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FOREIGN INCOME

U.S. Income Tax Treaties — Benefits Provided by a Country to Its Own Residents and Citizens

by

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TAX MANAGEMENT PORTFOLIOS™

FOREIGN INCOME

U.S. Income Tax Treaties — Benefits Provided by a Country to Its Own Residents and Citizens

PORTFOLIO DESCRIPTION

This Portfolio, 6875-2nd T.M., *U.S. Income Tax Treaties — Benefits Provided by a Country to Its Own Residents and Citizens*, covers the benefits granted under a bilateral income tax treaty by one of the parties to the treaty to its own residents. Among these benefits are (i) elimination or reduction of the tax liability of a country's residents to provide relief from double taxation that would otherwise arise from the other country's imposition of tax on the same items of income, with a focus on treaty and Code re-sourcing provisions; (ii) elimination or reduction of the tax liability of a country's individual residents with respect to specific types of income for which the treaty assigns primary taxing jurisdiction to the other country (e.g., compensation for government employment, benefits from and contributions to pensions and retirement plans, and alimony and child support); (iii) the saving clause, which preserves the right of the United States to tax its citizens on worldwide income even though they might otherwise qualify for treaty benefits with respect to such income (e.g., if a U.S. citizen is a resident of a foreign treaty partner); (iv) selected benefits for businesses provided by treaties, and (v) the non-discrimination clause, under which Contracting States cannot discriminate against each other's nationals or residents in matters of taxation.

This Portfolio also includes Worksheets that reproduce the 2016 and 2006 Model Treaties accompanying technical explanation issued by the U.S. Treasury Department in 2006 and selected re-sourcing provisions found in current U.S. income tax treaties.

This Portfolio may be cited as Browne, and Hellkamp, 6875-2nd T.M., *U.S. Income Tax Treaties — Benefits Provided by a Country to Its Own Residents and Citizens*.

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DETAILED ANALYSIS

I. Introduction

A. Scope of This Portfolio

This Portfolio covers a subset of the benefits granted under a bilateral income tax treaty: those benefits granted by a country to its own residents. Conceptually, this subject matter can be distinguished from benefits granted by a country to residents of the other country that is a party to the treaty (the Treaty Partner).

This Portfolio covers the following topics:

(i) Relief from Double Taxation — Elimination or reduction of the tax liability of a country's residents to provide relief from double taxation that would otherwise arise from the Treaty Partner's imposition of tax on the same items of income.

(ii) Savings Clause — The "Saving Clause," which preserves the right of the United States (and often the Treaty Partner) to tax its citizens or residents on worldwide income even though they might otherwise qualify for treaty benefits with respect to such income (e.g., if a U.S. citizen is a resident of a foreign Treaty Partner).

(iii) Residence Country Benefits for Individuals — Elimination or reduction of the tax liability of a country's residents with respect to specific types of income for which the treaty assigns primary taxing jurisdiction to the Treaty Partner by way of provisions that apply notwithstanding the Saving Clause. These include compensation for government employment, benefits from and contributions to pensions and retirement plans, and alimony and child support.

(iv) Residence Country Benefits for Businesses — Mutual agreement procedure (MAP) and Advance Pricing Agreements (APA); that is, allowing residents of either country to invoke the procedure for bilateral negotiations between the parties' "competent authorities" to prospectively agree on appropriate transfer pricing outcomes or relieve double taxation not otherwise resolved by the treaty's provisions.

(v) Non-discrimination — Contracting states cannot discriminate against each other's nationals or residents in matters of taxation.

Before tackling these subjects, some background on the role and nature of bilateral tax treaties in the international tax context may be useful.

B. Role of Tax Treaties

The bilateral international agreements commonly referred to as "income tax treaties"[1] occupy a unique place in the practice of tax law. Tax practitioners are used to seeking the answers to their questions in the Code,[2] the Treasury Regulations, case law, and a panoply of formal and informal administrative guidance. But whenever faced with an issue concerning the U.S. federal income taxation of an international transaction — a transaction producing either income earned from foreign sources by a U.S. citizen or resident (an outbound transaction)[3] or income earned from United States sources by a non-U.S. person (an inbound transaction) — the practitioner must not only consult these familiar sources of U.S. domestic tax law, but also must determine whether any income tax treaty to which the United States is a party applies. If there is an applicable treaty, it may change the taxation of the transaction.

Hundreds of bilateral income tax treaties are currently in force, with the United States currently a party to some 66 bilateral tax treaties in force.[4]

The general rule is that income tax treaties do not impose tax, but instead protect a taxpayer from imposition of tax by one or the other (generally not both)[5] parties to a treaty. Put another way, an income tax treaty is an agreement providing rules to enable the two countries to assign taxing jurisdiction over specified types of income between themselves. Thus, income tax treaties are largely, though not exclusively, intended to protect taxpayers against "double taxation" that can result when, due to differences in domestic tax law, both countries assert the right to tax the same income.[6] In general, the right to as-

[1] The official name of a United States income tax treaty is usually in the form "CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF ______________ FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME." For convenience, however, practitioners usually refer to such agreements as "income tax treaties" and will identify a given treaty by reference to the parties, for example, the "U.S.-Germany Income Tax Treaty."

[2] Pub. L. No. 115-97 (known as the "Tax Cuts and Jobs Act," or as here, the "2017 tax act") made fundamental changes to U.S. taxation of international transactions; for example, the long-standing principle of deferral (under which U.S. taxation of income earned by a foreign corporation was, with various anti-avoidance exceptions, generally deferred until repatriated as dividends to U.S. shareholders) was generally eliminated. Now income earned abroad by a U.S. shareholder's corporation is either subject to current taxation (though often at a reduced rate), or exempt from U.S. tax. While profound, this and numerous other changes to the Code generally do not affect the discussion of the topics considered herein.

[3] 6000 T.M., *Foundations of U.S. International Taxation.*

[4] This number includes as separate income tax treaties in force the agreements with members of the former Soviet Union. When the Soviet Union was dissolved, the U.S.-U.S.S.R. Income Tax Treaty was deemed to apply to the former member states Armenia, Azerbaijan, Belarus, Georgia, Kyrgyzstan, Moldova, Tajikistan, Turkmenistan, and Uzbekistan.

[5] But see IV.C.4., below, discussing certain treaty partners that exempt child support and alimony payments from taxation.

[6] Income tax treaties serve other purposes as well, such as providing a mechanism for the parties to exchange tax-related information among themselves to prevent tax evasion. For discussion of competent authority procedures of specific countries, see 6885 T.M., *Income Tax Treaties — Competent Authority Functions and Procedures of Selected Countries (A–C),* 6887 T.M., *Income Tax Treaties — Competent Authority Functions and Procedures of Selected Countries (D–G),* 6890 T.M., *Income Tax Treaties — Competent Authority Functions and Procedures of Selected Countries (H–K),* 6892 T.M., *Income Tax Treaties — Competent Authority Functions and Procedures of Selected Countries (L–N),* and 6895 T.M., *Income Tax Treaties — Competent Authority Functions and Procedures of Selected Countries (O–Z).*

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sert taxing jurisdiction over an item of income will be assigned either to the country in which the recipient of the income is a resident (residence state) or the country in which the item of income arose or to which it is sourced (source state).[7] In cases where primary taxing jurisdiction is assigned to the source state, relief from double taxation will typically be provided by the residence state to its own resident.

Once ratified and in force,[8] any U.S. treaty, including a bilateral income tax treaty, is considered the "supreme law of the land."[9] Treaties and federal statutes ("laws of the United States"), both being the supreme law of the land, have equal force.[10] Based on this principle, the Supreme Court has long held that if a treaty provision and a federal statute are inconsistent, the "last in time" (i.e., whichever is more recent) will be given effect.[11]

If carried to its logical conclusion, this last-in-time rule could lead to absurd results; any inconsistent amendment of the Code taking place after a given treaty had entered into force might be viewed as overriding that treaty. For example, if the general statutory withholding tax rate were changed, one might argue that any lower treaty rate, say a 5% withholding tax rate on dividends, had been overridden. Section 894, however, is intended to alleviate that potential problem by providing generally that the provisions of the Code "shall be applied to any taxpayer with due regard to any treaty obligation of the United States which applies to such taxpayer."[12] Moreover, applying the principle of statutory construction that repeal by implication is not favored,[13] the Supreme Court has held that the statute and treaty must be construed so as to give effect to both, if possible.[14] Therefore, "[a] treaty will not be deemed to have been abrogated or modified by a later statute unless such purpose on the part of Congress has been clearly expressed."[15] Notwithstanding this general rule, Congress reserves the right to override treaty provisions and has endorsed the "last in time" rule.[16]

This approach has been subject to discussion from various commentators,[17] some of whom feel it is contrary to international law[18] and invites retaliation from foreign countries. Congress, however, has continued to provide explicit treaty overrides when it believes such action to be justified as a policy matter.[19]

C. *Model Treaties*

Throughout this Portfolio, there are repeated references to various versions of the U.S. Model Treaty, and occasional references to the OECD Model Treaty. A bit of historical back-

[7] It is common to use the terms "source state" and "residence state" to refer, respectively, to the jurisdiction that is asserting a right to tax under an applicable treaty by virtue of property or payments being located in or sourced to that jurisdiction, as opposed to the jurisdiction that is asserting a right to tax under an applicable treaty by virtue of the owner or recipient of that property or payment being a resident of that jurisdiction. This terminology is generally useful in analyzing the allocation of taxing jurisdiction under an applicable treaty and the authors have adopted this convention as well. Nevertheless, in the analysis of certain provisions that do not clearly rely upon a source and residence distinction, this portfolio will sometimes use the more cumbersome treaty language of "first contracting state" and "other contracting state."

[8] Typically, although a treaty is "in force" once instruments of ratification are exchanged, it does not take effect until one or more effective dates stated in the treaty. For example, the U.S.-Chile Income Tax Treaty was signed in February 2010, approved by the Senate in June 2023, ratified and entered into force in December 2023, and came into effect January 1, 2024 (and in the case of provisions related to withholding taxes, February 1, 2024). The U.S.-Japan Income Tax Treaty was signed on November 6, 2003, approved by the Senate on March 9, 2004, ratified on March 30, 2004, and effective for taxable years beginning after January 1, 2005. *See* JS-1227 and JS-1275, *available at* https://www.treasury.gov/press-center/press-releases/Pages/js1227.aspx and http://www.treasury.gov/press-center/press-releases/Pages/js1275.aspx, respectively. The U.S.-Japan Income Tax Treaty was subsequently amended by a Protocol signed January 24, 2013, approved by the Senate on July 17, 2019, and entered into force on August 30, 2019, and came into effect January 1, 2020 (and in the case of provisions related to withholding taxes, November 1, 2019).

[9] *See* U.S. Const., art. VI, cl. 2 (the Supremacy Clause): "This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land … ."

[10] U.S. Const. art. VI, cl. 2; §7852(d)(1) ("For purposes of determining the relationship between a provision of a treaty and any law of the United States affecting revenue, neither the treaty nor the law shall have preferential status by reason of its being a treaty or law."). All section references are to the Internal Revenue Code of 1986, as amended, and the regulations thereunder, unless otherwise specified.

[11] *Reid v. Covert*, 354 U.S. 1, 18 (1957); *see also The Chinese Exclusion Case*, 130 U.S. 581, 600 (1889); *Whitney v. Robertson*, 124 U.S. 190, 195 (1888).

[12] §894(a)(1). Although this language appears to be deferential to treaty obligations, its adoption in 1988 was viewed as weakening the effect of treaties vis-à-vis the Code. Before the 1988 amendment, §894(a)(1) stated that "[i]ncome of any kind, to the extent required by any treaty obligation of the United States, shall not be included in gross income … ."

[13] *See Posadas v. Nat'l City Bank*, 296 U.S. 497, 503 (1936).

[14] *Whitney v. Robertson*, 124 U.S. at 194. Even though it asserted its authority to override treaty provisions in amending §894(a)(1), Congress was careful to leave this presumption in place. See S. Rep. No. 100-445, at 321–22 (1988), which states, "The committee does not intend this codification to alter the initial presumption of harmony between, for example, earlier treaties and later statutes. Thus, for example, the bill continues to allow an earlier ratified treaty provision to continue in effect where there is not an actual conflict between the treaty provision and a subsequent revenue statute (i.e., where it is consistent with the intent of each provision to interpret them in a way that gives effect to both)." As an example, it states that reenactment of a 30% withholding rate subsequent to ratification of a treaty providing a 5% rate would likely not override the 5% rate, because the intent of Congress in reenacting the subsequent statute was not to change then-current treaty withholding rates. S. Rep. No. 100-445, at 327.

[15] *Cook v. United States*, 288 U.S. 102, 120 (1933).

[16] Section 7852(d)(2), amended at the same time as §894(a)(1), applied a "saving clause" to treaties in effect on August 16, 1954 (the date of enactment of the Internal Revenue Code of 1954), meaning that such treaties could not be overridden by provisions of the 1954 Code as in effect on August 16, 1954. Such treaties, and all subsequently ratified treaties, however, may be overridden by subsequently enacted or amended legislation. This statutory provision was enacted to "make it clear that treaty provisions that were in effect in 1954 and that conflict[ed] with the 1954 Code as originally enacted [were] to prevail over then-existing Code provisions, but not over later amendments to the Code." H.R. Rep. No. 100-795, at 302 (1988); S. Rep. No. 100-445, at 317 (identical language).

