other two items can be credited within this limitation, before applying any treaty.

If the taxpayer claims benefits under the Country *X* treaty, then the first item will be treated as foreign source, but only for purposes of Country *X* taxes. One might then conclude that the 20 of Country *X* tax imposed on the first item can be claimed as a credit, in addition to the 35 that would be allowed under a pure application of domestic law. That result, however, assumes that none of this Country *X* tax is already being claimed as a credit under domestic law. Domestic law allows a credit of 35 but does not specify which country's taxes are included within that 35, and which are disallowed by reason of the limitation. One might suppose that at least 20 of that credit was for Country *Z* tax, given that the only income treated as foreign source under domestic law was taxed by Country *Z*, although there is no domestic-law rule that explicitly mandates this result. Even if that were the case, there is no rule that specifies whether the remaining 15 of allowable credit is being used for Country *X* tax or for Country *Y* tax. To the extent that Country *X* tax is already being allowed under domestic law, then the re-sourcing under the Country *X* treaty does not increase the allowable credit.

A taxpayer-friendly answer would say that the domestic-law credit is used for non-Country *X* taxes first, thereby maximizing the additional credits made available under the treaty. The government,

however, may well conclude that its treaty obligations do not require it to apply a rule that maximizes the amount of additional credit beyond the amount allowable under domestic law. It might argue instead that the domestic law credit applies to all foreign taxes in that basket on a pro rata basis. Indeed, the government might even conclude it can meet its treaty obligations by crediting Country *X* taxes first under domestic law; Country *X* can hardly complain if doing so reduces credits for taxes imposed by other countries.

These examples illustrate the difficulties with inconsistent sourcing of an item of income for purposes of taxes imposed by different countries. An alternative would be to put treaty re-sourced income in a separate basket for purposes of the foreign tax credit limitation. This approach was in fact adopted in 2010 by U.S. domestic law.[204] Such a rule is somewhat more generous to taxpayers than a rule treating the income as U.S. source for purposes of taxes imposed by non-treaty countries, since it allows credits for taxes imposed by those countries within the limits of the basket. However, no excess foreign taxes imposed on other items of income could be used to shelter any residual U.S. tax on these items.

This separate statutory basket for treaty re-sourced income should be consistent with U.S. treaty obligations, since it does not interfere with the allowance of a credit for taxes imposed by the treaty partner on that income, up to the amount of U.S. tax imposed on that income, and therefore it is sufficient to prevent double taxation. This approach, while complicated, at least has the virtue of being coherent when compared with inconsistent sourcing of a single item of income. Given that the statutory rule for treaty re-sourced income now applies to all treaties, there is a less pressing need for a rule restricting treaty re-sourcing to taxes imposed by the treaty partner, and the co-

[204] I.R.C. § 904(d)(6), *added by* Education Jobs Act of 2010, Pub. L. No. 111-226, § 213(a), 124 Stat. 2389, 2398, effective for taxable years beginning after Aug. 10, 2010.

nundrums created by such a rule are perhaps best avoided in future treaties.[205]

4. *Selective Treaty Re-Sourcing*

A more general question is whether a taxpayer should be permitted to use a treaty to determine the source of some items of income while using domestic law to determine the source of other items. One commentator argues that this sort of selective re-sourcing should not be permitted,[206] based on an example under the prior Japanese treaty, which sourced both rental and dividend income by reference to the residence of the payor.[207] In the example, the taxpayer leases an airplane to a United States person who uses it solely in Japan, so the rent

[205] The re-sourcing rule in art. 23(4)(c) of the 2006 U.S. Model provides:

> "[F]or the exclusive purpose of relieving double taxation in the United States under subparagraph b), items of income referred to in subparagraph a) shall be deemed to arise in ... to the extent necessary to avoid double taxation of such income under subparagraph b).

This language is somewhat problematic, since it applies "for the exclusive purpose" of relieving double taxation under the treaty and only "to the extent necessary" to avoid this double taxation. This clause could therefore be construed to provide re-sourcing only for taxes of the treaty partner. While that may be the stated purpose of the rule, however, nothing in the rule limits its application to situations in furtherance of that purpose. *But see* Philip D. Morrison, *Re-Sourcing Income under Treaties—Issue with Hybrid Entities*, 36 TAX MGMT. INT'L J. 385 (2007) (arguing that this language might limit re-sourcing).

For examples of treaties with similar language, *see* U.S.-U.K. treaty, *supra* note 143, art. 24(6)(d); U.S.-Ir. treaty, *supra* note 192, art. 24(3)(c); Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and the Prevention of Fraud or Fiscal Evasion, Aug. 25, 1999, U.S.-It., art. 23(4)(c), Hein's No. KAV 6238; U.S.-Mex. treaty, *supra* note 148, art. 24(4)(c); U.S.-Neth. treaty, *supra* note 143, art. 25(6)(c); U.S.-Austria treaty, *supra* note 177, art. 22(2)(c); U.S.-Lux. treaty, *supra* note 192, art. 25(3)(c).

[206] Pamela B. Gann, *The Concept of an Independent Treaty Foreign Tax Credit*, 38 TAX L. REV. 1, 25–28 (1982).

[207] Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Mar. 8, 1971, U.S.-Japan, art. 6(1), (5), 23 U.S.T. 967.

is foreign source under domestic law but U.S. source under the treaty. In the same year, the taxpayer also receives dividends from a Japanese corporation that derives all of its income from a trade or business in the United States; those dividends are U.S. source under domestic law but foreign source under the treaty. Such a taxpayer would naturally want to treat the rent as foreign source under domestic law but treat the dividends as foreign source under the treaty.

While the Technical Explanation of the Japanese treaty, like most others, is silent on the issue, the point is expressly addressed in some other Technical Explanations, such as the Technical Explanation of the Canadian treaty:

> A taxpayer claiming credits for Canadian taxes under the Convention must apply the source rules of the Convention, and must apply those source rules in their entirety. Similarly, a taxpayer claiming credit for Canadian taxes which are creditable under the Code and who wishes to use the source rules of the Convention in computing that credit must apply the source rules of the Convention in their entirety.[208]

Such a restriction smacks of strong consistency. It takes away a domestic-law benefit from one item of income based on a claim of treaty benefits for another item. Presumably the justification is that the taxpayer is always free to reject the treaty source rules, so those rules, taken as a whole, do not impose a higher tax burden. Unlike the permanent establishment rules discussed in Part II.D.4 above, the sourcing rules affect U.S. taxpayers, who are generally subject to the savings clause that permits the United States to tax its own citizens

[208] Technical Explanation of the U.S.-Can. treaty, *supra* note 69, commentary on art. 24, at 41,345. A similar point, although with less explicit language, is made in the technical explanation of the Chinese treaty. *See* Technical Explanation of the Agreement Between the Government of the United States of America and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Tax Evasion with Respect to Taxes on Income Signed on April 30, 1984, commentary on art. 22, 1988-1 C.B. 447.

and residents without regard to the treaty.[209] However, the treaty re-sourcing rule is expressly excluded from the operation of the savings clause,[210] so that U.S. taxpayers can claim treaty benefits in this context.

The restriction, moreover, serves no underlying purpose; it is just consistency for consistency's sake. The purpose of the re-sourcing rules is to ensure that the relief from double taxation offered by the treaty is available for an item of income that the treaty partner is entitled to tax. Allowing the taxpayer to use domestic law to treat a separate item as foreign source does not subvert the purpose of avoiding double taxation of this first item. Indeed, this flexibility preserves that purpose, since it attaches no penalty (in the form of giving up domestic law benefits) to a claim for treaty re-sourcing.

Nor can it be said that treaty source rules form a coherent whole, and must be applied in their entirety if they are to be applied at all. The source rules in most treaties apply only to items of income that the treaty partner is entitled to tax, leaving other items to be subject to domestic law rules. Even those treaties that also purport to assign source to items that the source country is not entitled to tax are best interpreted as applying in a merely permissive fashion to those items, as discussed in Part IV.A.2 above.

In some cases, a treaty provides that a particular foreign tax will be creditable for U.S. tax purposes even though it is not otherwise within the scope of the foreign tax credit provisions of domestic law.[211] The income on which that tax is imposed will be treated as foreign source under the treaty, assuming the treaty contains a typical re-sourcing rule. If a strong consistency rule is applied to treaty re-sourcing, the question then arises as to whether claiming a treaty-

209 *See supra* note 168.

210 U.S.-Can. treaty, *supra* note 143, art. 29(2)-(3).

211 *See, e.g.,* U.S.-Nor. treaty, *supra* note 175, art. 23(1); U.S.-U.K. treaty, *supra* note 143, art. 24(1) (petroleum revenue taxes); *see also* Gann, *supra* note 206, at 13–20.

based credit commits the taxpayer to using the treaty's source rules in their entirety as well. Such a restriction is included in the excerpt quoted above from the Technical Explanation of the 1981 Canadian treaty.[212] This restriction means that a taxpayer seeking to use a domestic source rule for an unrelated item has to give up any treaty-based credits. It is hard to see why such a restriction is needed to give effect to the purpose of the treaty credit and re-sourcing rules.

In the case of a corporate taxpayer that is a member of a consolidated group, the question then arises as to whether consistency is required of the group as a whole. There is no explicit answer to this question, and the consolidated return rules themselves are a blend of single- and separate-entity treatment.[213] The foreign tax credit for the group is determined on a consolidated basis,[214] which might support an argument for consistency across the group. Yet the foreign tax credit limitation is determined by reference to the aggregate foreign source income of each of its members, as determined on a separate basis.[215] Absent a group-wide restriction, a consolidated group might organize its group structure so that income that is intended to be sourced under domestic law is earned by one affiliate, while income that is intended to be sourced under the treaty is earned by another. That type of planning may be cumbersome to implement, however, and in the absence of a meaningful treaty policy basis for this sort of strong consistency, its extension to consolidated groups seems unwarranted.[216]

[212] *See supra* note 208 and accompanying text.

[213] *See* Stephen B. Land, *Entity Identity: The Taxation of Quasi-Separate Enterprises*, 63 TAX. LAW. 98, 132–35 (2009), *reprinted in* STEPHEN B. LAND, II PAPERS ON TAXATION 642-647 (2013).

[214] Treas. Reg. § 1.1502-4(c).

[215] Treas. Reg. § 1.1502-4(d).

[216] For a fuller discussion, *see* Dirk J.J. Suringa, *Group Consistency and the Canada Treaty Re-sourcing Rule*, 38 TAX MGMT. INT'L J. 108 (2009).

5. *Character as a Dividend*

An IRS Chief Counsel Advice (CCA) issued in 2005 concluded that a taxpayer should not be entitled to treat a payment as a dividend under a treaty while treating it as other than a dividend in order to avoid limitations under domestic law.[217] The CCA dealt with the U.K. treaty at a time when the U.K. corporate tax was partially integrated with shareholder-level taxes. During some of the years at issue, U.K. corporations were required to pay an advance corporation tax (ACT) upon making a distribution to shareholders. The ACT was treated as an advance payment of the mainstream corporate tax imposed on the corporation, but could also be used to offset the personal income tax liabilities of its U.K. resident shareholders. Non-U.K. resident shareholders, however, did not benefit from this credit. Then, as now, the U.K. did not impose any withholding tax on dividends paid to resident or non-resident shareholders. For distributions after April 5, 1999, the ACT was repealed, but a reduced credit continues to be allowed to resident shareholders.[218]

The treaty between the United States and the United Kingdom extended the shareholder-level refund to U.S. shareholders of U.K. corporations, but the U.K. was treated as imposing a withholding tax on the full amount of the dividend plus the refund (but not in excess of the amount of the refund).[219] Depending on the status of the investor or the year at issue, the investor might receive a cash refund after withholding; in other cases, the withholding fully offset the refund.

[217] C.C.A. 2006-12-013 (Nov. 29, 2005).

[218] Income Tax (Trading and Other Income) Act 2005 (U.K.) § 397.

[219] Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Dec. 31, 1975, U.S.-U.K., art. 10(2)(a), T.I.A.S. No. 9682.

The real value of these rules came from a further treaty provision[220] that caused the deemed withholding tax to be creditable in the United States, without regard to the refund. The legal fiction was that the refund represented a refund of tax paid by the corporation (a fiction that persisted even after the repeal of the ACT), and this refund was distributed to the shareholder and then partly or wholly paid to the U.K. government as a withholding tax. The result was that the gross refund was additional taxable income to a U.S. shareholder, but the U.S. tax credit for the deemed withholding tax produced a greater tax benefit. Analogous rules existed under French law and the French treaty,[221] although both the U.K. and the French treaty provisions have since been repealed.[222]

The consistency issue addressed by the CCA arose because the taxpayer claimed foreign tax credits with respect to substitute dividend payments on stock loans. Although these payments were not dividends under U.S. domestic law,[223] the taxpayer claimed that they were

[220] *Id.* art. 23(1).

[221] *CODE GÉNÉRAL DES IMPÔTS* [FRENCH TAX CODE], art. 242 quater, *prior to amendment by LOI DE FINANCES POUR 2004* [2004 FINANCE ACT], art. 93 n°2003-1311; U.S.-Fr. treaty, *supra* note 198, art. 10(4)(a), *prior to amendment by* the Protocol referenced *infra* in note 222; *see also* Technical Explanation of the Convention between the Government of the United States of America and the Government of the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to taxes on Income and Capital signed at Paris on August 31, 1994, commentary on art. 10(4), 3 TAX TREATIES (CCH) ¶ 3060, at 75,264.