[17] *See, e.g.*, Rosenbloom and Shaheen, *Treaty Override: The False Conflict Between Whitney and Cook* 24(2) Fla. Tax Rev. 375 (2023); David Sachs, *Is the 19th Century Doctrine of Treaty Override Good Law for Modern Day Tax Treaties?* 47 Tax Law. 867 (1994); Anthony C. Infanti, *Curtailing Tax Treaty Overrides: A Call to Action*, 62 U. Pitt. L. Rev. 677 (2001).

[18] *See Restatement (Third) of Foreign Relations Law of the United States* §115(b)(1) (1987) (stating that a change in domestic law does not relieve the United States of its international obligations); Am. Law Inst., *Federal Income Tax Project: International Aspects of United States Income Taxation II: Proposals on United States Income Tax Treaties* 73 (1992) (change in domestic law should not be sufficient to relieve United States of its obligations under treaties).

[19] *See, e.g.*, American Jobs Creation Act of 2004, Pub. L. No. 108-357 §801(a), 118 Stat. 1418, 1565 (2004) (AJCA), explicitly providing in the amended language of §7874(f) that "Nothing in section 894 or 7852(d) or in any other provision of law shall be construed as permitting an exemption, by reason of any treaty obligation of the United States heretofore or hereafter entered into, from the provisions of this section."

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ground will help put the role of these model treaties in perspective.

1. Model Treaties Drafted by International Bodies

The Organisation for Economic Co-operation and Development (OECD) published a draft model treaty in 1963 (1963 Draft) with extensive commentary. Most income tax treaties negotiated since then, including all U.S. income tax treaties, have generally followed the 1963 Draft or its successors. In 1977, the OECD issued a final version of the 1963 Draft[20] accompanied by extensive commentary explaining the provisions of the model treaty and describing the underlying theories and analysis. OECD has since updated its model treaty (OECD Model Treaty) and commentary multiple times, especially since 2017.[21] The OECD continues to explore issues and can be expected to periodically amend the OECD Model Treaty as the collective thinking of its member nations concerning international tax issues evolves.[22]

The influence of these OECD Model Treaties cannot be overstated. OECD member states, including the United States, have by consensus agreed to general principles and seek to implement those principles in their treaties. The OECD Model Treaty provides a framework for treaty negotiations, and the OECD's views on substantive issues such as transfer pricing provide at least a useful starting point for resolving issues of double taxation.[23] This is not to say that various member states will not sometimes disagree concerning particular issues; as with any set of complex rules, there is sufficient ambiguity that in some cases both parties can in good faith claim that their position is supported by the OECD Guidelines and the principles of the OECD Model Treaty. But the Commentary accompanying the OECD Model Treaty[24] provides assistance in interpreting treaties. In a sense, the Commentary serves a role similar to legislative history — although certainly not binding on the treaty partners,[25] it provides evidence of the intent of the drafters.[26]

In addition, in 1980 the United Nations began publishing a model treaty designed to similarly address double taxation and apply to treaties between economically developing countries and economically developed countries. The United Nations Model Tax Convention was most recently updated in 2021.[27]

2. United States Model Treaties

In 1977, the United States released its first model upon which it based its position in treaty negotiations. The 1977 U.S. Model Treaty was very similar to the OECD Model Treaty in effect at that time. The United States issued a revised draft in 1981.[28] In 1992, the Treasury Department withdrew the two model treaties and issued a revised, updated model.[29] That revised model, the 1996 U.S. Model Treaty, was issued in 1996, along with a detailed Technical Explanation. On November 15, 2006, the Treasury Department issued another revision of its model, the 2006 U.S. Model Treaty, along with a technical explanation (2006 Technical Explanation).[30] Subsequently, on February 17, 2016, the Treasury Department published the most recent revision of the model treaty (2016 U.S. Model Treaty).[31] In addition to highlighting the changes between the 2006 and 2016 models, the preamble to the 2016 U.S. Model Treaty (2016 Preamble) stated that the Treasury Department intended to issue a technical explanation at a later date. No such technical explanation was ever published, however. Although the 2016 U.S. Model Treaty is the most recent model, it is sometimes necessary to refer to the 1996 U.S. Model Treaty or the 2006 U.S. Model Treaty in this Portfolio, as treaties with many of the United States' important trading partners (for example, the United Kingdom, Ireland, and Mexico) were concluded while a prior U.S. Model Treaty was in effect.

The 1996 U.S. Model Treaty and the 2006 U.S. Model Treaty are quite similar, but there are a number of substantive differences. The 2006 U.S. Model Treaty included substantial

[20] 2017 OECD Model Tax Convention on Income and on Capital (2017 OECD Model Treaty), Introduction, ¶7.

[21] 2017 OECD Model Treaty, Introduction, ¶11. The official commentary published together with any OECD Model Treaty is hereinafter referred to as the "Commentary."

[22] 2017 OECD Model Treaty, Introduction, ¶11.

[23] The OECD has published an extensive set of transfer pricing guidelines and commentaries, designed to explicate the arm's-length standard in detail. *See Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD Guidelines). The competent authorities of OECD member states typically look to these guidelines in negotiating "mutual agreements" under bilateral income tax treaties to relieve particular taxpayers from double taxation. *See* V., below.

[24] Because the 2017 OECD Model Treaty Commentary is cumulative, citation throughout will be made to that version of the Commentary.

[25] *See, e.g., Animal Science Products, Inc. v. Hebei Welcome Pharmaceutical Co. Ltd.*, 138 S. Ct. 1865 (2018) (in a unanimous decision, the Court concluded that the U.S. federal courts must give "respectful consideration" to a foreign government's interpretation, but they are not "bound to defer" to that position).

[26] For example, in *Nat'l Westminster Bank PLC v. United States*, 58 Fed. Cl. 491, 498 (2003), aff'd, 512 F.3d 1347 (Fed. Cir. 2008), the U.S. Court of Federal Claims acknowledged that the OECD Model Treaty Commentary served "as a meaningful guide in interpreting treaties that are based on its provisions" and specifically relied on the OECD Commentary in ruling against the position advanced by the United States in that case. At times, not all members of the OECD will agree on the interpretation of a given model treaty provision, or on how the provision will be applied. In such cases, a dissenting member may add an "observation" to the appropriate Commentary, explaining how it will interpret or apply the provision in question. For example, Spain has made an Observation that because under its internal law the fiscal year coincides with the calendar year, a change in residence will not terminate the fiscal year as indicated by paragraph 10 of the Commentary to Article 4. OECD Commentary, art. 4, ¶26. Similarly, if an OECD member does not agree with the language of a given provision of the OECD Model Treaty, it may provide a "reservation" explaining that it will not agree to such provision. For example, Japan and Korean have each made a Reservation to the OECD Commentary to Article 4 and other articles that refer directly or indirectly to the "place of effective management." Instead, Japan and Korea wish to use the term "head or main office." OECD Commentary, art. 4, ¶28.

[27] United Nations Model Double Taxation Convention Between Developed and Developing Countries, United Nations (2021) (U.N. Model Treaty). Although the U.N. Model Treaty is generally consistent in many aspects with the 2017 OECD Model Treaty and U.S. model treaties, there are material differences. In general, the U.N. Model Treaty is more favorable to source state taxation, which is viewed as benefiting economically developing countries.

[28] U.S. Model Income Tax Convention of June 16, 1981 (1981 U.S. Model Treaty); *see also* United States Model Income Tax Convention of September 20, 1996, Purpose of Model Convention and Technical Explanation (1996) (1996 Technical Explanation).

[29] Treasury News Bulletin NB-1900, July 17, 1992.

[30] U.S. Treas. Dept. Press Release HP-168 (Nov. 15, 2006), *available at* http://www.treasury.gov/press-center/press-releases/Pages/hp168.aspx.

[31] U.S. Department of the Treasury, Treasury Announces Release of 2016 U.S. Model Income Tax Treaty (2016), https://www.treasury.gov/press-center/press-releases/Pages/jl0356.aspx.

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new language limiting the persons entitled to treaty benefits.[32] The 2006 U.S. Model Treaty also included a new Article 18 addressing pension funds.[33] Unlike its predecessor, the 2006 U.S. Model Treaty did not address independent personal services in a separate article.[34] In limited respects, the 2006 U.S. Model Treaty also modified the 1996 U.S. Model Treaty's approach to dividends and interest.[35] Finally, the 2006 Model Treaty also expanded slightly the definition of permanent establishment (PE)[36] found in the 1996 Model Treaty[37] and expressly recognized principles of the OECD Transfer Pricing Guidelines[38] for purposes of attributing business profits to a PE.

Perhaps the most important difference between the 2006 U.S. Model Treaty and the 1996 U.S. Model Treaty, however, occurred in the Technical Explanation relating to beneficial ownership. The 1996 Technical Explanation Article 10, paragraph 2 states that the term "beneficial owner" as applied to a dividend "is understood generally to refer to any person resident in a Contracting State to whom that State attributes the dividend for purposes of its tax." In contrast, Article 10, paragraph 2 of the 2006 Technical Explanation states that because "[t]he term 'beneficial owner' is not defined in the Convention, it is, therefore, defined under the internal law of the country imposing tax (i.e., the Source Country)." Thus, even though the text of Article 10(2) of the 1996 U.S. Model Treaty and the text of Article 10(2) of the 2006 U.S. Model Treaty are identical, the definition of the operative term beneficially owned has apparently changed. Given that this change from the residence state definition of beneficial ownership to that of the source state is only in the 2006 Technical Explanation, it is unclear whether it will (or ought to) have any impact on treaties currently in force.

The content of U.S. Model Treaties has continued to evolve with the 2016 U.S. Model Treaty. The primary goals of the 2016 U.S. Model Treaty were:

1. To provide relief from double taxation, but with increased emphasis on limiting tax evasion and avoidance that leads to reduced or non-taxation; and

2. To prevent treaty shopping by third-country residents, who are not intended treaty beneficiaries.[39]

These goals comport with a growing global trend to lessen the opportunity for tax avoidance by multinational entities, which can be seen by the plan to incorporate the results from OECD/G20 Base Erosion and Profit Shifting Project (BEPS) into more than 2,000 tax treaties worldwide.[40] There are a number of provisions designed to accomplish these goals, which lead to the key differences between the 2006 and 2016 U.S. Model Treaties; many of the other key provisions of the two model treaties remain the same. The 2016 U.S. Model Treaty contains a new article designed to account for future changes in a partner's domestic law by obligating the partners to consult on making necessary amendments should a change in law change the original balance of benefits between the parties.[41] Parties are also required to resolve disputes that arise between taxing authorities through binding arbitration, using the "last best offer" approach (sometimes referred to as "baseball arbitration" because of its use to resolve player salary disputes in Major League Baseball), which is the arbitration format prescribed in seven U.S. tax treaties, as well as one of the U.S. tax treaties awaiting ratification by the Senate.[42] The 2016 U.S. Model Treaty limits the benefits of corporate inversions by denying reduced withholding rates on U.S. source payments made by companies that undertake inversions with related foreign persons.[43] Another change from the 2006 U.S. Model Treaty is the introduction of restrictions on withholding tax relief for payments of interest, royalties, and guarantee fees deductible by the payor in its country of residence to a related party that is subject to a "special tax regime" with respect to the

[32] 2006 U.S. Model Treaty, art. 22(2)(c), 22(3)(b), 22(3)(c), 22(5)(d); *see also* 6855 T.M., *U.S. Income Tax Treaties — The Limitation on Benefits Article* (detailing the differences between the Limitation on Benefits Article of the 1996 U.S. Model Treaty and the same provision of the 2006 U.S. Model Treaty).

[33] 2006 U.S. Model Treaty, art. 18; *see also* 1996 U.S. Model Treaty, art. 18(6) (addressing pension funds); V.B., below (discussing the new pension fund article of the 2006 U.S. Model Treaty).

[34] 1996 U.S. Model Treaty, art. 14. The 2006 U.S. Model Treaty included Article 14, "Income from Employment," with provisions nearly identical to those in Article 15 of the 1996 U.S. Model Treaty, "Dependent Personal Services."

[35] 2006 U.S. Model Treaty, art. 10(3) (generally replacing the 1996 U.S. Model Treaty, art. 10(4) (exemption for source country dividend taxation of "qualified governmental entities" with an equivalent exemption for source country taxation of pension funds); 2006 U.S. Model Treaty, art. 10(4) (generally replacing the 1996 U.S. Model Treaty), art. 10(3) (treatment of source country taxation of Regulated Investment Companies (RICs) and Real Estate Investment Trusts (REITs)); 2006 U.S. Model Treaty, art. 11(2)(b) (permitting the United States to tax "contingent interest that does not qualify as portfolio interest under United States law" at a rate not exceeding 15%, in contrast to 1996 U.S. Model Treaty, art. 11(5), which includes no reference to "contingent interest").

[36] A PE is, generally speaking, a Country A branch office of a Country B taxpayer (corporation, individual, or unincorporated entity), which has a significant business presence in Country A. Such "PEs" are generally subject to Country A tax on business profits attributable to their Country A activities. *See* 2006 U.S. Model Treaty, arts. 5, 7.

[37] 2006 U.S. Model Treaty, art. 5(4)(f) (generally limiting the "combination of exempted activities" clause from the definition of PE as appearing in 1996 U.S. Model Treaty, art. 5(4)(f), by requiring all exemptions founded on a combination of activities to have a "preparatory or auxiliary character").

[38] 2006 U.S. Model Treaty, art. 7(3) (note) (recommending that Treaty Protocol or Notes include (1) an understanding that business profits attributed to a PE "shall include only the profits derived from the assets used, risks assumed and activities performed by the permanent establishment"; and (2) a reference to the "principles of the OECD Transfer Pricing Guidelines").

[39] U.S. Department of the Treasury, Treasury Announces Release of 2016 U.S. Model Income Tax Treaty (Feb. 17, 2016), https://www.treasury.gov/press-center/press-releases/Pages/jl0356.aspx.

[40] In November 2016, more than 100 jurisdictions concluded negotiations on a multilateral instrument that implemented a series of income tax treaty measures to update international tax rules and lessen the opportunity for tax avoidance by multinational enterprises. The instrument incorporated results from the OECD/G20 BEPS Project and entered into force in 2018. *See* OECD, Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (2016), http://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm. The BEPS multilateral instrument has over 100 signatories, though the United States chose not to become a party. *See* OECD, Signatories and Parties to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, http://www.oecd.org/tax/treaties/beps-mli-signatories-and-parties.pdf.

[41] 2016 U.S. Model Treaty, art. 28.

[42] 2016 U.S. Model Treaty, art. 25(9)(j). The treaty awaiting ratification that prescribes baseball arbitration is the U.S.-Croatia Income Tax Treaty.

[43] 2016 U.S. Model Treaty, arts. 10, 11, 12, 21.

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taxation of such payments.[44] The 2016 U.S. Model Treaty also includes a number of technical updates resulting from bilateral income tax treaty negotiations that have occurred since the drafting of the prior model treaty.

The preamble to the 2016 U.S. Model Treaty (found in worksheet 7) provides that the "2016 Model … is the baseline text the Treasury Department uses when it negotiates tax treaties." Similarly, the then-Chief of Staff to the Joint Committee on Taxation testified in 2009 that "U.S. model tax treaties provide a framework for U.S. tax treaty policy and a starting point for tax treaty negotiations with our treaty partners."[45]

This Portfolio often refers to the most recent U.S. Model Treaties, discussing their provisions because they tend to be representative of treaties in force, and also examining how they compare to the equivalent provisions of U.S. tax treaties in force.

[44] 2016 U.S. Model Treaty, arts. 11(2)(c), 12(2)(a), 21(2)(a). The term "special tax regime" is defined in Article 3(1)(l).

[45] Joint Committee on Taxation, Testimony of the Staff of the Joint Committee on Taxation Before the Senate Committee on Foreign Relations Hearing on the Proposed Tax Treaty with Malta and the Proposed Tax Protocols with France and New Zealand, JCX 54-09 (Nov. 10, 2009).

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II. Relief from Double Taxation

A. *Methods of Double Tax Relief*

An important functions of the U.S. income tax treaty network is relieving residents of Contracting States from, mitigating, double taxation, incurred by residents of the Contracting States — that is, tax imposed by both States treaty countries on the same item of income due to asymmetric domestic tax laws of the respective countries. The various substantive articles of a tax treaty define and prescribe rules concerning the types of income intended to be protected from double taxation and generally assign primary taxing jurisdiction over a particular type of income for each category to one or the other treaty partner country.[46] Generally U.S. tax treaties typically assign primary taxing jurisdiction to the Source Country, with the Residence (or citizenship) Country bearing source country (the country in which the income arises) for most categories of income while primary taxing rights conferred on the taxpayer's country of residence are more limited, generally to some types of gains as well as most wages and employment-related income, annuities and alimony.[47] The country without primary taxing rights then bears the burden of providing double tax relief. In some cases, such as interest, royalties, and dividends however, treaties permit both countries to tax the same item of income, such as with interest, royalties and dividends, though the permissible source country tax is usually limited to a reduced rate. In other more rare instances, the treaty may provide that neither country will tax an item of income, such as with child support. These approaches, however, can vary by treaty, and most categories of income remain subject to the Saving Clause. As discussed in III., application of the Saving Clause can result in a different, and sometimes counterintuitive, tax result than that described in the face of the relevant treaty provision.

1. *In General*

There are three potential methods of providing double tax relief: (1) the "deduction method," (2) the "exemption method," and (3) the "credit method." Different countries use different methods (or combinations of methods).[48]

Under the deduction method, foreign taxes paid may be deducted to reduce income and thus domestic tax. As a general rule, the international tax treaty network relies less on the deduction method, as that method fails to provide full relief from double tax — i.e., a taxpayer limited to the deduction method would typically end up paying a higher combined tax rate on foreign-source income exposed to double taxation than on domestic-source income. No U.S. tax treaty relies exclusively on the deduction method.[49]

Under the exemption method, all or specified types of foreign-source income are generally exempt from domestic tax. This method is common outside of the United States, and many U.S. treaties provide for this method of relief to be provided by both the U.S. and the foreign treaty country.

Under the credit method, a taxpayer may generally claim a credit for foreign taxes paid against its domestic tax liability, albeit usually subject to certain limitations (as discussed below). This is how the U.S. provides relief in U.S. tax treaties.

As a general matter, many, though not all, countries attempt to provide double tax relief unilaterally their domestic tax laws. For example, countries offer participation exemptions to resident corporations. In the United States, corporate and individual taxpayers generally may elect either to deduct, or to take a credit for, qualifying foreign taxes paid or accrued, subject to many limitations.[50] As discussed below, however, such unilateral domestic provisions may not always provide full double tax relief due to asymmetries between the tax laws of the relevant jurisdictions. Accordingly, countries enter into bilateral tax treaties in large part to provide (further) relief from double taxation arising from between tax systems. In general, U.S. tax treaties provide double tax relief some combination the three methods.

2. *The Credit Method*

U.S. tax treaties use the credit method to grant relief for U.S. tax purposes with respect to taxes imposed on U.S. residents (or citizens) by the other treaty country. In addition, many U.S. tax treaties use the credit method to provide relief in certain circumstances where U.S. withholding taxes are imposed on residents of the other country. Other countries party to U.S. tax treaties tend to use the credit method, the exemption method or a combination thereof to provide relief from double taxation because of U.S. taxes imposed on their residents.

As an academic point, using OECD parlance, the credit method can be conceptually categorized as either an "ordinary credit" method or a "full credit" method.[51] Under the ordinary credit method, the taxpayer's foreign tax credit is generally limited to (the portion of) its residence state tax liability that is attributable to income taxed by the source state treaty partner. Thus, if the source state's tax rate is greater than that of the residence state, the taxpayer would not receive full credit for its foreign taxes paid. In the case of the United States, this is accomplished by means of the U.S. domestic law foreign tax credit limitation.[52]

By contrast, under the full credit method, a taxpayer could claim as a credit against its residence state tax the full amount of tax paid to the source state, even if such source state tax exceeds the amount of residence state tax payable with respect to that source state income — that is, even if the source state's ef-

[46] *See generally* 6000 T.M., *Foundations of U.S. International Taxation* and 938 T.M., *U.S. Income Tax Treaties — Income Not Attributable to a Permanent Establishment.*

[47] The assignment of primary taxing jurisdiction predominantly to the source country, while in a sense an international norm among countries that employ OECD model-style treaties, is hardly universal. For example, many U.S. treaties eliminate source country withholding tax on interest payments.

[48] See the discussion and example provided in Thomas M. Brinker & Richard W. Sherman, *Relief from International Double Taxation: The Basics,* 16 J. Int'l Tax'n 3, 20 (2005).

[49] For an examples of a U.S. treaty in which the other country relieves double taxation in part via deduction, *see* U.S.-Portugal Income Tax Treaty, art. 25(3)(b).

[50] *See generally* §901(a) (foreign tax credit); §164(a)(3) (deduction for foreign income taxes paid); *see also* 6020 T.M., *The Creditability of Foreign Taxes — General Issues.*

[51] 2017 OECD Model Treaty, Commentary on Articles 23A and 23B, ¶23.

[52] *See* §904; *see also* 6060 T.M., *The Foreign Tax Credit Limitation Under Section 904.*

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fective tax rate is higher than the residence state's tax rate on the income. No U.S. tax treaty adopts the full credit approach, either with respect to U.S. credits for foreign taxes, or, that the authors are aware of, with respect to foreign credits for U.S. taxes. The difference between the full credit method and the ordinary credit method can be illustrated by the following example:

> *Example:* Individual is a U.S. citizen who earns $1,000, comprised of $500 of U.S.-source general basket[53] taxable income and $500 of general basket taxable income sourced to his PE in Foreign Country. The U.S. income tax rate is $500 Foreign Country-source income). Under the full credit method, Individual could credit the entire $250 of Foreign Country tax against his U.S. income tax, resulting in total U.S. tax of $120 ($370–$250) and Foreign Country tax of $250. Under the ordinary credit method, however, Individual can credit only $185 of Foreign Country tax (i.e., the 37% U.S. tax rate times $500 of Foreign Country-source income) against his U.S. tax, meaning that he would pay $185 U.S. tax and $250 Foreign Country tax.[54]

3. The Exemption Method

Under the exemption method of double tax relief, income subject to tax by one country under the treaty is exempt from tax imposed by the other country, even if such income would normally be subject to tax under that country's domestic tax law. For example, assume Country X taxes its residents on the basis of their worldwide income and has no foreign tax credit mechanism to relieve them from double taxation. Under the U.S.-X tax treaty, however, the United States is granted primary taxing jurisdiction over income earned by a U.S. PE of a Country X resident. To prevent double taxation, the treaty provides that Country X will treat such income as exempt from Country X taxes.

In rare cases, a treaty may provide relief from double taxation to residents of the treaty partner solely through the exemption method.[55] However, it is more common for U.S. treaty partners to provide double tax relief through the credit method, or a combination of the credit method and the exemption method.[56]

4. Policy Considerations: Credit Method vs. Exemption Method

Use of the credit method, at first glance, seems counterintuitive. Relief from double taxation could more easily be accomplished by assigning primary taxing jurisdiction over a given type of income to one or the other treaty partner, and providing that such income is exempt from tax by the other treaty partner. The ordinary credit method, by contrast, is more complicated, as a tax credit limitation provision of some sort must generally be applied.

Although a pure exemption method may be simple, countries are often loath to give up taxing jurisdiction with respect to foreign-source income taxed at a lower rate than that generally applicable to income under their domestic tax law. In these situations an exemption system can be seen as unfair because two residents with the same amount of income could be subject to different effective worldwide tax rates — i.e., a resident with low-taxed foreign-source income would be subject to less total tax than a resident with the same amount of domestic-source income.[57] Such a result would encourage investment abroad, particularly investment in tax havens, which is contrary to a general policy that business investment should be driven by non-tax considerations.[58]

This infirmity is avoided by the ordinary credit approach, which bases the available credit on the amount of foreign taxes actually paid (or accrued). A resident taxpayer therefore receives no tax advantage from investing in a foreign tax haven because the domestic tax of its country of residence still generally applies to the extent such domestic rates are greater than foreign rates.[59]

B. U.S. Treaty Approach to Addressing Double Tax

Article 23 of the 2016 U.S. Model Treaty (Relief From Double Taxation) adopts the ordinary credit method[60] approach for relieving U.S. persons from U.S. tax on income also subject to tax by the other treaty country to alleviate double taxation. This is generally consistent with all U.S. tax treaties in force. For relief of the Other Contracting State's residents from double taxation, the 2016 U.S. Model Treaty simply inserts a placeholder, with the terms to be adopted on a case-by-case basis depending on the treaty partner's domestic tax law and policy.[61]

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[53] *See* §904(d).

[54] This simplified example ignores additional limitations likely to further reduce the available U.S. foreign tax credit under section 904. Section 904 is discussed in detail in 6060 T.M., *The Foreign Tax Credit Limitation Under Section 904.*

[55] The 1976 U.S. treaty with the former Soviet Republic countries (excluding Russia) lists various types of income exempt from tax in the source country. This is an outlier.

[56] *See* discussion and examples in II.B.2., below.

[57] This discussion is indebted to Thomas M. Brinker & Richard W. Sherman, *Relief from International Double Taxation: The Basics,* 16 J. Int'l Tax'n 3 (2005), discussed in III.A., below, which provides further examples.

[58] To avoid this result, some foreign countries with an exemption method limit the exemption to foreign-source income taxed at a given minimum rate; others apply an "exemption with progression" method, which allows the foreign income to enjoy an exemption from domestic tax, but includes the foreign income in the domestic tax base for purposes of determining the rate at which domestic-source income will be taxed. *See* Brinker & Sherman, *Relief from International Double Taxation: The Basics,* 16 J. Int'l Tax'n 3 (2005).

[59] Generally in practice, the U.S. foreign tax credit limitation is imperfect because it permits "blending" of foreign-source income taxed at lower rates with other foreign-source income taxed at higher rates, meaning that a taxpayer with operations in several foreign jurisdictions may in effect be able to receive a credit even for foreign taxes paid at a higher rate than the U.S. rate. To curtail this result, Congress and the IRS have adopted extensive statutory and regulatory limitations, such as the separation of income into various "baskets," to minimize taxpayers' ability to engage in such blending of high- and low-tax foreign-source income. *See* 6060 T.M., *The Foreign Tax Credit Limitation Under Section 904.*

[60] *See* discussion of the full credit and ordinary credit approaches above at II.A.2.

[61] Interestingly, the 1996 U.S. Model Treaty did not adopt the "placeholder" approach, but instead used reciprocal credit language. 1996 Model Treaty, art. 23(2). In practice, however, the method used by actual treaties in force varies by country depending on the foreign government's tax policy and views. *See* II.B.2., below.