[222] The prior U.K. treaty allowing the credit was superseded by the current U.K. treaty, which came into force on Mar. 31, 2003, with effect for dividends paid on or after May 1, 2003. U.S.-U.K. treaty, *supra* note 143, art. 29(3). The corresponding provision of the French treaty was repealed by the Protocol dated Jan. 13, 2009, art. 2, Hein's No. KAV 8738, which entered into force Dec. 23, 2009, with effect under art. 16 from Jan. 1, 2010.

[223] Substitute dividend payments are not dividends because the recipient is not the owner of the loaned securities for U.S. federal income tax purposes, although they are treated in a manner similar to dividends in some contexts. *See, e.g.,* Treas. Reg. § 1.861-3(a)(6) (sourcing substitute dividend payments in the same manner

treated as dividends under U.K. law and that they were therefore entitled to a U.K. refund, subject to the withholding tax authorized by the treaty. The CCA questioned whether the claim for a foreign tax credit on this basis had been properly substantiated, but of more relevance here was the taxpayer's further claim that the credit should not be restricted by Section 901(k), which disallows a credit for withholding taxes on dividends paid on shares held for 15 days or less.

Essentially, the taxpayer's position was that it was entitled to treat the substitute payments as dividends for purposes of claiming a foreign tax credit under the treaty rules, but to treat these payments as not subject to the Section 901(k) limitation because the payments did not constitute dividends under domestic law. The CCA offered two reasons why the taxpayer should not be able to do this. First, the literal terms of the treaty require the dividend and the associated deemed credit to be "treated as a dividend for United States tax credit purposes." The consequence of dividend treatment is the application of the foreign tax credit limitations that are generally applicable to dividends, including the Section 901(k) disallowance.[224] Second, and more germane here, is that treating the substitute payment as a dividend for treaty purposes but not as a dividend under domestic law is the sort of inconsistency that would undermine the intent of the treaty provision, which was to provide tax credit equivalent to what a U.S. taxpayer would get on an actual dividend, but no more. The CCA was therefore proper in denying the credit on consistency grounds.

B. *Consistency over Time*

The discussion so far has focused on events happening within a single year. Our income tax system is based on annual accounting, the

as the underlying dividend). S*ee also* I.R.C. § 871(m) (providing similar treatment for a broader class of dividend equivalent payments).

224 *See also* Treas. Reg. § 1.894-1(c) (treating substitute dividend payments as dividends for treaty purposes).

concept of an accounting period being fundamental to the concept of income.[225] Annual accounting can produce distortions, most notably if profits arise in one year, losses in another. Rules for carryforwards and carrybacks reduce these distortions, but in so doing they cause the tax liability in one year to be affected by events in another. Even in the absence of losses, tax attributes, most notably tax basis, need to be carried over from year to year.

Issues of treaty consistency over time are embedded in this broader context. In one sense, a claim of treaty benefits can be seen as a sort of tax election; that is, an election to determine tax liability on the basis of the treaty rather than domestic law. The tax law is of course studded with elections. Some of these elections can be made independently from year to year; others can be revoked only with the consent of the IRS; others are revocable, but their revocation has significant tax consequences. It is hard to find a discernible pattern that governs which elections fall in which category.[226]

In the absence of a clear pattern outside the treaty context, it is not surprising that there is no statement of general principle regarding

[225] *See* HENRY C. SIMONS, PERSONAL INCOME TAXATION 50 (1938).

[226] For example, even within the limited context of accrual of income on debt instruments, some elections can be made on a per obligation basis, but other elections must be applied consistently to all obligations acquired in the year of the election and in subsequent years. Elections that can be made on a per obligation basis include an election to calculate accrual of market discount on a constant-yield basis, I.R.C. § 1276(b)(2)(C); an election to accrue short-term discount on a constant-yield basis, I.R.C. § 1283(b)(2); and an election to treat all interest as original issue discount, Treas. Reg. § 1.1273-3(b)(1). Elections that apply to all obligations acquired in the year of the election and in subsequent years include an election to report market discount as it accrues, I.R.C. § 1278(b)(2)-(3); a cash-basis holder's election to accrue discount on short-term obligations, I.R.C. § 1282(b)(2); an election to take into account discount on a short-term nongovernmental obligation based on original issue discount rather than acquisition discount, I.R.C. § 1283(c)(2); an election to accrue bond premium, I.R.C. § 171(c)(2); an accrual basis holder's election to translate foreign currency interest based on spot rates, Treas. Reg. § 1.988-2(b)(2)(iii)(B); and elections to translate purchase price and sales proceeds on date of receipt, Treas. Reg. § 1.988-2(a)(2)(v).

when the claiming of a treaty benefit constrains a taxpayer's inconsistent use of a domestic law benefit in a different year. Since the starting point for annual accounting is that each year stands on its own, there may be situations where inconsistent positions are tolerated if taken in different years, even if doing so leads to results that would not be permitted if those positions were taken within the same year. The discussion in this Part describes some of the situations in which considerations of annual accounting and treaty consistency come into conflict.

1. *Selective Use of Losses*

Recall the three businesses in the 1984 Ruling: a permanent establishment with a profit, and two businesses that did not constitute a permanent establishment, one operating at a profit, the other at a loss.[227] The 1984 Ruling concluded that the taxpayer could not claim a treaty exemption for the business operating at a profit while using the loss from the other business to offset the profits from the permanent establishment.

Now suppose that these three businesses are the same business, but in three different years. For example, a business that does not constitute a permanent establishment might have had a profit in year 1 and a loss in year 2. In year three, it creates a permanent establishment and operates at a profit. The taxpayer claimed a treaty exemption in year 1 since there was no permanent establishment; but had no need to claim a treaty exemption in year 2, since it had a loss. It elects to forgo a carryback of its year 2 loss, and instead carries forward the loss to year 3 in order to shelter the income from the permanent establishment in that year.

[227] *See supra* note 64 and accompanying text.

The ALI Study considered this example, and concluded that treaty consistency should be required here, just as in the 1984 Ruling.[228] Accordingly, if a taxpayer claims a treaty exemption for its profits in year 1, it cannot disclaim the treaty in year 2 in order to treat its loss as effectively connected so as to shelter income in year 3 that is not protected by the treaty. In the ALI's view, treaty consistency trumps the general tenet of annual accounting that each year stands on its own; the justification is that the allowance of the loss carryforward has already eroded the separateness of the accounting periods. Where taxable income is computed on a multi-year basis, treaty consistency should apply on a multi-year basis as well. Other commentators that have considered the issue have fallen in line with the ALI's view.[229]

Yet the analogy with the 1984 Ruling breaks down in a crucial respect: in the 1984 Ruling, everything happens at once; but in the example here, events unfold over time. When the taxpayer decides to claim treaty benefits in year 1, it may not be in a position to know whether it will incur a loss in year 2, or have a permanent establishment in year 3. If treaty consistency is enforced, the taxpayer has to choose between either claiming treaty benefits in year 1 and losing the year 2 loss carryforward, or forgoing treaty benefits in year 1 in order to preserve the year 2 loss as a carryback or carryforward against year 1 or year 3 income. The difficulty is that the taxpayer here, unlike the taxpayer in the 1984 Ruling, will likely have no idea in year 1 which is the better choice. Moreover, the taxpayer cannot wait until the end of year 3 to decide whether to elect to carryback the year 2 loss. That

[228] ALI Study, at 89–90.

[229] *See* Philip F. Postlewaite & David S. Makarski, *The A.L.I. Tax Treaty Study—A Critique and a Modest Proposal*, 52 TAX LAW. 731, 753 (1999); Arnold, *supra* note 174, at 894.

election must be made within the time, including extensions, for filing the year 2 return, and once made, is irrevocable.[230]

The ALI's support of a consistency requirement here is based on its observation that the calculation of taxable income in year 3 includes the loss carryforward from year 2. But the profits from year 1 do not enter into the year 3 calculation at all. The only reason the claim of treaty benefits for those profits is relevant is that it enables the taxpayer to make a cost-free election to carry the year 2 loss forward rather than back. Perhaps the real consistency issue relates to this election: whether the taxpayer should be required to first carry the loss back against income that is not attributable to a permanent establishment, since the loss itself was not attributable to a permanent establishment. But as we saw in the discussion of the 1984 Ruling, there is no principle that forbids use of an effectively connected but nonattributable loss from offsetting income attributable to a permanent establishment.[231]

Moreover, if the results in year 1 and year 3 were switched, so that the taxpayer had a permanent establishment in year 1 only, a loss in year 2, and a profit in year 3, then the taxpayer would not elect to carry the loss forward, and would instead simply rely on the carryback that is available in the absence of such an election. Given the facts as they are at the end of year 2, such a carryback is unproblematic. To enforce treaty consistency, the subsequent presence of a profit in year 3 would force the taxpayer to either amend its prior year returns to forgo the carryback, or forgo treaty benefits for the year 3 profit. It is odd that events occurring after year 2 could create a consistency issue for the original year 2 carryback. Further, it is difficult to see how such a consistency requirement could be enforced, since by the end of year

230 I.R.C. § 172(b)(3). For a corporation, the deadline for filing a return is normally 9 ½ months after the end of the year. I.R.C. § 6072(b) (3 ½-month deadline); Treas. Reg. § 1.6081-3 (automatic six-month extension).

231 *See supra* Part III.B.1 (p. 741).

3 it will be too late to make an election regarding the carryback from year 2.[232]

In the original example, the fact that the taxpayer could have elected to carry back the year 2 loss is critical to there being a treaty consistency issue, since if no such carryback were possible, then the year 1 profit would be truly irrelevant to the year 3 tax liability. Current law allows a two-year carryback, so even the presence of profits in the year immediately before year 1 could be relevant to the example, but any years before that can be safely ignored. Yet a decision to claim treaty benefits for business profits in one year can have consistency repercussions years down the road in cases where a subsequent loss qualifies for an extended carryback period.[233] A consistency requirement could prevent a taxpayer from using losses that could have been carried back to that year, even if, by the time the carryback year becomes relevant, the deadline for making or revoking a carryback election has expired.

Now suppose the example were switched around, so that the loss happened in year 1, and year 2 was profitable. For year 1, there is no need to make a treaty claim, there being a net loss. For year 2, the taxpayer is entitled to a treaty exemption, and would presumably claim it, particularly if the year 2 profit is greater than the amount of year 1 loss that could be carried forward in the absence of a treaty claim. For year 3, when there is a profit attributable to a permanent establishment, it is clear that the results in both year 1 and year 2 are relevant in determining how much loss can be carried to year 3. Does the claim of a treaty exemption for year 2 mean that none of the year 1 loss

[232] *See supra* note 230 and accompanying text.

[233] For example, a 10-year carryback is allowed for "specified liability losses," which include losses attributable to product liability and particular kinds of environmental liabilities. I.R.C. § 172(b)(1)(C), (f). Other extended carrybacks are permitted by I.R.C. § 172(b)(1), clauses (F) (3 years for casualty and disaster losses), (G) (5 years for farming losses), (H) (up to 6 years for losses in 2008 and 2009), (I) (5 years for losses up to 20% of capital expenditures in transmission property and pollution control equipment), and (J) (5 years for disaster losses).

may be carried forward? That would be the result if years 1 and 2 had to be treated consistently, as in the 1984 ruling. But the result would be harsh if the year 1 loss is greater than the year 2 profit, in which case it would have been better for the taxpayer to use up some of the loss to offset the year 2 profit rather than claim a treaty exemption, so the balance of the loss could be used in year 3.[234] An alert taxpayer will be attentive to these considerations in deciding whether to claim treaty benefits in year 2. But not every taxpayer will be alert to the possibility of a permanent establishment in a later year; indeed, possibly a much later year, given the 20-year loss carryforward period.[235] Perhaps the taxpayer could be allowed, with hindsight, to amend a claim of treaty benefits for any intervening profitable year (or years). The statute of limitations may have run for those years, but an amended claim of treaty benefits would not involve any additional assessment or refund for those years but would rather affect the amount of losses used in those years rather than carried forward beyond them.

The existence of multiple years in these scenarios also means that a treaty may not exist for all of the relevant years, or the taxpayer may not qualify for treaty benefits in some of those years. In this last example, suppose no treaty benefits were available in the year 1, when the loss occurred. Should that make a difference in whether the loss may be carried forward to year 3, if the taxpayer claimed a treaty exemption for the profits in year 2? The absence of treaty benefits in year 1 had no immediate tax effect, as the taxpayer had a loss in that year. But the taxpayer cannot be said to have made selective treaty

[234] An alternative that would avoid the treaty consistency issue would allow the taxpayer to apply the treaty exemption in year 2 only after absorbing any losses that are available to be carried forward to that year. However, gross income for year 2 does not include any income exempt by treaty. Treas. Reg. § 1.894-1(a). It is difficult to see how under current law any of the year 1 loss could be considered to be used in year 2 if there is no gross income in year 2.

[235] I.R.C. § 172(b)(1)(A)(ii).

claims, since it made only one claim, in year 2, the only year that treaty benefits were available. So it is difficult to see how the taxpayer's use of the loss in year 3 can be criticized on treaty consistency grounds.

These possibilities illustrate the difficulties in trying to apply treaty consistency in the multi-year context. Given the uncertainties in the unfolding sequence of events, there are fewer opportunities to game the system, and more potential for inadvertent planning errors. On balance, it appears that, notwithstanding the views of the ALI and like-minded commentators, the separateness of annual accounting periods should take precedence here over treaty consistency.