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1. *U.S. Credit for Tax Paid to Treaty Partner*

Article 23 of the 2016 U.S. Model Treaty is straightforward. Article 23(2)(a) provides that the United States must allow, as a credit against its federal income tax, income tax paid or accrued to the Other Contracting State. Article 23(2)(b) provides a "deemed paid" credit that allows a U.S. company owning at least 10% of the voting stock of a company that is a resident of the Other Contracting State, and from which the U.S. company receives dividends, to receive a credit for the income tax paid or accrued by or on behalf of the payor corporation with respect to profits out of which the dividends are paid. This is equivalent to the deemed paid credit provided under former section 902 until its repeal in 2017.[62]

Note that allowance of both the direct credit and the deemed paid credit is to be made "in accordance with the provisions and subject to the limitations of" U.S. tax law. This generally means that the credits are subject to the foreign tax credit limitation found in section 904, as well as other restrictions and limitations on the use of such credits.[63] Likewise, the deemed paid credit provided in Article 23(2)(b) was generally subject to the rules and limitations of former §902 while that provision was part of the Code.[64]

Observation: Because the repeal of §902 was accompanied by the enactment of §245A, which generally substitutes an exemption mechanism for the indirect foreign tax credit associated with dividends paid by certain foreign subsidiaries, the provision corresponding to Article 23(2)(b) in treaties in force is effectively rendered moot for tax years following repeal, at least for legal dividends. There is some uncertainty, however, about the continued availability of a treaty-based credit for §960 deemed paid taxes for §951 (subpart F) and §951A (GILTI) inclusions.[65] There is no discussion in the legislative history addressing the intended effect of these statutory changes on income tax treaties.

Given this structure, from a U.S. taxpayer's perspective, one might ask why bother to have a tax treaty at all? Domestic U.S. law already provides a foreign tax credit mechanism intended to provide relief from double taxation. The answer is that the domestic law foreign tax credit is in effect available only with respect to foreign taxes paid on foreign-source income,[66] as defined under U.S. law sourcing rules.[67] A treaty — at least in theory — protects U.S. residents from double taxation in the case of taxes attributable to income that is U.S. source under U.S. law but nevertheless is subject to taxation by a foreign treaty country. Thus the credit mechanism provided under the treaty is intended to protect U.S. residents from double taxation resulting from inconsistent assertion of taxing jurisdiction by the two countries.[68]

> *Example:* I, an individual U.S. citizen, resides in and is employed in Country A by a Country A employer. Because the United States asserts jurisdiction to tax its citizens on their worldwide income, even if they are residents in a foreign country, I's compensation income is generally subject to U.S. income tax. Country A also asserts jurisdiction to tax such income on the basis of I's residence and employment in Country A. Without a tax credit mechanism, I would be subject to double taxation on the income.[69] Further, assume some of the employment services are performed in the United States, causing a portion of the salary to be U.S.-source income under U.S. domestic law. Without the benefit of a treaty to re-source that income as foreign source, the U.S. statutory foreign tax credit would generally be limited to relieving the double taxation on only the portion of the salary attributable to work performed in Country A.

An additional benefit provided by treaty stems from the U.S. rule that foreign tax credits are available only with respect to income taxes. The United States has taken an increasingly restrictive view concerning the types of foreign taxes considered income taxes and thus potentially eligible for the U.S. foreign tax credit under the Code. But treaties can potentially provide a foreign tax credit for taxes that are covered by a treaty

[62] §902(a); *see* 6040 T.M., *Indirect Foreign Tax Credits.*

[63] *See generally* §901–§908. For example, the Technical Explanation to the 2006 U.S. Model Treaty explains that the dollar amounts of such credits are subject to the foreign currency rules of §986, and that such credits are subject to rules concerning excess credit carryover periods, the alternative minimum tax foreign tax credit limitation, and so forth. *See also* Technical Explanation to the U.S.-China Income Tax Treaty, art. 22(2) ("The guarantee of a foreign tax credit provided in this paragraph is independent of the statutory grant of a credit under §§901–903 of the Code, *but the amount of the credit to be allowed is determined in accordance with the limitations provided in the Code (e.g., §904(h)).*") (emphasis added).

[64] *See* 6040 T.M., *Indirect Foreign Tax Credits.* Section 902 was repealed in 2017 by the TCJA.

[65] Historically it was generally clear, albeit a somewhat academic point, that U.S. treaties provided double tax relief to U.S. shareholders via an indirect credit for foreign taxes borne by a controlled foreign corporation in the context of subpart F inclusions (which were treated as deemed dividends under §960). *See, e.g.,* Technical Explanation to U.S.-Finland Income Tax Treaty, art. 23(2) (explaining that the Relief from Double Taxation article "provides for a deemed-paid credit, consistent with sections 902 and 960 of the Code …"). An amendment and reservation to the U.S.-Chile Treaty published by the Senate Foreign Relations Committee in 2022, however, calls this into question. It effectively suggests that any indirect credit for foreign taxes must be sought under domestic law (i.e., section 960), as treaty relief for double taxation may not be available — at least with respect to future treaties containing such modified language. (The reservation did acknowledge that this was not intended to create any inferences regarding the interpretation of any other existing tax treaties to which the United States is a party.)

[66] As a technical matter, this statement is not strictly accurate, as the domestic law U.S. foreign tax credit is available with respect to foreign taxes paid regardless of the source of the income on which such foreign tax is levied. (For example, the IRS ruled in Rev. Rul. 55-414 that a Canadian tax on U.S.-source income of a U.S. beneficiary was eligible for the U.S. credit.) However, the foreign tax credit limitations under section 904 have the effect of limiting the amount of credit that can be claimed to that portion of foreign taxes attributable to foreign-source income. The greater a taxpayer's proportion of foreign-source income relative to total income, the higher the credit limitation and therefore the larger the tax credit that can be claimed. A taxpayer who has no foreign-source income (as defined under the Code) will not be able to claim any foreign tax credit as a matter of domestic U.S. tax law, because the numerator of the foreign tax credit limitation fraction will be zero. Thus, as a practical matter, and for convenience of reference, this section of the Portfolio will discuss availability of foreign tax credits in terms of whether the foreign tax is imposed on foreign-source income.

[67] For U.S. law sourcing rules, see §861–§865. *See also* 6620 T.M., *Source of Income Rules.*

[68] See the discussion below in II.D., concerning re-sourcing of income, which is used to ensure double tax relief is available.

[69] For simplicity, this example ignores the section 911 foreign earned income exclusion.

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that may not necessarily qualify as such under the Code.[70] The final sentence of Article 23(2) of the 2006 and 2016 U.S. Model Treaties-provides that the taxes covered under the treaty are automatically considered income taxes, which thereby generally eliminates that problem for taxes covered by a treaty.

A small number of treaties provide special rules for how double tax relief is applied to specific tax regimes of the Contracting States, usually related to taxes imposed in connection with the extraction or exploitation of natural resources.[71] Broadly speaking, these rules are intended to treat income and credits from the specified activities (e.g., extraction of minerals from oil and gas wells) separately from income derived from other activities.[72] Thus, under these rules, a taxpayer may be required to compute the U.S. tax that would be due with respect to income from such extraction activities under U.S. principles and then compute the tax that would be due solely with respect to income from such extraction activities under the principles of the Other Contracting State to determine the credit, if any, one is entitled to claim.[73] These rules may even prescribe special carryforward rules so that "excess credits" in respect of extraction activities otherwise due may not offset income from non-extraction related activities.[74]

2. *Treaty Partner Relief for Taxes Paid to the United States*

The treaty partner's mechanism for providing double tax relief with respect to U.S. taxes paid by its residents varies depending on the treaty partner's domestic tax system. Article 23(1) of the 2016 U.S. Model Treaty merely provides a placeholder, with details to be determined through bilateral treaty negotiations. Article 23(1) of the 2016 Model Treaty is the same as Article 23(1) of the 2006 Model Treaty. The 2006 Technical Explanation states that the treaty partner will provide relief through the credit method, the exemption method, or a mixture of the two. By contrast, the 1996 U.S. Model Treaty was drafted as if the treaty partner, like the United States, used the credit method. However, the 1996 Technical Explanation made clear that "[a]lthough the Model Article is drafted as though the Other Contracting State uses a credit system, in bilateral Conventions the relief may be in the form of a credit, exemption, or a combination of the two."[75]

Many U.S. treaties in force adopt a credit method for the treaty partner's grant of double tax relief to its residents. Some of these treaties that use the ordinary credit method[76] refer to the treaty partner's domestic tax law limitations on such credits, using language similar to that used in the provision granting double tax relief by the United States to its citizens and residents.[77] Others incorporate a foreign tax credit limitation concept in the language of the double tax relief provision itself.[78]

In other U.S. income tax treaties, the treaty partner provides double tax relief to its residents through a combination of the exemption method and the credit method.[79] There is much variation among treaties in force, but one common theme is the combination of: (1) exemption for income taxable by the United States without limitation; and (2) foreign tax credit relief for other income (i.e., dividends, interest, and/or royalties, which under a typical treaty are subject to tax by both states).[80] Often the treaty will also contain a provision that permits the treaty partner to calculate the rate of tax on the resident's non-exempt income as if the exempt income had been included.[81] Such provisions are designed to preserve the treaty partner's effective tax rate under a progressive rate structure.

> *Example:* Country X uses a combination exemption and credit system under the U.S.-X Income Tax Treaty to provide double tax relief to Country X residents. A Country X resident earns $10,000 through a U.S. PE and $20,000

[70] *See* Treas. Reg. §301.6114-1(b)(7) (imposing a reporting requirement when a treaty grants a credit for a foreign tax for which a U.S. foreign tax credit would not be allowed under the Code). For example, the U.S.-Italy Income Tax Treaty provides that a portion of the taxes imposed under the Italian *l'imposta regionale sulle attivitá produttive* (IRAP) tax shall be considered income tax creditable against U.S. income-tax liability. *See* U.S.-Italy Income Tax Treaty, art. 2(2)(b)(iii) and art. 23(2)(c). Before the treaty's ratification, the IRS had already stated publicly that the IRAP is *not* an income tax or an "in lieu of" tax, likely because it does not provide deductions for labor and interest costs. (*See* IR-INT-98-6.) The Joint Committee on Taxation expressly cautioned the U.S. Senate that ratifying the treaty would "guarantee creditability of a tax that otherwise is a noncreditable tax under U.S. law." Joint Comm. on Tax'n, JCS-9-99, Explanation of Proposed Income Tax Treaty and Proposed Protocol Between the United States and the Italian Republic 59 (1999). Yet the U.S. Senate ratified it anyway. To be sure, the U.S.-Italy Income Tax Treaty limits the amount of IRAP that can be deducted to an amount approximating income taxes. *See Id.* (But this arrangement also violates U.S. law because Treasury Regulations §1.901-2(a)(i) forbids treating only a portion of a foreign tax as income taxes: "A foreign tax either is or is not a foreign income tax, in its entirety, for all persons subject to the foreign tax." Yet even though the Code would not provide a credit here, credit against the IRAP is explicitly guaranteed by the treaty. *But see Toulouse v. Comm'r*, 157 T.C. 49 (2021), discussed in II.C.2.

[71] *See, e.g.,* U.S.-U.K. Income Tax Treaty, art. 24(3); U.S.-Norway Income Tax Treaty, art. 23(1)(b).

[72] *See* U.S.-U.K. Income Tax Treaty, Technical Explanation, art. 24(3).

[73] U.S.-U.K. Income Tax Treaty, Technical Explanation, art. 24(3), noting that the U.K. petroleum tax is creditable only to the extent it is imposed on income from U.K. extraction activities, but that other, non-creditable, U.K. taxes are also imposed on income from such activities and that the tax itself is imposed on income from certain non-extraction activities.

[74] U.S.-U.K. Income Tax Treaty, art. 24(3)(b), and accompanying Technical Explanation, art. 24(3).

[75] Technical Explanation to the 1996 U.S. Model Treaty, art. 23(2).

[76] *See* discussion of the ordinary credit method above at II.A.2.

[77] *See, e.g.,* U.S.-Australia Income Tax Treaty, art. 22(2); U.S.-Ireland Income Tax Treaty, art. 24(4); U.S.-Japan Income Tax Treaty, art. 23(1); U.S.-U.K. Income Tax Treaty, art. 24(4). *See also* U.S.-Mexico Income Tax Treaty, art. 24(1) (reciprocal "subject to the limitations of [domestic] law" proviso).

[78] *See, e.g.,* U.S.-China Income Tax Treaty, art. 22(1)(a); U.S.-Egypt Income Tax Treaty, art. 25(2).

[79] *See, e.g.,* U.S.-Germany Income Tax Treaty, art. 23 (exemption and credit method); U.S.-Luxembourg Income Tax Treaty, art. 25 (exemption and credit method); U.S.-Netherlands Income Tax Treaty, art. 25 (exemption and credit method). *See also* U.S.-Venezuela Income Tax Treaty, art. 24 (exemption *or* credit method). Note that in some treaties pursuant to which the other country provides double taxation relief via credit, the language of the relevant provision literally states that the country will provide a "deduction" from the tax (or similar). This generally refers not to a deduction in the common, U.S. law sense, but instead a deduction from the foreign tax that would otherwise be due — meaning, a credit. *See, e.g.,* Technical Explanation to U.S.-Portugal Income Tax Treaty, art. 25(3) ("Portugal shall provide a 'deduction from tax,' i.e., a credit, for taxes paid to the United States by a Portuguese resident.").