The IRS seems to agree. Consider a taxpayer with effectively connected income from two businesses, only one of which constitutes a permanent establishment. The permanent establishment is regularly profitable; the other business has occasional loss years. When the other business has a profitable year, it claims exemption under the treaty; when it has a loss year, it uses the loss to offset the profits of the permanent establishment. These selective claims of treaty benefits raise the same treaty consistency issues as the 1984 Ruling and the other multi-year examples discussed above. Yet, the IRS ruled on similar facts that the taxpayer could independently elect each year whether to claim treaty benefits.[236] In that ruling, the loss business had a permanent establishment, but was eligible for exemption under the Canadian treaty as a cross-border common carrier.[237] The ruling concluded that the taxpayer could annually choose whether to claim the treaty exemption; in the loss year addressed by the ruling, the ruling

[236] Rev. Rul. 80-147, 1980-1 C.B. 168.

[237] The ruling addresses art. 5 of the prior treaty. Convention, Mar. 4, 1942, U.S.-Can., art. 5, 56 Stat. 1399, *as modified by* Convention Modifying and Supplementing the Convention of March 4, 1942, as modified and supplemented, Aug. 8, 1956, U.S.-Can., 8 U.S.T. 1619. A similar exclusion is available under the current treaty. U.S.-Can. treaty, *supra* note 143, art. 8. In many cases, however, the income will also be exempt under a domestic law rule exempting income from transportation to and from countries that offer an equivalent exemption. I.R.C. § 883(a).

allowed the loss to be used to shelter other income that was not protected by the treaty.[238]

2. *Measurement of Attributable Profits*

Any restriction based on treaty consistency on the use of a treaty to compute business profits in some years but not others is an exception to the more general rule that taxpayers are free to choose each year whether to claim benefits under a treaty. This much is admitted even under strong consistency. For example, paragraph 5 of the Business Profits article of the Belgian treaty contains a requirement that "the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary."[239] However, the Technical Explanation of that paragraph makes clear that this restriction does not preclude selective use of the treaty from year to year, so long as adjustments are made to avoid duplication or omission of items of income or deduction:

> Paragraph 5 provides that profits shall be determined by the same method each year, unless there is good reason to change the method used. This rule assures consistent tax treatment over time for permanent establishments. It limits the ability of both the Contracting State and the enterprise to change accounting methods to be applied to the permanent establishment. It does not, however, restrict a Contracting State from imposing additional requirements, such as the rules under Code section 481, to prevent amounts from being duplicated or omitted following a change in accounting method. *Such adjustments may be necessary, for example, if the taxpayer*

[238] This fact pattern is also considered by Arnold, *supra* note 174, at 894–95, and by the ALI Study, at 90–91. Both commentators are troubled by the absence of a consistency requirement here, but acknowledge that it would be difficult to fashion a workable rule to enforce consistency.

[239] U.S.-Belg. treaty, *supra* note 143, art. 7(5).

> *switches from using the domestic rules under section 864 in one year to using the rules of Article 7 in the next.* Also, if the taxpayer switches from Convention-based rules to U.S. domestic rules, it may need to meet certain deadlines for making elections that are not necessary when applying the rules of the Convention.[240]

Similar language appears in the 2006 U.S. Model and its Technical Explanation. While these Technical Explanations assert that adjustments to avoid duplications or omissions may be necessary, they do not dispute the taxpayer's right to switch back and forth from year to year between Code-based rules and treaty-based rules.

It is interesting to speculate what sort of adjustments might be required by reason of such a switch. Section 481 requires adjustments upon changes of accounting methods, to account for differences in the timing of items of income and deduction. Without those adjustments, items of income or deduction might be duplicated or omitted. The suggestion that similar adjustments might be required upon a switch between Code-based and treaty-based rules for measuring business profits implies that there are timing differences between those rules. But the differences between those rules, which are described in Part II above, relate to the scope of the tax base rather than timing.

Domestic law contains numerous rules that defer or accelerate items of income or deduction from the period in which those items can fairly said to be earned. Deductions, for example, can be accelerated by means of the first-year depreciation allowance[241] and other forms of accelerated depreciation,[242] and can be deferred by application of the economic performance requirement.[243] Income items can

[240] Technical Explanation of the U.S.-Belg. treaty, *supra* note 84, commentary on art. 7(5), at 31,308 (emphasis added).

[241] I.R.C. § 168(k)-(n).

[242] I.R.C. § 168(a)-(c).

[243] I.R.C. § 461(h).

be accelerated by advance receipt,[244] and deferred, in the case of compensation for services, by deferred receipt.[245]

If these same rules for deferring and accelerating items of income and deduction also apply for purposes of determining profits attributable to a permanent establishment, then no timing differences can arise, and there is no reason to apply Section 481-type adjustments when a taxpayer switches between Code-based rules and treaty-based rules. Yet these Technical Explanations suggest that adjustments of this type may be necessary, which implies that some such differences can exist. But those differences can exist only if there are principles for measuring the timing of business profits in the treaty context that are independent of domestic tax rules. As discussed in Part III.A.5 above, no such principles have been articulated, although one might imagine a regime, similar to the rules for measuring the earnings and profits of controlled foreign corporations,[246] that uses the taxpayer's financial accounting records as a starting point, and adjusts to reflect some, but perhaps not all, U.S. tax accounting rules.

The quoted passage starts by asserting that business profits "shall be determined by the same method each year, unless there is good reason to change the method used." That sort of year-to-year consistency is a basic corollary of annual accounting, rather than an exception to it, and operates outside the treaty context as well.[247] The methods in question can be as general as the use of cash or accrual accounting,[248] and can be as specific as the method used to account for mutual fund distributor fees.[249] One might imagine a taxpayer that

[244] *See* Schlude v. Comm'r, 372 U.S. 128 (1963); Am. Auto. Ass'n v. Comm'r, 367 US 687 (1961); Auto. Club of Mich. v. Comm'r, 353 U.S. 180 (1957).

[245] *See* Treas. Reg. § 1.83-3(e).

[246] Treas. Reg. § 1.964-1(a).

[247] *See* I.R.C. § 446(e), Treas. Reg. § 1.446-1(e)(2)(i).

[248] *See* Treas. Reg. § 1.446-1(a).

[249] *See* Rev. Proc. 2000-38, 2000-2 C.B. 310.

uses one accounting method for determining some aspect of effectively connected income under domestic law, but uses a different method for the corresponding aspect of attributable profits under a treaty. In that case, a switch between Code-based rules and treaty-based rules could well trigger the need for a 481-type adjustment in order to avoid duplications or omissions of items of income or deduction. But a more straightforward approach would be simply to require taxpayers to use the same methods of accounting for determining attributable profits under a treaty that they use for determining effectively connected income under domestic law. Since "business profits" is not defined in treaties, in applying the treaty to U.S. tax the United States should be free to require that the normally applicable accounting rules be used. This appears to be the approach contemplated by the OECD Model.[250]

Most U.S. treaties contain a clause similar to paragraph 5 of the Business Profits Article of the 2006 U.S. Model, requiring branch profits to be computed in a consistent manner from year to year.[251] Interestingly, this clause was dropped in 2010 by the OECD Model. The Commentary to that Article states:

> At the same time, the Committee also decided to eliminate another provision that was found in the previous version of the Article and according to which the profits to be attributed to the permanent establishment were to be "determined by the same method year by year unless there is good and sufficient reason to the contrary." That provision, which was intended to ensure continuous and con-

[250] *See supra* notes 105–106 and accompanying text.

[251] *See, e.g.,* U.S.-Austl. treaty, *supra* note 143, art. 7(5); U.S.-Bulg. treaty, *supra* note 193, art. 7(5); U.S.-Can. treaty, *supra* note 143, art. 7(5); U.S.-China treaty, *supra* note 3, art. 7(6); U.S.-Fr. treaty, *supra* note 198, art. 7(6); U.S.-Ice. treaty, *supra* note 94, art. 7(5); U.S.-Ir. treaty, *supra* note 192, art. 7(6); U.S.-It. treaty, *supra* note 205, art. 7(5); U.S.-Japan treaty, *supra* note 143, art. 7(6); U.S.-Lux. treaty, *supra* note 192, art. 7(5); U.S.-Malta treaty, *supra* note 67, art. 7(5); U.S.-Neth. treaty, *supra* note 143, art. 7(5); U.S.-Switz. treaty, *supra* note 198, art. 7(6); U.S.-U.K. treaty, *supra* note 143, art. 7(4). A rare exception is the U.S.-Ger. treaty, *supra* note 86.

> sistent treatment, was appropriate as long as it was accepted that the profits attributable to a permanent establishment could be determined through direct or indirect methods or even on the basis of an apportionment of the total profits of the enterprise to its various parts. The new approach developed by the Committee, however, does not allow for the application of such fundamentally different methods and therefore avoids the need for such a provision.[252]

This excerpt suggests that the "same method" that was required to be used from year to year referred only to the transfer pricing method. Earlier paragraphs of the Commentary explain that the arm's length method is now to be used to the exclusion of other methods, such as the profit split method.[253] Hence this consistency requirement was thought to have become obsolete.

It remains to be seen whether the United States will include this consistency clause in future treaties. As the Technical Explanations make clear, the United States views this clause as pertaining to more than just the transfer pricing method. But requiring the use of a consistent method of accounting, and for proper adjustments when the method changes, can be seen as an instance of the more general principle that the domestic law of each country is the source of measurement of business profits. Consequently, this clause can be seen as a clarification of that principle, and its absence in current treaties, and possibly future treaties, should not be construed as granting to taxpayers the right to vary their methods of accounting for business profits without regard to the constraints of domestic law.

252 OECD Model, commentary on art. 7, ¶ 42, at 142.

253 OECD Model, commentary on art. 7, ¶¶ 15–17, at 134.

3. *Branch Profits Tax*

The branch profits tax plays out over time, as one year's earnings may be distributed by the branch in a later year. This feature puts the branch profits tax at odds with the flexibility that taxpayers normally have to choose whether to claim treaty benefits in any particular year. As discussed in Part III.B.5 above, in a year when treaty benefits are claimed, the amount subject to branch profits tax is limited to the earnings and profits that are attributable to a permanent establishment, adjusted downwards for increases, and upwards for decreases, in the net assets of the permanent establishment. This formula, when combined with selective use of a treaty in different years, has the potential to undermine the branch profits tax base.

Suppose in year 1 a taxpayer has a first business that operates through a permanent establishment, and a second business that does not. In that year, the permanent establishment has a profit, but the other business just breaks even. The taxpayer can avoid branch profits tax in that year by reinvesting the earnings and profits of the permanent establishment in the other business. By *not* claiming treaty benefits in that year, the reinvestment of earnings in the business that does not have a permanent establishment is taken into account in reducing the amount of the permanent establishment's earnings and profits that are subject to branch profits tax. If all of those earnings and profits are reinvested in this manner, the branch profits tax will be zero.

In year 2, the taxpayer remits to its home office the amount previously reinvested in year 1. Absent a treaty, that reduction in branch assets would increase the amount subject to branch profits tax. But by claiming treaty benefits in year 2, the taxpayer can ignore the reduction in assets of the business that does not have a permanent establishment, since in the treaty context the branch profits tax formula looks only to the earnings and profits, and changes in net assets, of the permanent establishment.

The overall result is that the earnings of the permanent establishment in year 1 can be remitted to the home office in year 2 without any imposition of branch profits tax. This result conflicts with the intent of the treaty, which is to preserve the right of the United States to impose the branch profits tax on remittances from a permanent establishment, except in cases where the taxpayer qualifies under one of the handful of treaties that provide for a complete exemption from this tax.[254] Arguably, therefore, this sort of selective use of a treaty might be barred on the grounds of treaty consistency.

Matters get more complicated, however, if the second business has other accumulated earnings that did not originate with the permanent establishment. When that business makes a remittance in year 2, some determination would need to be made as to whether the reinvested earnings of the permanent establishment are deemed to be distributed first, last, or pro rata with the other earnings. Any such determination would be arbitrary, given the fungibility of money. Moreover, suppose there was also a third business that did not have a permanent establishment. A remittance from that third business in year 2 raises the question whether any portion of that remittance should be deemed a distribution of the reinvested earnings of the permanent establishment in year 1, even though those earnings were reinvested in the second business, not the third. Perhaps not, given the absence of any connection between the remittance and the prior reinvestment; but that approach would add complexity, since some mechanism would be needed to track separately the net assets of each such business.

In this example, the avoidance of branch profits tax has been viewed as the result of selective use of a treaty, but the same result would follow if the taxpayer did not qualify for treaty benefits in year 1, or if there were no treaty at all in year 1. Even if the taxpayer was eligible to claim, and did claim, treaty benefits in both years, the same

[254] *See supra* note 148.

result would follow if the second business operated through a permanent establishment in year 1 but not year 2. These possibilities indicate that the potential for avoidance of branch profits tax in the treaty context can arise for reasons other than selective treaty claims.

Moreover, the usefulness of selective treaty claims as a planning technique in this context is hampered by the same difficulties as those discussed in Part IV.B.1 above in the context of selective use of losses. The taxpayer's decision to claim treaty benefits in year 1 will depend in part on what is expected to happen in year 2, but that cannot be known for sure. In the example, the decision was made easier by supposing that the second business broke even in year 1, so there was no other cost or benefit to the failure to apply the treaty in year 1. But if the second business had earned a profit, there would have been a cost to forgoing the treaty, which would have had to be weighed against the potential branch profits tax avoidance. Also, the example posits flexibility regarding the temporary reinvestment of earnings in the second business, but in actual situations that flexibility may not exist, or may come with a cost.

The Technical Explanations of treaty clauses authorizing the imposition of a branch profits tax typically state, "if an enterprise switches between domestic law and treaty principles from year to year, it will need to make appropriate adjustments or recapture amounts that otherwise might go untaxed."[255] One effective, but harsh, way to preserve the branch profits tax base in this context would be to treat a taxpayer that switches to computing its branch profits tax under a treaty as having repatriated all of its U.S. net assets that are not part of a permanent establishment. This approach is effective because it prevents a taxpayer from selectively applying a treaty from year to year to avoid branch profits tax in the manner described above. But it is harsh in that it can trigger branch profits tax in relation to assets that remain part of a U.S. trade or business (although not part of a permanent

[255] *See supra* note 153.

establishment), and that continue to generate effectively connected income that may be taxed in subsequent years when treaty benefits are not claimed or are unavailable. If "appropriate adjustments" include a deemed repatriation of all assets that are not part of a permanent establishment, the resulting branch profits tax could impose a significant burden on a taxpayer seeking to apply the business profits article for the first time.

4. *Rental Income and Gain on Sale*

A withholding tax imposed on gross income, even at a low rate, can be higher than a tax imposed at a higher rate on that same income with an allowance for related deductions. Lenders who are not eligible for the portfolio interest exemption or a treaty exemption will often prefer to lend through a U.S. branch for just this reason. Similarly, treaties that provide for a low but positive rate of withholding tax on rental income that is not attributable to a permanent establishment may permit a higher amount of tax on that income than would be imposed under domestic law if the income were effectively connected.

Consider a treaty-eligible foreign lessor that leases equipment to a U.S. lessee for use in the United States. Suppose that the resulting rental income is effectively connected with a U.S. trade or business, but that business does not operate through a permanent establishment. Absent the treaty, the rental income would be subject to the usual 35% corporate tax on a net basis, plus branch profits tax. If the treaty provides for a 15% withholding tax on rental income that is not attributable to a permanent establishment, the taxpayer may well prefer to pay the net tax under domestic law rather than the gross tax permitted by the treaty.

In a 1985 Technical Advice Memorandum,[256] the IRS was faced with a taxpayer in similar circumstances, who had made the choice to

[256] IRS Tech. Adv. Mem. 85-24-004 (Feb. 12, 1985).

be taxed on a net basis under domestic law on its rental income. The taxpayer also sought to apply the treaty to avoid U.S. tax on gain realized in that same year from a disposition of the leased property. The prior Canadian treaty that was then in effect provided for an exemption for gains from the sale of capital assets by a taxpayer with no U.S. permanent establishment.[257] Since the taxpayer had effectively connected income but no permanent establishment, its gain was generally eligible for this exemption. The IRS, however, disallowed the exemption for reasons of treaty consistency, concluding that the taxpayer was not entitled to simultaneously claim both the benefits of domestic law on its rental income and the benefits of the treaty on gain from the sale of the leased property.

The ALI Study considered this same fact pattern, and reached the same conclusion as the IRS.[258] The ALI acknowledged that rental income and gains from sale were different categories of income, dealt with by different articles of the treaty. Accordingly, under the ALI's approach, inconsistent treatment should be allowed unless doing so would "distort" the application of domestic law or the treaty.[259] The ALI found this sort of distortion to be present here, since "net basis taxation of the rents affects the basis of the property, which in turn affects the amount of gain on disposition."[260]

The ALI's premise here may well be inaccurate. The basis of depreciable property is reduced by depreciation that is allowed or allowable.[261] Had the taxpayer chosen to have its rental income taxed on a gross basis under the treaty, that choice does not change the status of the property as used in a trade or business under domestic law, and consequently eligible for a depreciation allowance. If the taxpayer

[257] U.S.-Can. treaty, *supra* note 237, art. 8.

[258] ALI Study, at 88.

[259] *See supra* Part III.B.3 (p. 746).

[260] ALI Study, at 88.

[261] I.R.C. § 1016(a)(2); Treas. Reg. §1.1016-3(a)(1)(i).

had decided not to claim that allowance (in order to benefit from the lower treaty rate of gross taxation), its basis in the property should nonetheless have been reduced by the amount that would have been allowed absent the treaty claim.[262] So the amount of gain realized on sale should not vary based on how the taxpayer chose to be taxed on its rental income. That invariance indicates an absence of distortion in the independent application of the treaty articles dealing with rental income and gains from sales. That absence of distortion undermines the ALI's conclusion that the taxpayer should be forced to apply either domestic law or the treaty consistently to both the rental income and the gain.

In another sense, distortion could be seen to be present, at least to the extent that the gain does not exceed the depreciation deductions taken into account by the taxpayer in computing its net income. The taxpayer's selective treaty claims enable it to enjoy the tax benefit of the depreciation deduction without suffering a corresponding tax cost when that depreciation is recovered through the gain on sale.[263] While this result might seem to give an improper benefit to the taxpayer, it does not support a complete denial of the treaty exemption of the gain, since some of the gain may be in excess of that year's

[262] The basis of depreciable property must be reduced even during periods when the taxpayer is not subject to U.S. federal income tax. Treas. Reg. § 1.1016-4(a)(2). The amount of the reduction is the amount charged off on the books and records of the taxpayer, if the Commissioner finds that amount to be reasonable; otherwise it is the amount that would have been allowable if the taxpayer had been subject to tax. Treas. Reg. § 1.1016-4(b). However, a taxpayer that claims a depreciation deduction in some years but not others is required to reduce basis for allowable depreciation in a manner that is consistent with the method used in years when depreciation is actually claimed. Treas. Reg. § 1.1016-4(a)(2)(ii).

[263] This gain on sale is treated as ordinary income to the extent of prior depreciation under the depreciation recapture rules. I.R.C. § 1245(a)(1). More limited recapture rules apply to real estate. I.R.C. § 1250(a)(1). In neither case, however, do the recapture rules affect the availability of a treaty exemption for the gain.

depreciation deductions, and may exceed all prior depreciation.[264] A more limited rule might deny the treaty exemption only to the extent that the taxpayer benefitted from depreciation deductions, but such a rule would lack support in the treaty text.

A more fundamental argument for treaty consistency in this example would look to the unitary nature of the underlying business that generated both the rental income and the gain. Either that business operates through a permanent establishment or it does not; there is no middle ground. It would seem conceptually muddled to claim that the business constitutes a permanent establishment for purposes of taxing rental income but not for purposes of taxing gain on sale. Yet the taxpayer does not appear to be making such a claim. To be sure, the treaty clause dealing with rental income applies only if the taxpayer does not have a permanent establishment. But forgoing a claim under that clause does not imply an assertion by the taxpayer that it does have a permanent establishment for that purpose. The taxpayer is simply declining to claim a treaty benefit to which it is entitled.

A treaty clause limiting the amount of tax that the United States can impose on rental income that is not attributable to a permanent establishment can be seen as just that: a limitation on the amount of tax. If that limitation is 15% of the gross income, the United States can tax up to that amount but not more. If the United States chooses to tax effectively connected but not attributable rental income on a net basis, it is free to do so, provided that the amount of tax does not exceed the treaty cap. In effect, the tax on this type of income is the lesser of two amounts: 15% of gross income, or 35% of net income. Which of these elements produces the lower tax in a particular year

[264] Under domestic law, gain in excess of depreciation recapture benefits from more favorable treatment, since that gain potentially constitutes "section 1231 gain" that may be taxed as a long-term capital gain. I.R.C. § 1231(a)(1).

can be ascertained without any commitment as to whether the enterprise has a permanent establishment or not.

Both the 1985 Technical Advice Memorandum and the ALI Study focus only on rental income earned in the year of sale. Even though both would require consistent use of the treaty or domestic law in that year for the rental income and the gain, they do not address whether the use of domestic law to compute rental income in an earlier year would preclude the taxpayer from claiming the benefits of the treaty to exempt the gain in a later year when the property is sold. To the extent that the taxpayer is seen as deriving an unfair advantage through selective treaty claims, that advantage exists regardless of whether the choice of domestic law to tax rental income is made for the year of sale or an earlier year. Yet when attempting to extend such a consistency requirement over time, difficulties arise that are similar to those encountered above with the selective use of losses[265] and remittance of branch profits.[266]

Once again, the fundamental problem is that events unfold over time. Before the year of sale, the taxpayer can be expected to choose the benefits of the treaty for its rental income if that produces a lower tax; otherwise it will simply pay tax on a net basis under domestic law. It is difficult to imagine requiring a taxpayer to pay a higher tax than that imposed under domestic law as a precondition for the potential use of the treaty in a later year when the property is sold. A taxpayer faced with such a requirement would have to decide whether the speculative future benefit is worth paying more tax now. And that benefit is indeed speculative: it depends on the timing of sale; the amount of gain, if any; the domestic law tax rate on that gain; the continued existence of the treaty exemption; and the taxpayer's eligibility for that exemption.

[265] *See supra* Part IV.B.1 (p. 787).

[266] *See supra* Part IV.B.3 (p. 798).

Moreover, the taxpayer's use of domestic law in a prior year may have had nothing to do with electing not to apply a treaty. The treaty may not have been in existence in that year, the taxpayer may not have qualified for benefits, or the benefits offered by the treaty may have been different or nonexistent. Thus, the potential for benefitting from depreciation while avoiding tax on gain arises in broader contexts than selective treaty claims.

Selective use of a treaty for rental income can produce advantages even before the year of sale. In cases where the principal deduction is for depreciation, net basis taxation will no longer be as advantageous once the leased asset is fully depreciated; after that, the benefits of a lower rate on gross rental income may become attractive. Using domestic law in the early years and the treaty in the later years can produce a lower overall tax than would be the case if domestic law or the treaty had been applied consistently in all years.

Outside the treaty context, domestic law provides some flexibility between gross and net basis taxation, but limits the taxpayer's ability to switch back and forth. In particular, in the case of income from real property that is not effectively connected with a U.S. trade or business, the taxpayer can elect under Code Section 871(d) to treat the income as effectively connected, and therefore subject to tax on a net basis. This election, however, must be applied to all such income, and cannot be revoked in subsequent years without the consent of the IRS.[267] If that consent is granted, no new election for net basis taxation can be made until the fifth taxable year that begins after the revocation became effective.[268] These restrictions severely limit a taxpayer's ability to use this election for some years but not others.

The prior Netherlands treaty contained an unusual clause that permitted a similar election to be made on an annual basis, thereby

[267] I.R.C. § 871(d)(1).

[268] I.R.C. § 871(d)(2).

inviting selective use of net basis taxation over time.[269] The flexibility, however, was dropped from the current treaty,[270] and has not been used in other treaties.[271] Instead, any such election provided by a treaty, like the statutory election, is irrevocable without the consent of the tax authorities.[272] The refusal to offer an annual election in the treaty context suggests a concern about giving taxpayers that sort of flexibility. As a result, for income that is not effectively connected under domestic law, taxpayers must accept gross basis taxation, unless the income falls within the scope of a Section 871(d) or treaty election, in which case the taxpayer gets net basis taxation, but as a practical matter must stick with it.

Yet annual flexibility continues to exist for rental income that is effectively connected but not attributable to a permanent establishment. If a treaty limits taxation of that income to a maximum permitted withholding tax rate, the taxpayer can pay tax at that rate, or pay tax on a net basis under domestic law, whichever is less. Unlike the Section 871(d) election, there appear to be no constraints on a taxpayer's use of this treaty limitation only in years when it produces a tax savings. Thus, a treaty-eligible taxpayer with rental income is potentially in a more favorable position if that income is effectively connected.

While annual elections of this type can produce a lower tax than would result from consistent use of a treaty or domestic law over time, this opportunity is of the same type as that blessed by the IRS in

[269] Convention with Respect to Taxes on Income and Certain Other Taxes, Apr. 29, 1948, U.S.-Neth., art. 10, 62 Stat. 1757, *as amended by* Protocol, Oct. 23, 1963, art. 2, 15 U.S.T. 1900.

[270] U.S.-Neth. treaty, *supra* note 143, art. 6(5).

[271] An apparent exception is Greece. U.S.-Greece treaty, *supra* note 42, art 8.

[272] *See, e.g.,* 2006 U.S. Model art. 6(5); U.S.-Austria treaty, *supra* note 177, art. 6(5); U.S.-Belg. treaty, *supra* note 143, art. 6(5); U.S.-Est. treaty, *supra* note 143, art. 6(6); U.S.-Mex. treaty, *supra* note 148, art.6(5); U.S.-Switz. treaty, *supra* note 198, art. 6(5).

Revenue Ruling 80-147,[273] when it permitted a taxpayer to take into account a U.S. trade or business that did not operate through a permanent establishment only in years when that business operated at a loss. In both cases, considerations of separate annual accounting trump those of treaty consistency.

If a taxpayer is to be permitted to have its rental income taxed on a net basis in prior years while still claiming a treaty exemption for the gain in the year of sale, there is scant protection to the revenue from trying to restrict the ability of the taxpayer to choose net basis taxation in the year of sale only. The class of affected taxpayers is narrow: those who earn rental income through a U.S. trade or business, but not through a permanent establishment. Given the weakness in the conceptual grounds for enforcing consistency here, this does not appear to be a worthwhile battle for the IRS to fight.[274]

C. *Dual Residents*

A dual resident is an individual or entity that is simultaneously a resident of two countries under the domestic laws of each. A tax treaty between those countries will typically contain a tie-breaker provision that permits such a taxpayer to be treated as a resident of only one of the countries. Where a taxpayer is treated as a resident of the United States under U.S. domestic law but is treated as a resident of a foreign country under a treaty with the United States, the question arises whether a claim of foreign residence under the treaty must be applied consistently for all purposes, or whether the taxpayer, or

[273] *See supra* note 236 and accompanying text.