[80] *See, e.g.,* U.S.-Belgium Income Tax Treaty, art. 22(1); U.S.-Bulgaria Income Tax Treaty, art. 22(1).

[81] *See, e.g.,* U.S.-Belgium Income Tax Treaty, art. 22(1)(a) ("Where a resident of Belgium derives income … which is taxed in the United States … Belgium shall exempt such income from tax but may, in calculating the amount of tax on the remainder of the income of that resident, apply the rate of tax which would have been applicable if such income had not been exempted."). This is the "exemption with progression" system referred to in II.A.4., above.

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from Country X sources. Country X's domestic law applies a 10% rate to the first $15,000 of a taxpayer's income and a 30% rate to any income in excess of $15,000. suant to the relief from double tax article of the U.S.-X Income Tax Treary, Country X exempts the $10,000 of U.S.-source income earned through the U.S. PE. The Country X tax on the remaining $20,000 of income is $5,000 (10% rate applied against the first $5,000, or $500, and 30% rate applied against the remaining $15,000, or $4,500). Without this provision, the Country X tax would have been only $3,000. That is, if the exempt income were not taken into account in determining the applicable tax rate, the $20,000 of non-exempt income would have been subject to a 10% tax on the first $15,000, or $1,500 tax, plus a 30% rate on the remaining $5,000, or $1,500 tax, for a total of $3,000 tax.

Many treaties in force contain a provision similar to Article 23(4) of the 2006 and 2016 U.S. Model Treaties,[82] dealing with residents of the foreign treaty country who are also citizens of the United States.[83] The purpose of such provisions is to prevent double tax attributable to the fact that the United States asserts taxing jurisdiction on the basis of citizenship, but under applicable domestic law, provides "double tax relief" only to the extent the taxpayer has foreign-source income.

C. Taxes Covered

1. Income Taxes Covered by Treaties

Given the mechanism for reducing or eliminating double tax under the Relief from Double Tax Article of U.S. treaties (including Article 23 of the 2016 U.S. Model Treaty), the threshold issue for any taxpayer is to determine whether the relevant tax is covered by the treaty — and only then, which treaty country has taxing jurisdiction over the income subject to tax and the obligation to provide a credit or other relief.

Article 2 of most treaties, including the 2016 U.S. Model Treaty, identifies the taxes of the Contracting States to which the treaty applies. (With certain exceptions, this article typically also specifies that the protections afforded by the treaty are limited to the taxes listed therein.) Specifically, article 2(1) provides that the treaty applies to all "taxes on income imposed on behalf of a Contracting State irrespective of the manner in which they are levied." The 2016 U.S. Model Treaty, art. 2(2), further elaborates that "taxes on income" includes "all taxes imposed on total income, or on elements of income, including taxes on gains from the alienation of property."[84]

Article 2(3) of the 2016 U.S. Model Treaty lists existing taxes of the Contracting States that are "covered taxes" for purposes of the treaty. This means that the taxes listed in this provision of a treaty in force will be deemed to be income taxes for purposes of claiming double tax relief under Article 23 (Relief from Double Taxation) — even if such taxes would not be considered an "income tax" under section 901 or "a tax paid in lieu of a tax on income" under §903.[85] The U.S. taxes expressly covered by the 2016 U.S. Model Treaty are "federal income taxes imposed by the Internal Revenue Code (which do not include social security and unemployment taxes) and the federal taxes imposed on the investment income of foreign private foundations."[86] While this provision varies by treaty — usually in how it addresses certain social security or excise taxes (and sometimes other types of taxes) that are being intentionally included or excluded, the "federal income taxes imposed by the Internal Revenue Code" language is fairly standardized across U.S. treaties.[87]

In addition, Article 2(4) provides that legislation enacted by one of the Contracting States after the date that the treaty is signed will also be deemed to be income taxes under Article 2(3) if such newly enacted legislation is "identical or substantially similar" to the legislation listed in Article 2(3).

Rev. Rul. 2002-16 addresses the meaning of "identical or substantially similar" legislation in the context of such a treaty provision. In that ruling, the IRS confirmed that the Netherlands investment yield tax was substantially similar to a prior Dutch tax that was a "covered tax." In making the decision, the IRS applied a facts and circumstances test to determine whether the new Dutch tax was substantially similar to the prior Dutch tax.[88] It is not clear that the substitution of a vaguely defined facts and circumstance test is an analytical improvement over the vaguely defined term "substantially similar"; however, it appears that the IRS intended for the analysis to focus on whether the new Dutch tax was intended to tax effectively the same tax base as the prior Dutch tax.[89] The ruling also notes that

[82] *See* discussion of Article 23(4) of the 2016 U.S. Model Treaty at II.D.3.b., below.

[83] *See, e.g.,* U.S.-France Income Tax Treaty, art. 24(2)(b); U.S.-Germany Income Tax Treaty, art. 23(5); U.S.-Ireland Income Tax Treaty, art. 24(3).

[84] The Technical Explanation to the 2006 U.S. Model Treaty, art. 2(2), however, provides that the treaty "does not apply, however, to social security charges, or any other charges where there is a direct connection between the levy and individual benefits" and only applies to property taxes for purposes of Article 24 (Non-Discrimination). Nevertheless, the IRS opined that the so-called employee's portion of Federal Insurance Contribution Act (FICA), the social security tax imposed by §3101–§3128, was a "covered tax" under the U.S.-Japan Income Tax Treaty in force at that time, but that the so-called employer's portion of FICA was an excise tax and therefore not a "covered tax." See TAM 200017043.

[85] *See* FSA 1997 WL 33314914 ("For [a taxpayer] to be entitled to the [foreign tax] credits, it must: (1) identify the separate levies involved, and (2) establish that the levies themselves are either creditable 'income taxes' under section 901, taxes 'in lieu of' income taxes under section 903, *or taxes covered by an applicable income tax treaty*.") (emphasis added); FSA 200047041 (holding that the modified Canadian Income Tax Act tax was a creditable income tax for purposes of §901 and §903 under the U.S.-Canada Income Tax Treaty as then in effect, which specifically provided that such tax was to be considered an income tax, but was not a creditable tax for purposes of §901 and §903 under the former U.S.-Canada Income Tax Treaty, Mar. 1, 1942 (no longer in force), which provided only that the Canadian income taxes would be creditable subject to the otherwise applicable limits of those sections).

[86] Art. 2(3)(b).

[87] *See, e.g.,* U.S.-U.K. Income Tax Treaty, art. 2(3)(a)(i); U.S.-Canada Income Tax Treaty, art. II(2)(b); U.S.-India Income Tax Treaty, art. 2(1)(a); U.S.-France Income Tax Treaty, art. 2(1)(a)(i); U.S.-Finland Income Tax Treaty, art. 2(1)(b); U.S.-Portugal Income Tax Treaty, art. 2(1)(b)(i).

[88] Rev. Rul. 2002-16 ("There is no definitive test for whether a tax is substantially similar to a covered tax; rather, the outcome rests on the facts and circumstances of each particular case.").

[89] This apparent focus is seen in Rev. Rul. 2002-16, which analyzed the amount of the prior law's tax base covered by the new tax.

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the "substantially similar" inquiry will be revisited if the new legislation is further amended.[90]

The 2016 U.S. Model Treaty expands the scope of treaty coverage in only two situations: (1) Article 24 (Non-Discrimination) applies to "all" taxes, including those imposed by state and local governments, and (2) Article 26 (Exchange of Information and Administrative Assistance) applies to "all national" taxes. Thus, the prohibition on subjecting nonresidents to taxation that is more burdensome than that imposed on residents applies with respect to *all* (income and non-income) taxes, and the obligation of competent authorities to share relevant information applies with respect to *all national* (income and non-income) taxes.[91] Many U.S. treaties in force adopt one or both of these expansions.[92]

2. *U.S. Net Investment Income Tax*

Courts and taxpayers are currently wrestling with whether treaties can provide an independent basis for a foreign tax credit. This issue, while once primarily academic in nature, has become more prominent recently in the context of the 2022 foreign tax credit regulations[93] and the net investment income tax (NIIT).

The NIIT was introduced with the passage of the Affordable Care Act and imposes a 3.8% tax on income for individuals in certain circumstances. Usually, U.S. income-tax liability can be reduced using foreign tax credits, which generally offset income tax liabilities by the amount of foreign income taxes paid abroad on foreign-source income.[94] Those tax credits are authorized by §27 and §901(a), which allow credits to offset income taxes imposed under Chapter 1 of the Code. The NIIT, however, was codified in §1411, which is located in Chapter 2A of the Code. There is no indication that Congress placed §1411 in Chapter 2A to prevent taxpayers from claiming foreign tax credits.[95] But because §27 and §901(a) expressly provide foreign tax credits only for taxes imposed under Chapter 1, and the NIIT is codified in Chapter 2A, a foreign tax credit cannot be claimed using the Code.

Because taxpayers seeking to claim a foreign tax credit for NIIT liabilities have argued that tax treaties provide an independent basis for foreign tax credits. This issue first arose in *Toulouse v. Commissioner*,[96] a case before the Tax Court. There, an individual taxpayer sought to reduce NIIT by claiming a foreign tax credit for income taxes that were paid in France and Italy. The taxpayer acknowledged that, given §1411's location in Chapter 2A, the Code did not provide her a foreign tax credit. Instead, and pointed to the "Relief from Double Taxation" articles of both the French and Italian treaties, which require the United States to provide U.S. citizens and residents a credit for income taxes paid to France or Italy. As a U.S. citizen residing abroad during the relevant tax years, the taxpayer claimed that these treaties required the United States to allow the taxpayer to claim an independent treaty-based foreign tax credit, regardless of whether the provisions of §§27 and 901(a) would permit a statutory-based foreign tax credit.

The Tax Court denied the taxpayer's claim.[97] It explains the treaty section the taxpayer relied on in each of the treaties contained the same limiting language: the United States must allow a credit "[i]n accordance with the provisions and subject to the limitations of the law of the United States."[98] The Code allows foreign tax credits against income taxes arising under Chapter 1, not Chapter 2A, where the NIIT is located. Accordingly, the court reasoned that allowing a treaty-based credit against the NIIT would not be "[i]n accordance with [or] subject to the limitations of" U.S. law. The taxpayer pointed out that such a conclusion would make the "Relief from Double Taxation" provisions simply track the Code, rendering the treaty provisions superfluous. But the court responded that the treaties do not guarantee absolute relief from double taxation, and the statutory limitations of §§27 and 901(a) controlled.

Like *Toulouse*, the taxpayers in *Christensen v. United States*[99] relied on the U.S.-France Income Tax Treaty to claim a foreign tax credit against NIIT liabilities. Unlike the Tax Court in *Toulouse*, the court in *Christensen* permitted a treaty-based tax credit independent from the Code. In *Toulouse*, the taxpayer had relied on only Article 24(2)(a) of the treaty's "Relief from Double Taxation" article, which contained the limiting language discussed above. The taxpayers in *Christensen* also sought to rely on section Article 24(2)(a), arguing that the *Toulouse* court had misinterpreted the limiting language. The *Christensen* court refused to depart from *Toulouse* and found that the limiting language and the NIIT's placement in Chapter 2A made a tax credit unavailable.

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[90] Rev. Rul. 2002-16 ("If it is concluded that a newly enacted tax is substantially similar to a covered tax, it also becomes a covered tax, but remains so only until such time as it is amended. When that occurs, a separate analysis must be made to determine whether the amended tax is substantially similar to the taxes in force at the time the treaty was signed.").

[91] *See also* 2006 U.S. Model Treaty, art. 24(7) and 26(1), and TE to art. 2 of the 2006 Model Treaty (similarly expanding the scope of the 2006 U.S. Model Treaty beyond federal income taxes).

[92] *See, e.g.*, U.S.-Japan Income Tax Treaty, art. 24(6) and 26(1); U.S.-Germany Income Tax Treaty, art. 24(6) and 26(6); U.S.-U.K. Income Tax Treaty, art. 25(7).

[93] In early 2022, the IRS published new rules limiting taxpayers' ability to claim foreign tax credits in certain situations. T.D. 9959; 87 Fed. Reg. 276 (Jan. 4, 2022). These changes were met with both confusion and criticism, due in large part to their effect of denying a foreign tax credit to many ordinary-course foreign income taxes regularly borne by U.S. taxpayers. *See, e.g.*, Kim Blanchard, *Sources of Confusion: The Taxation of Cross-Border Royalty Income*, 51 Tax Mgmt. Int'l J., no. 12 (Dec. 2, 2022). This reality thrust the existence of an independent treaty-based credit into the forefront as this could now be many U.S. taxpayers' sole recourse for avoiding double taxation (other than potentially taking a deduction for foreign taxes paid). In July 2023, however, the IRS granted temporary relief, allowing taxpayers to apply the rules in effect before 2022 for taxable years beginning on or after December 28, 2021, and ending on or before December 31, 2023. Notice 2023-55, 2023-32 I.R.B. 427. In 2023, the IRS extended its temporary relief indefinitely. I.R.S. Notice 2023-80; 2023-52 I.R.B. 1583.

[94] The Code rarely provides for a complete offset, but those details are discussed elsewhere. *E.g.*, 6060 T.M., *The Foreign Tax Credit Limitation Under Section 904*.

[95] *See Christensen v. United States*, 168 Fed. Cl. 263, 331 (2023).

[96] 157 T.C. 49 (2021).

[97] *Toulouse* was decided on summary judgment. The taxpayer never appealed.

[98] Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and Capital, Fr.-U.S., art. 24(2)(a), Aug. 31, 1994, 1963 U.N.T.S. 67, as supplemented by Protocols dated Dec. 8, 2004, and Jan. 13, 2009 (U.S.-Fr. Treaty); Convention for the Avoidance of Double Taxation With Respect to Taxes on Income and the Prevention of Fraud or Fiscal Evasion, It.-U.S., art. 23(2)(a), Aug. 25, 1999, T.I.A.S. No. 09-1216, as supplemented by Protocol dated Aug. 25, 1999 (U.S.-It. Treaty).

[99] 168 Fed. Cl. 263 (2023).

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But unlike the taxpayer in *Toulouse*, the taxpayers in *Christensen* also relied on Article 24(2)(b) of the French treaty. That article specifically applies to U.S. citizens residing in France and establishes the amounts of credits that can be claimed in the U.S. and France for certain taxes. Importantly, Article 24(2)(b) does not contain the limiting language found in Article 24(2)(a). The *Christensen* court reasoned that, given the absence of this limiting language, Article 24(2)(b) provided a credit independent of the Code. And because the taxpayers were U.S. citizens residing in France, they could claim this treaty-based credit against their NIIT liabilities.

The government has appealed its loss in *Christensen*, and that appeal remains pending.[100] In a subsequent case brought in the Court of Federal Claims, *Bruyea v. United States*,[101] the court held in favor of a taxpayer similarly claiming a treaty-based foreign tax credit under the U.S.-Canada Income Tax Treaty for NIIT paid. The availability of treaty-based credits for NIIT paid has also arisen in other cases,[102] and the issue is likely to recur until federal courts reach a consensus.

Comment: The lower courts in *Toulouse* and *Kim* found that the standard limiting language in the "Relief from Double Taxation" articles bars a foreign tax credit against the NIIT. Many commentators believe this result is incorrect.

Each of the treaties discussed in these cases covers "Federal income taxes imposed by the Internal Revenue Code."[103] And each extends to "substantially similar" taxes imposed after the date of the treaty's signature.[104] The NIIT, a tax on net investment *income*, is substantially similar to the income taxes that existed when these treaties were signed.[105] And presumably taxpayers need not rely on Code-based provisions akin to §§27 or 901(a) to claim these credits under a treaty. The Code itself contemplates treaty-based foreign tax credits: §6511, which provides deadlines for claiming a credit, establishes a 10-year statute of limitations for credits claimed "in accordance with the provisions of §901 *or the provisions of any treaty to which the United States is a party*."[106] Further, as explained by Treasury in the Technical Explanation to the U.S.-China Treaty: "The guarantee of a foreign tax credit provided in [the Relief from Double Tax in the U.S.-China Treaty] is independent of the statutory grant of a credit under §§901–903 of the Code, but the amount of the credit to be allowed is determined in accordance with the limitations provided in the Code (e.g., §904(h))."[107]

[100] *See Christensen v. United States*, No. 24-1284 (Fed. Cir. Dec. 22, 2023).

[101] No. 23-766T (Fed. Cl. Dec. 5, 2024).

[102] *See Kim v. United States*, 664 F. Supp. 3d 1062 (C.D. Cal. 2023) (similarly seeking treaty-based credit for NIIT under the U.S.-Korea Treaty; the government prevailed and the taxpayer did not appeal).

[103] U.S.-France Income Tax Treaty, art. 2(1)(a)(i); U.S.-Italy Income Tax Treaty, art. 2(2)(a); S. Korea-U.S. Income Tax Treaty, art. 1(1)(a).

[104] U.S.-France Income Tax Treaty, art. 2(2); U.S.-Italy Income Tax Treaty, art. 2(3); U.S.-South Korea Income Tax Treaty, art. 1(2).

[105] *See* Kim Blanchard, *The Tax Court's Erroneous Decision in Toulouse*, 50 Tax Mgmt. Int'l J., no. 10 (Oct. 1, 2021).

[106] §6511(d)(3)(A) (emphasis added).

[107] Technical Explanation to the U.S.-China Income Tax Treaty, art. 22(2).

D. Re-Sourcing Relief for Income Source Mismatches

1. General Re-Sourcing Issue and Types of Re-Sourcing Provisions

As discussed in II. above, even without a treaty, U.S. domestic law generally provides a tax credit for foreign taxes paid with respect to foreign-source income earned by a U.S. person, subject to the limitations of section 904 and other Code provisions. Given that the United States (and in many cases, also other countries that are party to U.S. treaties) already provide a foreign tax credit mechanism under domestic law, the double taxation relief expressly provided by treaties is arguably superfluous — except in cases where the treaty provides broader foreign tax credit rights than may be available under domestic law. One such instance of this is sourcing mismatches. For example, a foreign country may assert taxing authority over income that U.S. domestic law defines as U.S. source. (Indeed, a tax treaty may even cede primary taxing jurisdiction over such income to the foreign country.) If such income is not recharacterized as foreign-source income — commonly referred to as "re-sourced" income — the taxpayer generally would not be protected from double taxation because for U.S. purposes foreign tax credits are generally available only for taxes paid on foreign-source (not U.S.-source) income. A treaty's re-sourcing language, typically included in the Relief from Double Taxation article of modern U.S. treaties, enables a U.S. person to claim an otherwise unavailable foreign tax credit by causing certain U.S.-source income to be treated as foreign-source income for U.S. purposes.

For a case illustrating how the absence of a re-sourcing provision in an applicable treaty results in double taxation, see *Filler v. Commissioner*.[108] That case involved a U.S. citizen who was a resident of and employed in France. He spent a few days a year on business in the United States, resulting in an allocation of a small portion of his income to U.S. sources under domestic U.S. tax law. France asserted the right to tax his entire income on the basis of residence, and under the personal services article of the then-applicable treaty,[109] would have had sole jurisdiction to tax this income because he was not resident of the United States. However, due to the Saving Clause,[110] the Tax Court held that the United States retained the right to tax him as a U.S. citizen. The Tax Court further held that the relief from double taxation article of the treaty (as then in effect) neither prevented the United States from taxing the income, nor required a credit for French taxes paid on the U.S.-source income:

> [T]he effect of [the Saving Clause] is to reserve the right of the United States to tax its citizens and residents on the basis of the provisions of the Internal Revenue Code without regard to the provisions of the treaty … . [T]he savings clause … has the effect of providing that the source of income allocation rules

[108] 74 T.C. 406 (1980). The applicable treaty was the U.S.-France Income Tax Treaty of 1967, as amended by the 1970 protocol.

[109] Under that provision, standing alone, the United States would not have had the power to tax such income because the taxpayer was not present in the United States for a period exceeding 183 days.

[110] *See* II., above.

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found in the Internal Revenue Code are applicable to U.S. citizens, rather than the provisions of [the personal services article]. … *Thus, it seems clear that in [the Relief from Double Taxation article] of the Convention, the United States consented only to provide a foreign tax credit on income attributable to sources in France, as determined under the source of income rules of the Internal Revenue Code, and not to income from United States sources.*[111]

Thus, the court implicitly rejected the position that income should be re-sourced to avoid double taxation in the absence of a specific re-sourcing treaty provision.[112] The unfortunate taxpayer's only remaining remedy would be to seek competent authority relief.[113]

U.S. model treaties and many U.S. treaties in force have since adopted a variety of explicit re-sourcing provisions to avoid this result. Although varying in specifics, such re-sourcing provisions generally attempt to avoid double taxation by sourcing the income in question consistent with the treaty's assignment of primary taxing jurisdiction, thereby enabling a taxpayer to claim a foreign tax credit with respect to the income.

Very generally, there are four types of re-sourcing provisions in U.S. treaties.[114] The first type uses a general (or blanket) re-sourcing approach. This type of re-sourcing provision first appeared in the 1981 U.S. Model Treaty[115] and offers taxpayers the most comprehensive relief. It is contained in the 2016 U.S. Model Treaty as well as a number of U.S. income tax treaties currently in force, including the treaties with Germany, Japan, the United Kingdom and China.[116] The Technical Explanation to Article 23(3) of the 2006 U.S. Model Treaty explains that such an approach is "intended to ensure that a U.S. resident can obtain an appropriate amount of U.S. foreign tax credit for income taxes paid to the other Contracting State when the Convention assigns to the other Contracting State primary taxing rights over an item of gross income." The key re-sourcing language under this approach typically reads something like this:

> For purposes of applying the [Relief from Double Taxation paragraph granting a U.S. foreign tax credit], an item of gross income … derived by a resident of the United States that, under this Convention, may be taxed in [the foreign treaty country] shall be deemed to be income from sources in [that foreign treaty country].[117]

The second, more limited type of re-sourcing provision in U.S. treaties re-sources only certain types of income, generally that earned by U.S. citizens residing in the treaty partner country. U.S. treaties containing this more limited re-sourcing approach include treaties with Denmark, France, South Africa, and Switzerland.[118] The problem with such a re-sourcing provision can be illustrated as follows: assume a U.S. citizen does not reside in the foreign treaty country, but instead resides in the United States. If an item of income is subject to tax by that foreign country, but is considered U.S.-source income under the Code, no relief from double taxation would presumably be available to such U.S. individual because the United States generally limits its obligation to provide foreign tax credits to taxes imposed on foreign-source income.

The third type of re-sourcing provision in U.S. treaties contains a general re-sourcing rule, but it is made expressly subject to domestic sourcing rules that apply for purposes of limiting the foreign tax credit. U.S. treaties containing this type of re-sourcing provision include treaties with Luxembourg, Austria, Estonia, Latvia, Sweden, Thailand and India.[119] ,[120] Al-

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[111] 74 T.C. at 410–13 (footnotes and citations omitted, emphasis added).

[112] GCM 38792 (Aug. 28, 1981) similarly refused to imply a re-sourcing provision more liberal than that literally applying under the amended U.S.-France Income Tax Treaty re-sourcing rule to relieve a U.S. citizen resident in France from double taxation on alimony income — alimony not being a type of income specifically included in the applicable re-sourcing provision of the treaty. Subsequent treaties, including the U.S. model treaties and the U.S.-France Income Tax Treary now in force, have addressed the specific issue arising in *Filler* — that is, the double tax that can arise when a U.S. citizen is a resident of a treaty partner. *See* discussion at II.D.3., below.

[113] *See* V.B., below. In addition to case-by-case resolution, competent authorities sometimes enter into general agreements designed to address recurring instances of double taxation. For example, a 1997 agreement between the U.S. and French competent authorities alleviates double taxation for compensation received for services rendered to the French government by a U.S. permanent resident; the agreement requires the United States to grant a foreign tax credit for French taxes on such compensation, even though the income would be considered U.S. source under U.S. domestic law. Announcement 97-61.

[114] *See* N.Y. State Bar Association Tax Section, *Report on Treaty Re-Sourcing Rules*, Nov. 24, 2014, *available at* http://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Reports_2014/Tax_Section_Report_1313.html (discussing the four types of treaty re-sourcing provisions in U.S. treaties).

[115] *See* 2006 U.S. Model Treaty, art. 23(3) and (4) and 2016 U.S. Model Treaty, art. 23(3) and (4).

[116] *See* 2016 U.S. Model Treaty, art. 23(3); U.S.-Japan Income Tax Treaty, art. 23(2); U.S.-Germany Income Tax Treaty, art. 23(2); U.S.-U.K. Income Tax Treaty, art. 24(2) and (5); U.S.-China Income Tax Treaty, art. 22(3) ("Income derived by a resident of a Contracting State which may be taxed in the other Contracting State in accordance with this Agreement shall be deemed to arise in that other Contracting State."). *See also* Article 23(2) of the 2022 proposed U.S.-Croatia Income Tax Treaty.

[117] 2016 U.S. Model Treaty, art. 23(3).

[118] *See* U.S.-Denmark Income Tax Treaty, art. 23(2); U.S.-France Income Tax Treaty, art. 24(2); U.S.-South Africa Income Tax Treaty, art. 23(2); U.S.-Switzerland Income Tax Treaty, art. 23(3). In these treaties, limited sourcing language may also (or instead) be included within the operative treaty article specific to a particular type of income or, in some older treaties, in a standalone sourcing provision. *See, e.g.*, U.S.-Italy Income Tax Treaty, art. 23(4) (sourcing for U.S. citizens resident in Italy), 23(5) (sourcing for certain government services), 11(6) and (8) (sourcing for certain interest), 12(6) (sourcing for royalties). *See also* discussion below on the fourth category of re-sourcing approaches, *infra*.

[119] *See* U.S.-Luxembourg Income Tax Treaty, art. 25(4) (key re-sourcing language in Relief from Double Taxation made "subject to such source rules in the domestic laws of the Contracting States as apply for purposes of limiting the foreign tax credit"); U.S.-Austria Income Tax Treaty, art. 22(4); U.S.-Estonia Income Tax Treaty, art. 23(3); U.S.-Latvia Income Tax Treaty, art. 24(3); U.S.-Sweden Income Tax Treaty, art. 23(4); U.S.-Thailand Income Tax Treaty, art. 25(3); U.S.-India Income Tax Treaty, art. 25(3). Most treaties with this domestic source rule proviso do, however, nevertheless expressly empower the competent authorities to address source mismatches in the Mutual Agreement Procedure article. *See, e.g.*, U.S.-Luxembourg Income Tax Treaty, art. 27(3) (MAP article expressly authorizing competent authorities to agree on "common determination" of source for items of income); U.S.-Latvia Income Tax Treaty, art. 26(3) ("The competent authorities of the Contracting States shall endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. In particular the competent authorities of the Contracting States may agree … to the same application of source rules with respect to particular items of income"); U.S.-Sweden Income Tax Treaty, art. 25(3); U.S.-Austria Income Tax Treaty, art. 24(3); U.S.-Estonia Income Tax Treaty, art. 25(3).