[274] The FSA discussed *supra* in Part III.B.1, in the text accompanying note 124, presents the converse situation, where a taxpayer was seeking to apply a treaty to exempt interest income from a loan, while ignoring the treaty in order to use a loss from the sale of the loan to offset other unrelated gains. The FSA does not discuss whether the availability of the loss deduction would have been affected by treaty claims for the interest in prior years.

the government, can apply treaty residency for some purposes but not others.

1. *Entities*

It is not unusual for an entity to be dual resident, since the U.S. residency standards for corporations and trusts differ from those employed by most foreign countries.[275] Under U.S. domestic tax law, a corporation is treated as a U.S. person, and as a resident in the treaty sense, if it is organized under the laws of the United States or any state thereof.[276] Most other countries, by contrast, determine residency by where the corporation is managed and controlled. Consequently, any corporation formed in the United States but managed and controlled elsewhere has the potential to be a dual resident.

In the absence of a treaty, dual residency can be a tax planning disaster, since the corporation may owe taxes on its net income to two countries, with no credit in either country for taxes paid to the other. Dual residency has also been used to create tax planning opportunities in cases where the dual resident operates at a net loss, which is then used to offset other income in both countries, although those opportunities have been severely curtailed by the dual consolidated loss rules.[277]

The 2006 U.S. Model contains a tie-breaker rule for dual resident corporations that assigns residency based on where the corporation is organized,[278] which matches U.S. domestic law. For a treaty with a tie-breaker rule based on this model,[279] no question of treaty consistency

[275] The discussion here will focus on corporations, although similar considerations apply to trusts.

[276] I.R.C. § 7701(a)(4); 2006 U.S. Model art. 4(1).

[277] I.R.C. § 1503(d).

[278] 2006 U.S. Model art. 4(4).

[279] *See, e.g.,* U.S.-Austria treaty, *supra* note 177, art. 4(3); U.S.-Can. treaty, *supra* note 143, art. 4(3).

will normally arise, since U.S. domestic law and the treaty assign residence the same way. Yet even here, it is possible that a difference can arise, in the case of a corporation that is simultaneously organized under U.S. and foreign law. Delaware corporate law, for example, permits a Delaware corporation to reincorporate elsewhere without losing its Delaware charter.[280] In such a case, the corporation is subject to the corporate law of both jurisdictions under which it is organized. The 2006 U.S. Model states that "the competent authorities of the Contracting States shall endeavor to determine the mode of application of the Convention to such company," failing which the corporation shall not be entitled to claim any benefits under the treaty in either country.[281]

Most other treaties with tie-breakers omit the reference to the place of incorporation, and refer the matter straight to the competent authorities.[282] In the absence of agreement by the competent authorities, the taxpayer is left without treaty benefits, although in a handful of treaties the taxpayer is entitled to a credit in its home country for taxes paid to the other country. In the case of a dual resident, however, one cannot unambiguously say which is the "home" country. The Belgian treaty resolves the issue by allowing a credit in Belgium for U.S. taxes.[283] The Netherlands treaty goes the other way, allowing a

[280] DEL. CODE ANN. tit. 8, § 390(a) (2011).

[281] 2006 U.S. Model art. 4(4).

[282] *See, e.g.,* U.S.-China treaty, *supra* note 3, art. 4(3); U.S.-Ger. treaty, *supra* note 86, art. 4(3); U.S.-Ice. treaty, *supra* note 94, art. 4(4); U.S.-Ir. treaty, *supra* note 192, art. 4(4); U.S.-It. treaty, *supra* note 251, art. 4(4); U.S.-Japan treaty, *supra* note 143, art. 4(4); U.S.-Lux. treaty, *supra* note 192, art. 4(3); U.S.-Mex. treaty, *supra* note 148, art. 4(3); Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Feb. 22, 1990, U.S.-Spain, art. 4(3), Hein's No. KAV 2567; U.S.-Swed. treaty, *supra* note 180, art. 4(4); U.S.-Switz. treaty, *supra* note 198, art. 4(4). Treaties lacking a tie-breaker clause include those with Australia and the United Kingdom.

[283] U.S.-Belg. treaty, *supra* note 193, art. 4(5).

credit in the United States for Dutch taxes.[284] The Israeli treaty establishes no such priority; its Technical Explanation states that such a dual resident can claim a credit in "one or both" countries to relieve double taxation.[285]

In cases where the competent authorities do reach agreement and assign foreign residency to a U.S. corporation, significant benefits could potentially arise through selective use of treaty residency. A 2005 Technical Advice Memorandum describes some of these possibilities.[286] The taxpayer had dual corporate charters, one in a state of the United States, the other in a foreign country. The taxpayer claimed that it was entitled to be treated as a foreign resident under a treaty, although the basis for this claim is unclear since the language of the relevant treaty provision was redacted. The IRS questioned the validity of the treaty residence claim, but of more relevance here is its discussion of the taxpayer's selective use of that claim if valid.

The parent of the taxpayer had contributed some intellectual property to the taxpayer in a transaction that was tax-free under Section 351 of the Code, as both parties were purely domestic at that time. Later that year, the taxpayer reincorporated in Country A, while retaining its domestic corporate charter, thereby creating the dual residency. The taxpayer took the position that Section 367 did not apply since the taxpayer remained domestic.[287] The taxpayer then recontributed the intellectual property to its subsidiary in Country B.

[284] U.S.-Neth. treaty, *supra* note 143, art. 4(4).

[285] U.S.-Isr. treaty, *supra* note 175, art. 3(3), *as amended by* Second Protocol, Jan. 26, 1993, art. 2(3), Hein's No. KAV 3554. Technical Explanation of the Second Protocol Amending the Convention Between the Government of the United States of America and the Government of the State of Israel with Respect to Taxes on Income Signed on January 26, 1993, commentary on art. 2(3) of the Second Protocol *amending* art. 3(1) of the Treaty, 4 TAX TREATIES (CCH) ¶ 4663, 107,202.

[286] I.R.S. Tech. Adv. Mem. 2005-09-023 (Mar. 4, 2005).

[287] *See* I.R.C. § 367(a) (providing for gain recognition on otherwise tax-free transfers of property from a U.S. person to a foreign corporation).

The taxpayer claimed that this second contribution was not taxable under Section 367 because of an exemption to which it was entitled as a resident of Country A under the treaty between Country A and the United States. Further, the taxpayer had taken a stepped-up basis in the property for Country A tax purposes when it was contributed to it by the parent, so it did not recognize any gain for Country A tax purposes when the property was subsequently dropped down to its Country B subsidiary. The overall result sought by the taxpayer was therefore a removal of this intellectual property from U.S. taxing jurisdiction without any U.S. tax charge or other limitation under Section 367, and without any tax cost in Country A as well.

This result depended on the taxpayer's claim to be a U.S. resident when the intellectual property was contributed to it, and to have remained a U.S. resident even after the reincorporation, so that it continued to join in the parent's consolidated return. Yet despite its claim of U.S. residency for those purposes, it also claimed to be a resident of Country A in order to claim a treaty exemption on the further drop-down of the intellectual property to its Country B subsidiary. These inconsistent claims of residency, if allowed, would enable it to achieve a tax-free expatriation of the intellectual property, which would not be possible if the taxpayer was treated consistently as a resident of the United States or of Country A. Not surprisingly, the IRS concluded that the taxpayer could either rely on domestic law to be treated as a U.S. resident, or rely on the treaty to be treated as a resident of Country A, but could not make selective residency claims to achieve results that were not intended by the treaty.

This same taxpayer had sought further benefits from its mixed residency claims. It earned U.S. source interest income, which was subject to tax in Country A. The taxpayer sought a treaty exemption from U.S. tax for the interest income, while claiming a credit for the Country A tax on that income in the parent's consolidated return in which the taxpayer joined. The IRS treated the taxpayer's decision to remain in the parent's consolidated return as a waiver of treaty bene-

fits; in effect, as an election to be treated as a U.S. resident for all purposes.

A 2001 Field Service Advice describes an attempt by a taxpayer to use a selective claim of treaty residence to repatriate foreign income free of U.S. tax.[288] The taxpayer here was a U.S. corporation that joined in a consolidated group with its parent, and had a subsidiary in Country G. The taxpayer became a dual resident by incorporating in Country I while retaining its domestic charter. The Country G subsidiary paid a dividend to the taxpayer, which the taxpayer sought to exclude from U.S. taxable income under the treaty between the United States and Country I, based on an assertion of Country I residency. Moreover, the taxpayer sought a credit on its consolidated tax return for Country G taxes withheld on the dividend. The IRS rejected the taxpayer's treaty claims, stating that its positions under domestic law were "inconsistent with the structure and underlying assumptions of the Treaty." The IRS also claimed that the taxpayer's inclusion in a U.S. consolidated return was a waiver of treaty benefits.

The IRS position in these circumstances is that a choice of resident status is an all-or-nothing matter. This outright prohibition on any "mix and match" approach to residency resembles strong consistency in the permanent establishment context. While the particular results sought by these taxpayers are clearly unwarranted, not every selective treaty claim would be abusive. Imagine a foreign company that becomes a dual resident, and receives dividends from U.S. and foreign sources. It claims foreign residency under a treaty to exclude the foreign dividends, but claims U.S. residency with respect to the U.S. source dividends in order to benefit from the domestic dividends received deduction.[289] This result would indeed be better than the taxpayer could get as a pure U.S. or foreign resident. Yet these outcomes do not appear to be inconsistent with the purposes of the

[288] I.R.S. Field Serv. Adv. Mem. 2001-17-019 (Jan. 24, 2001).

[289] *See* I.R.C. § 243(a), (c).

treaty exclusion or the domestic deduction. The treaty assigns taxing rights on the foreign dividends to the treaty partner, and the domestic dividends will have been paid on income that was already subject to U.S. corporate tax in the hands of the payor. The taxpayer could reasonably argue that it should not have to give up the domestic benefit in order to get an unrelated treaty benefit.

Notwithstanding these non-abusive possibilities, requiring taxpayers to be consistent in their claims of residency is likely to be much simpler to administer, and may better accord with the expectations of the treaty negotiators and competent authorities when they assign residency to dual residents. As discussed in the next Part, there are regulations that require this sort of consistency of individual dual residents. While those regulations do not deal with entities, the motivating policies appear to apply equally in the entity context.

Needless to say, nothing requires a taxpayer to be consistent in its claims of residency status for purposes of United States and foreign tax laws. Indeed, absent a treaty, this sort of inconsistency is unavoidable for a dual resident. Even where a treaty assigns residency to a single country, the taxpayer is not obligated to apply the treaty at all, if it concludes that it is better off filing as a resident in both countries.

The opposite of dual residency is "crossover" residency, where each of two countries regards the taxpayer as a resident of the other. For example, suppose a foreign corporation is managed and controlled in the United States, and is treated as U.S. resident under foreign law but foreign resident under U.S. law. That corporation would not be dual resident for treaty purposes, since it is not a resident of either country under that country's own laws. Indeed, since it is not a resident of either country in that sense, it would get no treaty benefits at all.

2. *Individuals*

Individuals can also be dual residents, most notably in the case of U.S. citizens living abroad. Dual residency can also arise under the presence-based test for U.S. residency, which can treat a person as a U.S. resident based on days spent in the United States over a three-year period,[290] since that test can be met in a year when the individual is resident in a foreign country for purposes of that country's tax laws.

Many U.S. treaties contain a tie-breaker rule that follows the approach of the 2006 U.S. Model. Under that rule, the residency of an individual dual resident is assigned based on the individual's center of vital interests, if that can be determined; or by the individual's habitual abode, if in one of the two countries; or by citizenship, if in one of the two countries; or as determined by the competent authorities.[291] Just as with entities, whenever a treaty assigns foreign residency to a dual resident individual, there is the potential for inconsistent claims of residency under domestic law and the treaty, in order to achieve a result that is better than could be obtained under a consistent approach to residency. For example, an individual might claim foreign

[290] I.R.C. § 7701(b)(3)(A). Under this test, an individual is a resident for a year if present in the United States for at least 31 days in that year, and the sum of the days present in that year, plus one-third of the days present in the immediately preceding year, plus one-sixth of the days present in the next preceding year, is at least equal to 183 days. An individual can avoid U.S. residency under this test if he or she has a tax home in a foreign country and has a closer connection to that country than to the United States. I.R.C. § 7701(b)(3)(B).

[291] 2006 U.S. Model art. 4(3). For treaties that follow the 2006 Model, *see., e.g.,* U.S.-Can. treaty, *supra* note 143, art. 4(2); U.S.-Fr. treaty, *supra* note 198, art. 4(4); U.S.-Ger. treaty, *supra* note 86, art. 4(2); U.S.-Ir. treaty, *supra* note 192, art. 4(3); U.S.-Isr. treaty, *supra* note 175, art. 4(2); U.S.-It. treaty, *supra* note 251, art. 4(2); U.S.-Japan treaty, *supra* note 143, art. 4(3); U.S.-Lux. treaty, *supra* note 192, art. 4(2); U.S.-Mex. treaty, *supra* note 148, art. 4(2); U.S.-Neth. treaty, *supra* note 143, art 4(2); U.S.-U.K. treaty, *supra* note 143, art. 4(4). The U.S.-Austl. treaty, *supra* note 143, art. 4(2) has a slightly different test. The U.S.-China treaty, *supra* note 3, art. 4(2) refers the matter directly to the competent authorities.

residency to exclude interest income, while claiming U.S. residency in order to obtain net income taxation on rental income.[292]

Any such inconsistent claims are foreclosed by the regulations issued under the domestic rules for defining U.S. residency. Those regulations provide that if an individual claims to be a foreign resident under a treaty, then that individual will also be treated as a foreign resident under domestic law.[293] Consequently, it is not possible for an individual to take the position that it is a foreign resident for one item of income but a U.S. resident for another. An IRS memorandum cites this regulation in concluding that a purported green card holder can enjoy the benefits of graduated rates on social security benefits as a resident alien only if the individual does not claim any treaty benefits as a resident of a foreign country.[294]

This consistency rule only applies in a particular year if the individual actually uses a foreign residency claim to obtain a tax benefit in that year; the mere eligibility for treaty benefits is not enough. While the regulations prevent inconsistent claims within a year, they do not purport to prevent a dual resident individual from claiming to be a U.S. resident in one year and a foreign resident in the next.

This consistency requirement applies to individuals, not entities. This limited scope does not appear to be the result of any view that entities should be entitled to make inconsistent claims of residency; rather, the regulations were issued under Section 7701(b) of the Code, which only deals with residency of individuals. As discussed in the

[292] *Cf.* ALI Study, at 88–89 (domestic-law claim of U.S. residence to obtain net taxation of rental income coupled with a treaty claim for foreign residence to exclude income from a controlled foreign corporation).

[293] Treas. Reg. § 301.7701(b)-7(a)(1).

[294] I.R.S. Tech. Adv. Mem. 2002-35-026 (Aug. 30, 2002). In that case, the individual had been living outside the United States for some time, and it was thought likely that the Immigration and Naturalization Service would revoke the green card upon an attempted re-entry. The IRS nonetheless permitted the individual to file as a resident alien if he or she did not claim treaty benefits. *See also* I.R.S. Tech. Adv. Mem. 1999-35-058 (July 8, 1999).

preceding Part, the IRS has sought to apply a similar consistency requirement to entities.

Although individuals are required to be consistent in their claims of residency for purposes of determining their own tax liabilities, for other purposes the regulations provide for U.S. resident treatment even if a claim of foreign residency is made under a treaty.[295] For example, a dual resident individual is considered to be a U.S. resident for purposes of determining whether a foreign corporation is a controlled foreign corporation in cases where the individual owns a direct or indirect 10% voting interest.[296] This rule mandates a sort of inconsistency, in that the individual can be a U.S. resident for this purpose but a foreign resident for purposes of determining the individual's own tax liability. However, the rule provides some measure of predictability for other shareholders of the foreign corporation, in that its status as a controlled foreign corporation in a particular year is unaffected by whether the dual resident makes a claim for treaty relief for that year on an unrelated item of income.

The treatment of a dual resident S corporation shareholder can affect the status of the S corporation. If the dual resident were treated as a U.S. resident notwithstanding a claim of foreign residence under the treaty, the S corporation could preserve its status as such, but the shareholder might seek to avoid tax on his or her share of the S corporation's business income on the grounds that the shareholder lacked a U.S. permanent establishment. As a result, the shareholder's share of the S corporation's income would avoid U.S. tax altogether, contrary to the intent of the S corporation rules, which presume taxa-

[295] In addition to the circumstances discussed in the text, the temporary regulations for reporting foreign financial assets under I.R.C. § 6038D treat a resident alien as subject to those reporting obligations even if the individual has elected foreign resident status under a treaty. T.D. 9567, 76 Fed. Reg. 78,553, 78,555 (Dec. 19, 2011).

[296] Treas. Reg. § 301.7701(b)-7(a)(3).

tion at the shareholder level.[297] To prevent this result, proposed regulations would cause a dual resident shareholder who claims foreign residency under a treaty to be treated as foreign for purposes of the S corporation rules, which would have the effect of terminating the S corporation's election, unless the shareholder agrees to be taxed on the S corporation's income as if the S corporation were a partnership and the shareholder were a partner.[298]

Claims of "crossover" residency, where each country regards an individual as a resident of the other, can only arise in the case of non-U.S. citizens, since U.S. citizens are taxed as residents regardless of where they live. Cases of individual crossover residency are presumably rare and, as with entities, do not typically present treaty consistency issues, since the individual is not entitled to claim treaty benefits as a resident of either country. Yet in an unusual case, crossover residency can be *created* by a treaty. Consider a Canadian working in the United States for the government of Canada.[299] Such an individual would be treated as a U.S. resident under the domestic laws of both the United States and Canada. Yet special provisions of the Canadian treaty dealing with government employees treat such an employee as a Canadian resident,[300] and permit only Canada to tax the employment income.[301] This situation creates the potential for inconsistent claims of residency for Canadian tax purposes. For example, the individual might apply Canadian domestic law rather than the treaty in order to be treated as a U.S. resident in respect of his U.S.

[297] *See* I.R.C. § 1361(b)(3), which requires S corporations shareholders to be U.S. individuals, with limited exceptions for trusts and exempt organizations. I.R.C. § 1361(c)(2), (6). In the case of a exempt organization, any income from an S corporation shareholding is taxable as unrelated business taxable income. I.R.C. § 512(e)(1).

[298] Prop. Reg. § 301.7701(b)-7(a)(4), 57 Fed. Reg. 15,272 (Apr. 27, 1992).

[299] This example is discussed in Arnold, *supra* note 174, at 902.

[300] U.S.-Can. treaty, *supra* note 143, art. 4(5).

[301] U.S.-Can. treaty, *supra* note 143, art. 19.

source employment income, thereby avoiding Canadian tax on that income, while claiming Canadian residency under the treaty in order to be taxed on a net rather than gross basis on Canadian source investment income. It is apparently unclear whether these inconsistent claims would be allowed as a matter of Canadian law.[302] Of more relevance here, however, is whether a claim of Canadian residency under the treaty should be respected for U.S. tax purposes if the taxpayer is simultaneously claiming U.S. residency for Canadian tax purposes. The taxpayer's employment income would thereby avoid U.S. taxation by reason of the treaty, which permits only Canada to tax it; but would also avoid Canadian taxation, since it would be U.S. source income of a U.S. resident under Canadian domestic law. This sort of inconsistency would not be precluded by the U.S. regulations described above, which require an individual claiming foreign residency under a treaty to be treated as foreign resident for all U.S. tax purposes.[303] Yet as a policy matter it is difficult to justify the outcome, which is avoidance of both U.S. and Canadian taxation on this employment income.

D. *Hybrid Entities*

Hybrid entities are transparent in the United States and opaque in a foreign country (a "regular" hybrid") or vice versa (a "reverse" hybrid). As a result, they have inconsistency built into their very nature. Since transparency in the United States is largely an elective matter,[304] it is usually easy to cause an entity to be a hybrid, and hybrid entities have become a staple of international tax planning. The availability of treaty benefits to a hybrid or its owners generally depends on their status under foreign law. Questions of treaty consistency arise when a

302 *See* Arnold, *supra* note 174, at 902.

303 *See supra* note 293 and accompanying text.

304 *See* Treas. Reg. § 301.7701-3 (the "check the box" regulations).

taxpayer makes treaty claims based on the status of an entity under foreign law, while also seeking to benefit from the different status of the entity under domestic law.

1. *Treaties and Hybrids*

Shortly after creating the elective regime for entity classification, the IRS addressed the growing popularity of hybrids in the international context by issuing regulations under Section 894 that provide rules for determining when a hybrid entity or its owners are entitled to treaty benefits.[305] Those rules generally look to the status of the entity under the laws of the treaty partner to determine whether the entity or its owner has derived the income for treaty purposes. Thus, the entity can treat itself as deriving an item of income if it is opaque with respect to that item under the laws of the country where it is a resident, even if it is transparent under U.S. law.[306] Also, an owner of an equity interest in a foreign entity is treated as deriving income earned by that entity if, with respect to that item, the owner is an individual or an entity that it is opaque under the laws of the country where it is a resident, and in addition the entity through which the income is earned is transparent under the laws of the owner's country, even if that entity is opaque under U.S. law. Most subsequent treaties contain similar rules, which secure for U.S. residents the benefits of equivalent treatment by the treaty partner.[307] Unlike the Section 894

[305] T.D. 8889, 65 Fed. Reg. 40,993, 40,997 (July 3, 2000), *amending* Treas. Reg. § 1.894-1(d).

[306] A resident of a treaty country will also need to satisfy any further requirements, such as the treaty's limitation on benefits clause or the domestic anti-conduit rules of Treas. Reg. § 1.881-3, which is presumed for purposes of the discussion here.

[307] *See, e.g.*, 2006 U.S. Model art. 1(6); 1996 U.S. Model art. 4(1)(d):

> An 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

regulations, which apply only to income subject to withholding tax,[308] these treaty rules apply to all types of income, including business profits.[309]

Both the Section 894 regulations and the treaties with similar rules operate with respect to a particular item of income, rather than with respect to the status of an entity generally. This presumably means that an entity could claim under its treaty for one item, while its owner could claim under another treaty for another item. Even with regard to a particular item, one owner might want to claim benefits at the owner level for that owner's share, while another owner might want to claim benefits at the entity level.

Consider, for example, an entity that earns interest that is ineligible for the portfolio interest exemption. It is resident and opaque in a treaty country such as Italy, which has a treaty with the United States that allows a 10% withholding tax on interest.[310] The entity is transparent, however, in the countries of residence of its two owners. One of those owners is resident in a country such as the United Kingdom, whose treaty provides a full exemption from withholding on inter-

> for purposes of the taxation law of such Contracting State as the income, profit or gain of a resident.

Treaties with similar language include U.S.-Belg. treaty, *supra* note 143, art. 1(6); U.S.-Ger. treaty, *supra* note 86, *as amended by* protocol, *supra* note 148, art. 1(7); U.S.-Neth. treaty, *supra* note 143, art. 24(4), *as amended by* protocol, *supra* note 148, art. 6(e); U.S.-N.Z. protocol, *supra* note 198, art. 1(6); U.S.-U.K. treaty, *supra* note 148, art. 1(8). A few treaties omit the reference to "profit or gain": U.S-Bulg. treaty, *supra* note 193, art. 1(6); Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, Sept. 21, 1989, U.S.-Fin., art. 1(6), T.I.A.S. 12101, *as amended by* Protocol, May 31, 2006, art. 1, Hein's No. KAV 7644; U.S.-Ice. treaty, *supra* note 94, art. 1(6).

308 Treas. Reg. § 1.894-1(d)(1).

309 *See supra* note 307. *See also* N.Y. ST. BA. ASS'N TAX SEC., *Report on Guidance under U.S. Income Tax Treaties*, 9-11 (May 28, 2010) (recommending that the Section 894 regulations be amended to confirm this treatment).

310 U.S.-It. treaty, *supra* note 251, art. 11(2).

est.[311] This first owner would prefer to claim that exemption on its share of the interest rather than rely on the 10% limitation available to the entity itself. The other owner, however, is resident in a country that lacks a tax treaty with the United States. This second owner would only be able to rely on the entity's 10% limitation for its share of that income. Nothing in the Section 894 regulations or similar treaty provisions appears to require consistency in whether these claims are made at the owner level or the entity level.

2. ***Domestic Reverse Hybrids***

A domestic reverse hybrid is a U.S. entity, usually a partnership, that has elected to be treated as a corporation for U.S. tax purposes, but is treated as transparent under the law of the foreign country where its owners reside. Such a hybrid is a sort of dual resident, since its income is taxed in both the United States and the foreign country. Not surprisingly, a domestic reverse hybrid is used in situations where the entity is expected to operate at a loss for tax purposes. Typically, the hybrid is the common parent of a U.S. consolidated group, and its losses, which may be attributable to interest deductions from acquisition financing, are used to offset the operating income of U.S. group members, while also being available to offset other income of its foreign owners for foreign tax purposes.

If a domestic reverse hybrid were in fact a dual resident, the use of its losses would be restricted by the dual consolidated loss rules.[312] Such a hybrid, however, avoids actual dual resident status for the simple reason that the hybrid itself is not a resident of a foreign country; instead, its profits and losses flow up to its foreign owners. Even though the hybrid is not a dual resident, its *income* is effectively dual

[311] U.S.-U.K. treaty, *supra* note 143, art. 11(1).

[312] I.R.C. § 1503(d).

resident, since it is subject to tax both in the United States (at the entity level) and a foreign country (at the owner level).

The Section 894 regulations do not allow an owner of an interest in a domestic reverse hybrid to claim treaty benefits on the hybrid's income, even though the hybrid is transparent in the owner's country of residence.[313] This denial of treaty benefits applies even where the treaty itself considers the income to be derived by the owner.[314] The rationale for denying treaty benefits is the savings clause, which allows the United States to tax its own citizens and residents as if the treaty did not exist.[315] Since the reverse hybrid is itself a U.S. corporation, the United States can freely tax its income under the savings clause. Although there are exceptions that typically limit the scope of savings clauses, none of these exceptions relates to claims by owners of income derived through the hybrid.