[120] India is an interesting example of a treaty in this category, in part because it contains a slightly modified version of the "subject to" language, and in part because as a practical matter it is not necessarily uncommon to en-

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though the subject of much debate and uncertainty, presumably such "subject to domestic source laws" language is not intended to wholly undermine the treaty's re-sourcing rule by causing all conflicting domestic sourcing rules to trump the treaty re-sourcing rule (thus effectively rendering the re-sourcing provision moot). Instead, it is generally believed this language was likely included to ensure appropriate application of certain U.S. foreign tax credit limitations contained in §904 for U.S. purposes.[121]

The fourth type of re-sourcing provision is found in certain older U.S. treaties that generally provide sourcing rules specific to particular types of income addressed by the treaty, including in many of them a location-of-sale test for sourcing sales of personal property. In these treaties, the sourcing language may be incorporated directly into one or more various operative articles addressing the relevant types of income or, alternatively, set forth in a stand-alone sourcing article (usually separate from the Relief from Double Taxation article). Included in this category are U.S. treaties with Cyprus, Egypt, Indonesia, Israel, Korea, Morocco and Norway.[122]

counter double taxation with India. The Technical Explanation to Article 25 of the U.S.-India Income Tax Treaty specifically provides:

> [The re-sourcing provision within the Relief from Double Tax article] provides rules for determining the source of income for purposes of the [U.S.-India] treaty foreign tax credit. The general rule is (1) that income of a resident of a Contracting State is deemed to arise in the other Contracting State, if that other State is given the right to tax that income by the Convention, so long as that taxing right is not solely on the basis of citizenship in accordance with the saving clause … and (2) if a resident of a Contracting State derives income which, in accordance with the Convention, may not be taxed in the other State, the income is deemed, for purposes of the credit, to be sourced in the first-mentioned Contracting State. *If, however, the rules in the laws of a Contracting State for the determination of source of income for foreign tax credit purposes differ from the general rule stated above, the statutory rule will apply.* This granting of precedence of statutory source rules over the treaty source rule, however, does not apply to determining the source for credit purposes of [royalties and certain service fees dealt with in one specific article of the treaty].

Technical Explanation to U.S.-India Income Tax Treaty, art. 25(3) (emphasis added). *See also* New York State Bar Association, *Report on Treaty Re-sourcing Rules,* at 28–30 (November 24, 2014).

[121] *See, e.g.*, New York State Bar Association, *Report on Treaty Re-sourcing Rules*, at 28–30 (November 24, 2014).

[122] For examples of U.S. treaties with a stand-alone sourcing provision, *see e.g.,* U.S.-Israel Income Tax Treaty, art. 4; U.S.-Cyprus Income Tax Treaty, art. 6; U.S.-Egypt Income Tax Treaty, art. 4; U.S.-Indonesia Income Tax Treaty, art. 7; U.S.-Morocco Income Tax Treaty, art. 5; U.S.-Norway Income Tax Treaty, art. 24; U.S.-Republic of Korea Income Tax Treaty, art. 6. For examples of U.S. treaties with (limited) sourcing rules scattered throughout selected operative provisions but containing no general re-sourcing language, *see, e.g.,* U.S.-Greece Income Tax Treaty, art. 3(2) and (3) (sourcing rules for PEs); U.S.-Poland Income Tax Treaty, art. 12(5) (interest sourcing) and 13(5) (royalty sourcing) (note however, that the pending 2013 U.S.-Poland Treaty incorporates a modern re-sourcing provision in the Relief from Double Taxation article); U.S.-Venezuela Income Tax Treaty, art. 11(7) (interest sourcing), 12(5) (royalty sourcing) and 26(3) (competent authorities shall endeavor to address, among other things, source mismatches). *See also* footnote [88], *supra.* Significantly, it should be noted that interaction with the Saving Clause can potentially undermine the usefulness of sourcing language located outside of a treaty's Relief from Double Taxation article. For discussion of the Saving Clause, *see* III., below.

2. *Additional Source-Mismatch Examples*

Although in most instances a treaty's assignment of taxing rights generally will be consistent with U.S. domestic sourcing rules, sourcing mismatches can, and do, still arise in a variety of circumstances. In each of the following examples, the mismatch could result in double taxation in the absence of re-sourcing relief.[123]

> *Example 1:* Individual I is a U.S. citizen who is a resident of Country X. I is the beneficiary of several U.S. trusts that hold marketable securities consisting primarily of publicly traded stocks. I does not have any non-U.S.-source income other than through these trusts. Under Country X's tax law, a capital gains tax is imposed upon Country X resident-beneficiaries arising from the deemed disposition of certain trust assets each year. I is subject to the Country X tax because I resides in Country X.
>
> Assume that the Country X capital gains tax rate is 9%; that the Country X capital gains tax triggered by the deemed sale is considered a creditable foreign tax for U.S. federal income tax purposes; and that the Country X tax rules treat the gain as Country X-source income.
>
> As discussed above, the §904 limitation may disallow a U.S. foreign tax credit for the Country X imposed on this trust income since it would be considered U.S.-source income for U.S. purposes. Specifically, §865(a)(2) provides the general domestic sourcing rule that income from the sale of personal property is sourced outside the United States if sold by a nonresident of the United States (such as individual I). Section 865(g)(2), however, essentially turns off this general rule for nonresidents who are U.S. citizens (such as I) unless the gain is subject to foreign income tax of at least 10%.[124]
>
> Consequently, the §865 sourcing rules do not source the taxable gain outside the United States. Thus, in the absence of a treaty re-sourcing provision, individual I will generally be unable to claim a foreign tax credit for the Country X tax paid on the deemed disposition.[125]
>
> *Example 2:* A U.S. corporation (US Corp) is a U.S. resident eligible for benefits under the U.S.-X Income Tax Treaty. It directly owns 75% of the stock in a Country X holding company (X Corp), which owns significant Country X real estate. Country X taxes gain from the sale of stock in Country X companies that own Country X real

[123] Note that treaty re-sourcing relief alone may not be sufficient to address all mismatches, including when a particular taxpayer's facts do not fall within the relevant treaty's re-sourcing language (which, as discussed above can vary from treaty to treaty) as well as certain timing mismatches. *See* N.Y. State Bar Ass'n, *Report on the Model Income Tax Convention Released by the Treasury on November 15, 2006*, Report No. 1127, at 49–50 (Apr. 11, 2007), *available at* http://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Reports_2007/1127_Report_pdf.html.

[124] *See also* §865(e)(1) (providing similar sourcing rules and a minimum 10% foreign country income tax for sales of personal property by a U.S. citizen attributable to an office or other fixed pace of business in a foreign country).

[125] Note that even if the relevant treaty has a re-sourcing provision, it may not necessarily apply or otherwise be broad enough to address this situation. In that case, individual I would need to seek competent authority relief.

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estate under domestic Country X rules (i.e., rules conceptually similar to the U.S. FIRPTA regime), and that such gains are likewise permitted to be taxed by Country X under the U.S.-X Income Tax Treaty. When US Corp sells its X Corp stock, it will be subject to Country X tax on the gain (as well as U.S. corporate income tax under U.S. domestic law due to the Saving Clause). Under §865, such gain would generally be U.S.-source income. Therefore, absent re-sourcing relief, the Country X tax paid would generally be ineligible for a U.S. foreign tax credit and double tax will result.

Example 3: Directors' fees. Individual I is a resident of the United States and provides director's services for a corporation resident in Country X, with which the United States has a treaty. Article 15 of the 2016 U.S. Model and a number of U.S. treaties in force generally provide that such fees may be taxed by the other country to the extent the services are rendered in the other country. Such fees attributable to services performed in the other country (i.e., outside the United States) would generally be compensation treated as foreign-source income under section 862(a)(3) for which a U.S. foreign tax credit would generally be available and re-sourcing would be unnecessary. However, some treaties to which the United States is a party do *not* limit the treaty partner's right to tax director's fees solely to compensation attributable to services performed in that country (i.e., here, in Country X).[126] In such a case, Country X could tax individual I on all compensation received for director services including those performed in the United States. The portion of such income attributable to his U.S.-based services would generally be deemed U.S.-source income under U.S. domestic law, and therefore ineligible for a U.S. foreign tax credit in the absence of an applicable treaty re-sourcing provision.[127]

Example 4: A foreign corporation resident in Country X (Foreign Co) earns all of its income from operations in the United States. Individual I, a U.S. citizen and resident, owns 5 percent of the Foreign Co stock. Any dividend paid to I would be subject to withholding tax under Country X domestic law as well as the U.S.-X Income Tax Treaty (albeit at a reduced rate, as is the case in most U.S. treaties). The dividend would, however, generally be treated as U.S.-source income under §861(a)(2)(B) for U.S. purposes.[128] Accordingly, absent an applicable treaty re-sourcing provision, relief from double tax for the U.S. shareholder is not assured.

Example 5: Assume that U.S. citizens employed by a U.S. company (US Corp) prepare architectural drawings for a construction project in Country X. US Corp also provides certain advisory services to a local Country X construction company in connection with the drawings. The ancillary services are provided in the United States by U.S.-based employees. US Corp does not have a PE in Country X, and none of US Corp's services-related income is foreign-source income under U.S. law. Under Country X domestic law, however, such technical services are subject to tax by Country X.[129] In the absence of re-sourcing rules that treats such income as foreign source, US Corp will be unable to claim a foreign tax credit for the Country X taxes paid on this service income.[130]

Example 6: Individual I is a U.S. citizen and resident who owns 30 percent of the stock of Corporation C, a Country X corporation. Individual I sells all of her Corporation C stock. Country X domestic tax law imposes tax on stock sales by significant shareholders of Country X corporations, including sales by non-Country X citizens or residents such as I.[131] Assume I has no foreign-source income. Generally, the sale of stock by a U.S. resident is U.S.-source income under §865(a)(1). In the absence of an applicable treaty re-sourcing provision treating such income as foreign source, I will be unable to claim a foreign tax credit for the Country X taxes paid on the stock sale.[132]

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[126] *See, e.g.*, U.S.-Switzerland Income Tax Treaty, art. 16; U.S.-Denmark Income Tax Treaty, art. 16; U.S.-China Treaty, art. 15; U.S.-Latvia Income Tax Treaty, art. 16; U.S.-India Income Tax Treaty, art. 17. *See also* Technical Explanation to U.S.-India Income Tax Treaty, art. 17 ("a resident of one Contracting State who is a director of a corporation which is resident in the other Contracting State is subject to tax in that other State in respect of his directors' fees regardless of where the services are performed").

[127] As discussed in II.D.1., above, the specific re-sourcing language as well as the breadth of relief conferred can vary widely by treaty. Inevitably, some fact patterns fall through the cracks. The U.S.-Italy Treaty, for example, contains somewhat limited re-sourcing language, and the situation described in example three could result in double taxation under this treaty absent competent authority relief. In particular, the re-sourcing language in Article 23 of the U.S.-Italy Treaty provides relief to only certain Italian residents and dual citizens (neither of which would apply to I, a U.S. resident).

[128] Assume I is the only U.S. shareholder and thus §904(h) does not apply.

[129] *See, e.g.*, Article 12 of the U.S.-India Income Tax Treaty, dealing with income from certain technical and consultancy services, which permits either country to impose withholding tax with respect to such services, even if the services are performed in the other country.

[130] If country X in this example were India, Article 25(3) of the U.S.-India Treaty contains a re-sourcing provision that should eliminate the issue. Although the general re-sourcing provision in the U.S.-India Income Tax Treaty is generally neutered by a sentence that states "the determination of the source of income for purposes of [the Relief from Double Taxation article] shall be subject to such source rules in the domestic laws of the Contracting States as apply for the purpose of limiting the foreign tax credit," the next sentence relaxes this rule specifically (and only) for income related to certain technical and consultancy services: "The preceding sentence shall not apply with respect to income dealt with in Article 12 (Royalties and Fees for Included Services)."

[131] *See, e.g.*, U.S.-China Income Tax Treaty, art. 12(5) (permitting a Contracting State to tax gains from the sale of stock representing a 25% participation in a company resident in that Contracting State); U.S.-Israel Income Tax Treaty, art. 15(1).

[132] If Country X were China, article 22(3) of the U.S.-China Income Tax Treaty contains a general re-sourcing provision that should eliminate this problem.

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In each of these cases, the absence of a re-sourcing provision will likely lead to double taxation. The various U.S. model treaties, as well as treaties in force, have attempted to address this problem in a variety of ways.[133]

3. *The U.S. Model Treaty*

a. *General Re-Sourcing Language*

Article 23(3) of the 2016 model treaty provides:

> For the purposes of applying paragraph 2 of this Article, an item of gross income, as determined under the laws of the United States, derived by a resident of the United States that, under this Convention, may be taxed in ----- shall be deemed to be income from sources in -----.[134]

In other words, if under the treaty the other country is permitted to tax an item of income derived by a U.S. resident, the United States will treat that income as foreign source for U.S. foreign tax credit purposes. This rule is necessary (or at least desirable from a certainty standpoint) to enable the U.S. resident to receive the appropriate foreign tax credit for foreign taxes paid on such income.