This denial of treaty benefits to reverse hybrids is similar to the treatment of dual residents that choose the benefits of U.S. residency rather than claiming benefits as a foreign resident under a treaty. Unlike actual dual residents, however, owners of interests in a domestic reverse hybrid are not given the choice of whether to apply the treaty. Nor is there any analogue to the concept of a tie-breaker for dual residents that would determine which country is given the right to tax the income on a residence basis. This being the case, domestic reverse hybrids do not generally present any treaty consistency issues, as domestic law completely trumps the treaty.

In one limited circumstance, a consistency issue arises. If a domestic reverse hybrid receives a dividend from an 80%-owned U.S. affiliate, and makes an interest payment to a foreign owner that is eligible for a reduction in withholding tax under a treaty, then a special rule in the Section 894 regulations causes the interest payment to be

313 Treas. Reg. § 1.894-1(d)(2)(i).

314 *See supra* note 307.

315 2006 U.S. Model Technical Explanation, commentary on art. 1(6).

subject to withholding as a dividend rather than as interest.[316] This rule is intended to prevent the foreign interest holder from treating the income as a dividend derived through the hybrid under foreign law (which may benefit from a participation exemption or generate indirect foreign tax credits), while also gaining the benefit of treaty rates on interest, which are typically lower than dividend withholding rates.[317] The inconsistency here is not between U.S. domestic law and the treaty, as the withholding under the treaty would, absent this rule, be determined in a manner consistent with the character of the payment under U.S. law as interest. Rather, the inconsistency is between U.S. law and foreign law. In most cases covered by the regulation, U.S. law effectively disregards the payment *to* the hybrid, either because the dividend is eliminated in consolidation,[318] or is eligible for a 100% dividends received deduction.[319] Foreign law, on the other hand, effectively disregards the payment *by* the hybrid, since the entity's deduction for the payment under foreign law will pass through to the owner. So the only real tax effects are the foreign law treatment of the payment to the hybrid as a dividend, and the U.S. law treatment of the payment by the hybrid as interest.

Viewed in this way, the inconsistency is no different from that of a hybrid instrument that is treated as debt under U.S. law but equity under foreign law. Suppose, for example, a U.S. subsidiary issues a convertible note to its parent, which is resident in a jurisdiction that treats the note as equity even before conversion.[320] If the note is treat-

[316] Treas. Reg. § 1.894-1(d)(2)(ii)(B). This rule applies, however, even if the withholding rate on dividends under the treaty is lower than the rate on interest. *See* Treas. Reg. § 1.894-1(d)(2)(iii), Ex. (5).

[317] Notice of Proposed Rulemaking, 66 Fed. Reg. 12,445, 12,446 (Feb. 27, 2001).

[318] *See* Treas. Reg. § 1.1502-13(f)(2)(ii).

[319] *See* I.R.C. § 243(a)(3).

[320] In Australia, for example, a convertible obligation will be treated as equity (even before conversion) if it has a term of more than ten years, and the present value of its fixed payments is less than its issue price, when discounted at a rate equal

ed as debt under U.S. law, then the same inconsistency between U.S. and foreign law arises as in the case of a domestic reverse hybrid.

When a domestic reverse hybrid pays through to its foreign owners as interest amounts received as dividends from affiliates, the Section 894 regulations treat the payment as a dividend not only for withholding purposes, but also for regular tax purposes, causing the interest payment by the hybrid to be nondeductible. This rule gives the regulations broader scope than simply denying treaty benefits; they deny a domestic law benefit as well. Moreover, this rule applies whenever the interest payment is eligible for reduction under a treaty, even if the recipient chooses not to claim the benefits of the treaty. Some treaties, such as the treaty with Mexico, only reduce withholding on interest to a rate as high as 15%,[321] so the loss of deductibility may significantly outweigh the benefit of the reduction in withholding under the treaty.

As noted above, domestic reverse hybrids resemble dual residents in having the potential for net losses to be taken into account under both U.S. and foreign tax law. When it applies, the recharacterization rule prevents the hybrid from making interest payments to its owners that are deductible under both U.S. and foreign law. However, other payments that can give rise to net losses, such as interest payments to unrelated third parties, are outside the scope of this rule. When the existing rule was made final in 2002, the IRS indicated that it may be appropriate to consider an extension of the dual consolidated loss rules to domestic reverse hybrids,[322] but it has not since addressed this broader issue.

to 75% of the rate that the issuer would pay on a comparable nonconvertible obligation. *See generally* Income Tax Assessment Act (Austl.) 1997 §§ 974-1 to 974-165.

[321] U.S.-Mex. treaty, *supra* note 148, art. 11(2).

[322] T.D. 8999, 67 Fed. Reg. 40,157–58 (June 12, 2002).

3. *Foreign Reverse Hybrids*

Foreign owners of a foreign reverse hybrid can potentially claim treaty benefits for income earned by the hybrid. Treaty consistency issues arise when a foreign owner wants to rely on the transparency of the entity in its own country of residency to make a treaty claim, while relying on the opaque status of the entity under domestic law for other purposes.

For example, suppose a hybrid entity located in a tax haven is 5% owned by a resident of a treaty country that treats the entity as transparent, while the entity is treated as opaque under U.S. law. That resident is the parent of a wholly-owned U.S. subsidiary that pays interest to the hybrid. If the other 95% of the hybrid is owned by unrelated parties, the hybrid can claim the portfolio interest exemption for all of the interest it receives from the subsidiary, since it is not a 10% shareholder of the subsidiary under the relevant attribution rules.[323] This exemption even applies to the 5% portion attributable to the parent, even though that portion would not be eligible for the portfolio interest exemption if the hybrid were transparent under U.S. domestic law.[324] If the parent's treaty does not provide for zero withholding on interest, then treating the hybrid as opaque in order to benefit from the portfolio interest exemption is the only way that the parent's share of this interest can be exempt from U.S. tax. Meanwhile, the hybrid earns dividend income from U.S. portfolio equity investments, which is subject to a 30% U.S. withholding tax under domestic law. The treaty resident owner, however, may seek to claim a treaty rate on its 5% share of those dividends, based on the transparent status of the hybrid under the owner's country of residence. Thus, the owner is simultaneously relying on the hybrid's being opaque un-

[323] *See* I.R.C. § 871(h)(3)(C)(ii) (attributing stock from a less than 50% shareholder only in proportion to that shareholder's interest).

[324] Treas. Reg. § 1.871-14(g)(3)(i).

der domestic law, to get the portfolio interest exemption for the interest, and on its being transparent under foreign law, to get the reduced treaty rate on the dividends. This inconsistency, which appears to be permitted under the Section 894 regulations, contrasts with the all-or-nothing approach that the IRS takes towards dual residents.

More serious consistency issues arise when a foreign owner wants to take advantage of the differing status of the entity under U.S. and foreign law with respect to the same item of income. Although the Section 894 regulations are limited to withholding taxes, treaties that embody similar principles apply those principles to all income, including business profits.[325] Suppose a foreign owner derives income through a permanent establishment of a foreign reverse hybrid, but the owner does not itself have a U.S. permanent establishment. One might imagine the owner aggressively arguing that it should be exempt from tax under the treaty, on the basis that the owner is deemed to have derived the income (since the entity is transparent under the tax law of the owner's country of residence) and the owner has no permanent establishment (since under U.S. domestic law a permanent establishment of a corporation is not imputed to its shareholders).

Such an argument would predictably fail on grounds of treaty consistency. In discussing the U.S. treatment under the Canadian treaty of a partnership that is a reverse foreign hybrid, the Technical Explanation states, "in determining whether there is a permanent establishment, both the activity of the entity and its partners will be considered."[326] Thus, an owner seeking treaty benefits on the grounds that the entity is transparent in the owner's home country cannot hide behind the opaque status of the entity under U.S. domestic law in claiming that the income is not attributable to a permanent establishment.

325 *See supra* note 307.

326 Technical Explanation of the U.S.-Can. protocol, *supra* note 95, commentary on Protocol art. 2, *amending* treaty art. 4(6), at 41,183.

This rule is a legitimate application of treaty consistency, since otherwise the income would escape U.S. taxation entirely, even though it is in fact attributable to a permanent establishment of the entity. The treaty clearly intends that the United States retains taxing power over the income earned through a permanent establishment within its borders. The means by which this result is accomplished is an extra-statutory extension of the principles of Code Section 875, which attributes the business activities of a partnership to its partners, but does not attribute the business activities of a corporation to its shareholders. But where the owner's treaty claim for an item of income is based on the transparency of the entity, it is reasonable to require the owner to treat the entity consistently as transparent with regard to that item.

a. Dealers. Consistency issues also arise when the hybrid is a dealer in stocks or securities, or in commodities. As discussed in Part II.D.1 above, traders in these items are eligible for domestic-law safe harbors that prevent their trading activities in the United States from constituting a U.S. trade or business. These safe harbors are not available to dealers, so the trading activities of a dealer can constitute a U.S. trade or business. Suppose an owner has an interest in a hybrid that earns dealing and trading income that would be effectively connected income in the hands of the hybrid, and is attributable to the hybrid's permanent establishment. The owner, however, is not a dealer, and resides in a country with a treaty that contains a clause allowing treaty claims on business income earned through reverse hybrids. The owner accordingly claims that it derives its share of the hybrid's trading income for treaty purposes, and should benefit from the statutory safe harbor, since it is not a dealer.

Whether to allow such a claim has more to do with the actual exercise of taxing rights under domestic law than with the right to tax this income under a treaty. The income is, after all, earned through a permanent establishment of the entity, and as discussed above the owner cannot use its own absence of a permanent establishment to

argue that the United States lacks taxing rights. The question under domestic law is whether the safe harbor should apply to exempt a foreign non-dealer's share of trading income earned through a reverse hybrid dealer. But once the power of the United States to tax this income is acknowledged, then the owner's treaty becomes irrelevant, so the income can be viewed as trading income earned by a dealer (the hybrid) and ineligible for the safe harbor.

Now suppose the owner earns other trading income in the United States through its own permanent establishment, independent of its investment in the reverse hybrid dealer. As a matter of domestic law, the safe harbor should be available to the owner, since the hybrid's dealer status would not be attributed to the owner. The fact that the owner resides in a country with a treaty that entitles the owner to view itself as deriving the hybrid's income directly should not cause the hybrid's dealer status to be attributed to the owner, at least where the owner is not claiming benefits under the treaty for the hybrid's income. In such a case, the owner should be able to ignore the treaty and claim the domestic law benefit of non-dealer status. However, the owner might wish to use the treaty for other income earned through the hybrid; for example, the hybrid might earn dividend income on its dealer securities for which the owner can benefit from a lower treaty rate. The treaty consistency question then becomes whether the owner can treat the hybrid as transparent under the treaty to obtain reduced withholding on this dividend income, while treating the hybrid as opaque under domestic law to obtain the benefit of the safe harbor on the unrelated trading income.

Here again, the question is whether the United States chooses to exercise its taxing power on the trading income. It unquestionably has this power, since the trading income was earned through a permanent establishment of the owner. But the owner is not itself a dealer, and would benefit from the domestic-law safe harbor in the absence of a treaty. In this case, permitting the owner to treat the hybrid as transparent for the dividend income and as opaque for the trading income

does not seem at odds with the restriction of the safe harbor to non-dealers.

b. Controlled Commercial Entities. Foreign sovereigns enjoy a domestic-law exemption from taxation on income from stocks and securities under Code Section 892. This exemption extends to an entity that is controlled by a foreign sovereign, but only if the entity does not engage in commercial activities in the United States or elsewhere.[327] The rise of sovereign wealth funds has increased the importance of tax planning to preserve the Section 892 exemption, as these funds are controlled entities that would lose this exemption if they were found to engage in commercial activities. Commercial activities of an entity are attributed to its owners only if the entity is transparent.[328] Consequently, it is normal practice for these funds to isolate their commercial activities by conducting them through separate entities that are opaque for U.S. tax purposes.[329]

Suppose one of these controlled commercial entities is a foreign reverse hybrid. Under domestic law, the entity itself will be ineligible for the Section 892 exemption, but its commercial activities will not disqualify its parent for the exemption, because of the opaque status of the entity. In some cases, however, the parent may seek treaty benefits on income through the hybrid on the basis that the hybrid is transparent under the tax laws of its parent's jurisdiction, and that the

327 I.R.C. § 892(a)(2). The regulations add a further requirement that the entity be, directly or indirectly, wholly owned by the foreign sovereign. Treas. Reg. § 1.892-2T(a)(3)(i).

328 *Compare* Treas. Reg. §1.892-5T(d)(2)(i) (no attribution from a subsidiary to its parent) *with* Treas. Reg. §1.892-5T(d)(3) (attribution from a partnership to its partners unless the partnership is publicly traded). Proposed regulations would also block attribution to a limited partner. Prop. Reg. § 1.892-5(a)(5)(ii), 76 Fed. Reg. 68,119, 68,123 (Nov. 3, 2011).

329 This opacity comes naturally, since a business entity that is wholly owned by a foreign sovereign is a *per se* corporation that cannot elect to be transparent for U.S. tax purposes. Treas. Reg. § 301.7701-2(b)(6).

parent is therefore entitled to treat itself as having derived the income for purposes of the treaty.

For example, the hybrid might have effectively connected income that is not attributable to a permanent establishment. If the hybrid itself is not a treaty resident, it will have no grounds to avoid tax in its own right. However, if the parent is a treaty resident, it could treat itself as having derived the income for treaty purposes and claim a treaty-based exemption under the business profits article. At the same time, the parent may claim the Section 892 exemption on U.S. dividend income that it earns directly. These claims raise a treaty consistency issue, since the parent is treating the hybrid as transparent for its treaty claim, but as opaque under domestic law to preserve its Section 892 exemption. Both claims should nonetheless be allowed, as they do not undermine the purpose of either the business profits article or the Section 892 exemption.

Public pension trusts can qualify as controlled entities of the sovereign.[330] In the treaty with the United Kingdom, both public and private pension trusts enjoy an exemption from withholding tax on dividends.[331] Suppose a U.K. public pension trust earns dividend income through a foreign reverse hybrid that is a controlled commercial entity. The hybrid is ineligible for the Section 892 exemption because of its commercial activities. The pension trust claims an exemption under the U.K. treaty on the grounds that for treaty purposes the hybrid is transparent and therefore the pension trust has derived the dividend income. Needless to say, the trust will want to rely on the opaque status of the hybrid under domestic law in order to preserve its Section 892 exemption for other income that it earns directly. As in the preceding paragraph, the treaty claim should not result in a loss of the Section 892 exemption; it should not matter whether the treaty claim is made under the business profits article or the dividend article.

330 Treas. Reg. § 1.892-1T(c)(1).

331 U.S.-U.K. treaty, *supra* note 143, art. 10(3)(b).

c. Non-Corporate Owners. A non-corporate owner might wish to invest in a foreign reverse hybrid as a "blocker" in order to prevent activities of the hybrid from being attributed to the owner under domestic law, while still relying on a treaty to treat the owner as deriving income directly. The owner could be an individual, a partnership with individual owners, or a non-business trust.[332] For example, an owner might invest through such a hybrid so that any effectively connected income of the hybrid would not be attributed to its owner, and therefore the owner would not have any U.S. tax filing or direct payment obligations. At the same time, the owner might wish to treat the hybrid as transparent for treaty purposes in order to obtain a reduction in withholding for non-effectively connected dividend income. While these claims are based on inconsistent views of the hybrid, the claims relate to different income of the hybrid, and do not appear contrary to the purposes of the relevant provisions of a treaty or domestic law.

The hybrid's effectively connected income will also be subject to branch profits tax if not reinvested. A non-corporate owner might claim exemption from branch profits tax under the treaty, even if the income is attributable to a permanent establishment and the treaty permits the imposition of branch profits tax. The basis for the claim would be that the treaty only permits the branch profits tax to be imposed on "companies,"[333] and the owner is not a company. Here the

[332] The trust category could also include foreign pension trusts, which the IRS has treated as trusts for tax purposes, in circumstances where they (i) are tax-exempt in their home country; (ii) are subject to regulation by a government body in charge of regulating pension funds, and (iii) invest their funds according to an annually approved investment plan. *See* I.R.S. Priv. Ltr. Ruls. 2008-45-024 (July 8, 2008), 2008-44-002 (July 8, 2008), 2008-10-002 (Nov. 28, 2007), 2007-34-018 (May 22, 2007), 2005-08-004 (Nov. 10, 2004), 2003-20-005 (Jan. 28, 2003), 1999-36-032 (June 11, 1999).

[333] *See* 2006 U.S. Model art. 10(8). *But see* Oren Penn, Steve Nauheim, & Susan J. Conklin, *Applying Branch Profits Tax Treaty Limits to Hybrid Entities*, 133 TAX NOTES 1003, 1011 (Nov. 21, 2011) (arguing that the source country should be entitled to impose branch profits tax in this circumstance, to achieve parity with the dividend withholding tax that would have been imposed if each non-corporate owner had held its interest through a separate U.S. subsidiary).

owner is relying on the status of the hybrid as opaque to avoid personal liability for the U.S. tax on effectively connected income,[334] but relying on the status of the hybrid as transparent under the treaty to avoid branch profits tax. Moreover, these inconsistent views of the hybrid's status relate to the same underlying income of the hybrid.

The inconsistency is thrown into sharper relief if the income is subject to tax at a lower rate in the hands of the hybrid than in the hands of its owner. Suppose the hybrid earns only a modest amount of income, and the owner seeks the benefit under domestic law of lower corporate tax rates on the first $75,000 of corporate income.[335] If the benefit of those lower rates is combined with a treaty-based exemption from branch profits tax, then the owner gets a better result than could be obtained by either an individual or a corporation earning the same income directly rather than through a reverse hybrid. If that result were to be denied on treaty consistency grounds, it would be unclear how to treat an owner that wished to claim the treaty exemption from branch profits tax, there being no basis under domestic law to apply tax rates other than the usual corporate rates for income that, for domestic tax purposes, is earned by a corporation.

[334] However, the owner will not avoid a return filing obligation. There appears to be no mechanism similar to Treas. Reg. § 1.1441-6(b)(2) (providing a regime for owners of foreign reverse hybrid entities to claim a reduced rate of U.S. withholding tax under an income tax treaty) for claiming a reduced rate of U.S. tax on effectively connected income; thus, the owner of a foreign reverse hybrid may have to file a U.S. tax return in order to claim a refund of branch profits tax paid by the hybrid. *But see* N.Y. ST. BA. ASS'N TAX SEC., *Report on Guidance under U.S. Income Tax Treaties* 11 (May 28, 2010) (arguing that no filing obligation should apply).

[335] The rate is 15% on the first $50,000 and 25% on the next $25,000. The benefits of these lower rates are clawed back as income rises above $75,000. I.R.C. § 11(b)(1). If the current maximum rate for individuals rises to 39.6%, as it is currently scheduled to do at end of 2012, the corporate rate advantage will exist for higher amounts of income. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16 § 901(a)(1), 115 Stat. 38, 150, *as amended by* the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 101(a)(1), 124 Stat. 3296, 3298.

The tables are turned if the income is capital gain from U.S. real estate that is treated as effectively connected under Code Section 897 and permitted to be taxed by the United States under the relevant treaty. Absent a treaty, these real estate gains, when earned by a foreign corporation, are generally subject to both regular corporate tax and branch profits tax. A non-corporate owner of a reverse hybrid earning gains from U.S. real estate might assert a claim under the treaty not only to avoid branch profits tax, but also to obtain the benefit of the 15% maximum tax rate on capital gains earned by a non-corporate taxpayer. The rationale for the latter claim would be that, under the treaty, the income was derived by the non-corporate owner.

The difficulty with this claim is that treaties do not prescribe rates on business profits or gains that the United States is permitted to tax. Consequently, the only argument for a treaty-based claim to apply non-corporate rates would be the non-discrimination article, which prevents the United States from imposing tax on a foreign national that is greater than the tax imposed on a similarly situated U.S. national.[336] If, however, the non-corporate owner of the hybrid were a U.S. person rather than a foreign person, its income would be subject to both regular corporate tax as well as branch profits tax, and distributions to the owner would be subject to a second layer of shareholder-level tax. It would be difficult, therefore, for a foreign owner to complain of discrimination on the basis of the tax rate.

Moreover, bizarre things could happen if effectively connected income of a reverse hybrid were deemed to be derived by its owner for purposes of determining the rate of tax paid by the hybrid. Suppose the hybrid is owned equally by two individuals, the first of whom resides in a treaty country that treats the hybrid as transparent. If that first individual were to obtain the benefit of individual rates, that would reduce the amount of remaining income subject to tax at corporate rates. If the remaining income were modest, it could benefit

[336] *E.g.* 2006 U.S. Model art. 24; OECD Model art. 24.

from lower corporate tax rates to a greater degree than if all of the hybrid's income were taken into account at corporate rates. In that case, the second individual's share of the income would be more lightly taxed by reason of the first individual's treaty claim, a result that would be hard to justify.

4. *Regular Hybrids*

Treaty consistency issues can also arise for regular hybrids, but only when the hybrid is foreign. Income of domestic hybrids is not eligible for treaty relief, since the hybrid itself, being both domestic and transparent under U.S. tax law, cannot make a treaty claim; while the owner resides in a country that treats the hybrid as opaque, and therefore cannot claim under a treaty to have derived the income of the hybrid.[337] A foreign regular hybrid can itself make a treaty claim, if it is opaque in its country of residence and otherwise qualifies for treaty benefits. Meanwhile, its owners may seek to take advantage of the transparency of the hybrid under U.S. domestic law.

For example, suppose an individual resident of the United Kingdom owns 100% of a limited company that is U.K. resident and opaque for U.K. tax purposes, but has filed an election to be treated as a disregarded entity for U.S. tax purposes. The limited company is thus a regular hybrid, and the company (but not its owner) can claim benefits under the U.K. treaty. If the hybrid receives dividends from a U.S. subsidiary, it may claim exemption from U.S. withholding tax under the treaty, once a 12-month holding period test has been satisfied.[338] That exemption is only available for "companies," but the hybrid here is entitled to treat itself as having derived the income for

[337] Penn et al., *supra* note 333, at 1007–09, take the view that a domestic regular hybrid should be entitled to make a treaty claim for branch profits tax, on the grounds that the branch profits tax is imposed on income *from* the hybrid, rather than on income derived *through* the hybrid.

[338] U.S.-U.K. treaty, *supra* note 143, art. 10(3).

purposes of making a claim under the treaty, as it is a company that is opaque under U.K. law.[339] At the same time, if the company has gains from U.S. real estate, its owner would wish to rely on the transparency of the hybrid under U.S. domestic law, in order to avoid branch profits tax, and take advantage of the 15% maximum capital gains tax rate.

Although this combination of claims is favorable to the taxpayer, and is based on inconsistent views of the status of the hybrid, it is difficult to see how these claims would be denied. The preferential rate on capital gains and absence of branch profits tax are direct consequences of the transparent status of the hybrid under domestic law. The treaty provides no basis for changing the rate of taxation, or imposing a branch profits tax that would not otherwise apply. Likewise, the treaty claim is a straightforward application of the treaty, and cannot be considered to be waived by the application of provisions of domestic law that are not in themselves elective.

These results might also be justified on the basis that they relate to differing investments of the hybrid, but that will not always be the case. For example, the U.S. subsidiary might be a U.S. real property holding corporation,[340] and the hybrid might realize in a single year both dividend income, on which it claims exemption under the treaty, and capital gains from the sale of that company's stock, on which it claims the benefit of the owner's preferential tax rate. Even though

339 U.S.-U.K. treaty, *supra* note 143, art. 1(8). Under the treaty, "the term 'company' means any body corporate or any entity that is treated as a body corporate for tax purposes." *Id.* at art. 3(1)(b). Regrettably, the treaty does not specify *whose* tax purposes. The 2006 U.S. Model definition remedies this omission by adding the words, "according to the laws of the state in which it is organized." 2006 U.S. Model art. 3(1)(b). The discussion here assumes that the reverse hybrid is organized in the United Kingdom, and that the United States would interpret this aspect of the U.K. treaty in a manner consistent with the 2006 U.S. Model.

340 A U.S. real property holding corporation is a corporation (for U.S. tax purposes) of which more than half of its assets constitute U.S. real property interests. I.R.C. § 897(c)(2). Gain from a sale of shares of a domestic U.S. real property holding corporation is subject to tax as effectively connected income, but is not subject to branch profits tax. I.R.C. §§ 884(d)(2)(C), 897(c)(1)(A)(ii).

the claims relate to the same investment, there does not appear to be a technical basis for denying this combination of claims.

V. CONCLUSION

There is no global duty of consistency, in the sense that making a treaty claim in one context obligates the taxpayer to apply the treaty in all contexts. A treaty resident can normally apply particular provisions of the treaty as it wishes, while forgoing other treaty provisions where U.S. domestic law provides a better result. But this freedom is not unlimited: there are cases where positions taken under a treaty need to be harmonized with positions taken under domestic law, so as to give effect to the intended operation of the treaty. Viewed in this way, treaty consistency is a norm of interpretation, guiding the application of treaty and domestic law rules. It is a purposive norm, in that it seeks to implement the purpose of these rules, rather than relying on a more focused textual analysis.

Even when there are valid reasons for asserting a consistency requirement, those reasons may be outweighed by other considerations. Thus, in the case of consistency over time, there are situations where it may be appropriate to tolerate selective use of a treaty over different years, even if the same sort of selectivity is prohibited within a single year.

No simple short cuts can resolve all treaty consistency issues. A taxpayer cannot justify unbridled selectivity based on the rule that treaties can only be used to reduce tax. Nor is it sufficient for the IRS to say that this rule is satisfied even when a treaty is applied to increase tax, so long as the overall net effect of a treaty is to reduce tax. Any application of a treaty consistency requirement must be based on a need to protect the ability of the United States to impose taxes that it is permitted to impose under the relevant treaty, and does seek to impose under its domestic law.

This means that in general treaty consistency should not take the form of all-or-nothing rules, such as the strong consistency asserted

by the 2006 U.S. Model for U.S. permanent establishments. A rare exception where an all-or-nothing rule is justified is in the dual residency context, in which the taxpayer uses the tie-breaker rule of a treaty to vary residence from that provided under domestic law. But in that particular context, the taxpayer's application of the tie-breaker clause can be seen as an acceptance of the treaty's assignment of residence, which is then to be applied consistently by the taxpayer and the governments of both countries. By contrast, with hybrid entities there is no intention to have the hybrid treated consistently by both countries; if it were, it would no longer be a hybrid. In this context, treaty claims by the hybrid and its owners should be applied in a way that satisfies general norms of treaty consistency, without requiring the hybrid to be treated as transparent or opaque for all purposes.