As described above, however, for U.S. purposes, the available credit amount is nonetheless generally "subject to the limitations of" U.S. domestic law. What this means, as described above, is that the U.S. foreign tax credit limitations of section 904 still generally apply. Thus, for example, the re-sourcing benefit conferred by the treaty generally applies to gross, not net, income — i. e., U.S. tax rules governing the allocation and apportionment of expenses[135] generally apply for determining the relevant amount of net income for foreign tax credit purposes.[136]

This reference to U.S. law expense allocation rules can in itself create mismatches similar to the income source mismatches targeted by the general re-sourcing provision. For example, even if an item of gross income is deemed to be foreign source, double tax could result to the extent U.S. law allocated more expense to the foreign-source income than provided under the relevant foreign law. This would have the effect of reducing the amount of foreign-source income, thus reducing the amount of foreign taxes eligible for the U.S. foreign tax credit because the §904 foreign tax credit limitation is imposed on the basis of relative (foreign-source versus U.S.-source) taxable income. More complete double tax relief could be afforded by requiring the country granting the credit (in this case the United States) to allocate expenses to income consistent with the domestic tax rules of the country with primary taxing jurisdiction over that income.[137] The U.S. Model Treaty does not take this approach, however.

It should be noted that the technical explanation to the 2006 U.S. Model Treaty arguably created some unnecessary uncertainty about the precise scope and application of the general re-sourcing rule, and without a 2016 technical explanation, this uncertainty remains unresolved in the 2016 U.S. Model Treaty. Specifically, under the language of the 2006 and 2016 U.S. model treaties, the key re-sourcing provision applies with respect to "an item of gross income … derived by a resident of the United States that, under this Convention, *may* be taxed in [the other country],"[138] while the 2006 technical explanation states that this re-sourcing rule applies to provide relief when the treaty "assigns to the Other Contracting State *primary taxing rights* over an item of gross income."[139] It is not clear if the drafters of the Technical Explanation intended that the formulation "primary taxing rights" have any significance, but at least on its face the phrase "primary taxing rights" seems more restrictive than "may" tax. For example, a foreign treaty country "may" impose income tax on director fees earned by a U.S. resident for U.S.-based services, capital gains tax on certain sales of stock in a foreign corporation by a U.S. shareholder or (limited) withholding tax on dividends paid by a foreign corporation to a U.S. shareholder — but such fees, gains and dividends will also generally be subject to tax by the United States. It is a matter of semantics which country has the "primary" right to tax such dividends. One could argue that it is the United States because its right to tax the recipient is not limited, particularly in cases where the foreign treaty partner's ability to tax is capped (such as limiting withholding to 5% or 15%).[140] If this were the case, though, re-sourcing would not be available under the language of the Technical Explanation, at least if taken literally (because the U.S., not the other country, would presumably have primary taxing rights), while it would be available under the language of the treaty itself (since the other country "may" (also) tax the fees, capital gains and dividends).[141] It stands to reason that the treaty language would pre-

[133] There are also a limited number of (narrow) statutory re-sourcing provisions in the Code, which are discussed in II.D.5., below.

[134] The 2006 U.S. model treaty contained identical re-sourcing language. The 1996 Model did not include a general re-sourcing provision (other than a limited re-sourcing rule applicable to U.S. citizens resident in the other treaty country subject to U.S. tax due to the Saving Clause), and the 1996 Technical Explanation did not explain why the general re-sourcing provision was dropped. Some commentators suggest that re-sourcing is implied under the general concept of double tax relief, so the drafters may have considered the re-sourcing provision unnecessary. *See, e.g.*, Donald A. Finlayson, *U.S. Source Income Earned by Foreign Branches and Affiliates*, 47 Tax Law. 349, 366–67 (1994). Alternatively, the drafters may have omitted the re-sourcing provision because they felt it would not be appropriate to provide relief to any greater extent than provided under U.S. domestic tax law; as such an attitude is at odds with a major purpose of the tax treaty network (relief from double taxation) however, it may also be that the drafters omitted a re-sourcing provision based on the belief that it would be more appropriate to address the issue on a case-by-case basis as actual treaties were negotiated. *See* Richard L. Doernberg & Kees van Raad, *The 1996 United States Model Income Tax Convention: Analysis, Commentary and Comparison* at 190 (1997).

[135] *See, e.g.*, Treas. Reg. §1.861-9.

[136] Technical Explanation to 2006 U.S. model treaty, art. 23(3) ("the credit against U.S. tax generally is limited to the amount of U.S. tax due with respect to net foreign source income within the relevant foreign tax credit limitation category" under §904).

[137] *See TEI Calls for Stronger Protection From Double Taxation*, 92 TNI 94-11 (Dec. 8, 1992). In its comments on a 1992 proposal to revise the 1981 U.S. Model Treaty, the Tax Executives Institute discussed this issue and recommended that the residence country be required to allocate expenses to an item of income consistent with the rules of the country with primary taxing jurisdiction over such income; but further suggested that "the residence country should be permitted … to apply its own rules to apportion expenses not directly allocable to any item of income (i.e., in accordance with section 861 of the Internal Revenue Code)."

[138] 2016 U.S. Model Treaty, art. 23(3) (emphasis added).

[139] 2006 Technical Explanation of Article 23(3) (emphasis added).

[140] *See* 2016 U.S. Model Treaty, art. 10(2).

[141] As a practical matter this question often might not present a difficulty for dividends, at least from a U.S. perspective, because dividends payable by a foreign corporation are usually foreign source under §862(a)(2); thus re-sourc-

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vail, so we flag the Technical Explanation's use of the "primary taxing rights" language as an area where clarification may be helpful.

b. U.S. Citizens Resident in the Other Contracting State

Article 23(4) of the 2006 and 2016 U.S. Model Treaties provide a special rule addressing the specific situation whereby U.S. citizens are residents of the foreign treaty country (thus directly addressing the problem presented in the *Filler* case, discussed in III.B.).[142] Some version of this provision is included in all modern U.S. treaties. This rule, commonly referred to as the "three bite rule," is necessitated by the fact that the United States taxes its citizens on their worldwide income, regardless of their residence or the existence of an applicable treaty.

The Saving Clause[143] (discussed in III., below) functions to preserve the right of the United States to tax its citizens in accordance with U.S. domestic tax law even if they are residents of a foreign treaty country — i.e., it essentially "turns off" otherwise available treaty relief, including eligibility for a lower rate (or elimination) of U.S. tax on U.S.-source income for which U.S. withholding is permitted under a treaty. The purpose of Article 23(4) is fundamentally to enable the United States and the other treaty country to coordinate the tax credit mechanics to prevent double tax while preserving the United States' right to tax its citizens on worldwide income by providing for sequential crediting and, to the extent necessary, re-sourcing of the relevant U.S.-source income. The policy underlying Article 23(4) is that the United States, and not the other country, should generally bear the burden of providing double tax relief in cases where double taxation results from the U.S. imposition of tax solely on the basis of U.S. citizenship — while still requiring that the foreign treaty country provide a credit with respect to the relevant item of U.S.-source income (i.e., before calculating the residual U.S. tax on worldwide income).[144]

Article 23(4)(a) provides that the foreign treaty country need not provide tax credits for U.S. taxes paid by a U.S. citizen who is a resident of that country in excess of the amount of tax the United States could impose if that person were not a U.S. citizen affected by the Saving Clause. For example, if the relevant treaty provided a 10% rate for withholding on U.S.-source dividends, but the United States imposed a rate of 33% on this income because the recipient is a U.S. citizen, the foreign treaty country's tax credit need not exceed 10%.

Of course, under such circumstances, the U.S. citizen would be subject to double taxation if the Other Contracting State's tax rate exceeded 10%.[145] To alleviate this double taxation, Article 23(4)(b) of the 2016 U.S. Model Treaty states that the United States will provide a tax credit for the other country's tax remaining after the credit provided in Article 23(4)(a) because of the taxpayer's U.S. citizenship. Such credit, however, may not reduce the U.S. tax creditable against the foreign country's tax under Article 24(4)(a), meaning that the United States need not offset U.S. tax to the extent it could be collected from a non-U.S. citizen resident of the foreign treaty country on the same type of income.

Finally to make the mechanics of this provision work (without generating excess credits), Article 23(4)(c) provides that the income described in Article 23(4)(a) is deemed to arise in the Other Contracting State to the extent necessary to provide double tax relief — thus re-sourcing it as foreign-source income for U.S. foreign tax credit purposes. As discussed above, such re-sourcing is necessary to avoid double taxation, permitting the United States to credit foreign taxes paid on such income without violating the foreign tax credit limitation rules under U.S. law.

The following examples from the Technical Explanation to the 2006 U.S. Model Treaty illustrate the application of Article 23(4):

> Assume a U.S.-source portfolio dividend of $100 is received by a U.S. citizen resident of the Foreign Country (FC). In the examples, the U.S. rate of withholding tax under the relevant treaty is 15%. In both examples, the U.S. income tax rate on the U.S. citizen is 35%. In Example 1, the income tax rate of FC on its residents (i.e., including the FC resident who is a U.S. citizen) is 25% (below the U.S. rate), and in Example 2, the rate on its residents is 40% (above the U.S. rate).

In Example 1, the amount resourced is the net post-credit FC tax ($10) divided by the U.S. tax rate (35%). In Example 2, because the FC tax rate exceeds the U.S. tax rate, the amount re-sourced is the maximum amount of the U.S. tax available for credit ($25) divided by the U.S. tax rate (35%). The 1996 Technical Explanation, art. 23, ¶3, containing a similar example based on a 36% tax rate, explains that: In order for a U.S. credit to be allowed for the full amount of the [FC] tax, an appropriate amount of the income must be resourced. The amount that must be resourced depends on the amount of [FC] tax for which the U.S. citizen is claiming a U.S. foreign tax credit. In example 1, the [FC] tax was $10.00. In order for this amount to be creditable against U.S. tax, $27.77 ($10 divided by .36) must be resourced as foreign source. When the [FC] tax is credited against the U.S. tax on the resourced income, there is a net U.S. tax of $11.00 due after credit. In example 2, [FC] tax was $25 but, because the amount available for credit is reduced under subparagraph 3(c) by the amount of the U.S. source tax, only $21.00 is eligible for credit. Accordingly, the amount that must be resourced is limited to the amount necessary to ensure a foreign tax credit for $21 of [FC] tax, or $58.33 ($21 divided by .36). Thus, even though [FC] tax was $25.00 and the U.S. tax available for credit was $21.00, there is no excess credit available for carryover.

ing to achieve double tax relief is not necessary unless the dividend falls within one of the narrow categories of dividends considered U.S.-source income under domestic law. *See* §861(a)(2)(B), (C).

[142] *Filler v. Commissioner*, 74 T.C. 406 (1980).

[143] 2016 U.S. Model Treaty, art. 1(4).

[144] This policy provides a result that is the opposite of the Tax Court's conclusion in *Filler* (that the French government erred by refusing to provide a French tax credit against the U.S. tax imposed on U.S.-source income earned by a U.S. citizen resident in France.)

[145] Thus, for example, if the foreign treaty country had a 30% tax rate, a U.S. citizen would pay a combined rate of 55% — 35% U.S. tax plus 30% foreign tax, less a 10% credit.

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	Example 1	Example 2
Article 23(4)(a)		
U.S. dividend declared	$100	$100
U.S. withholding tax	15	15
FC taxable income	100	100
FC tax before credit	25	40
FC foreign tax credit	15	15
Net post-credit FC tax	10	25
Article 23(4)(b) and (c)		
U.S. pre-tax income	$100	$100
U.S. pre-credit citizenship tax	35	35
U.S. withholding tax	15	15
U.S. tax available for credit	20	20
Tax paid to FC	10	25
Income re-sourced from U.S. to FC	28.57 ($10/.35)	57.14 ($25/.35)
Net post-credit U.S. tax	10	0
Total U.S. tax (withholding tax + net post-credit U.S. tax)	25	15

4. Hybrid Entities and Re-Sourcing

As discussed above, the 2006 and 2016 U.S. Model Treaties (as well as many treaties in force) provide for re-sourcing of what would otherwise be U.S.-source income to the extent such income is taxed by the treaty partner to provide relief from double taxation. In cases where the treaty partner also uses credits to relieve double taxation, the treaty typically contains a reciprocal re-sourcing provision to protect both country's residents from double taxation. Under this provision, income subject to tax by the United States is deemed to be U.S.-source income (just as income subject to tax by the foreign treaty partner is deemed to be foreign-source income for U.S. purposes).[146]

Application of such reciprocal re-sourcing rules in the case of income derived by a hybrid entity[147] is not always clear.[148] Consider the following example, based on the U.S.-U.K. Treaty's reciprocal re-sourcing provisions:

> *Example:* U.S. Corp wholly owns U.K. Entity. U.K. Entity checks the box to be disregarded for U.S. federal tax purposes, but it is treated as a separate taxable entity for U.K. purposes. U.K. Entity earns interest income. The interest income would be considered under U.S. law to be derived by U.S. Corp., a U.S. resident, because U.K. Entity is disregarded. Under U.K. law, however, the interest income would be subject to U.K. tax as income of a U.K. resident entity.

Under paragraph (2)(a) of the Relief from Double Taxation Article 24 of the U.S.-U.K. Income Tax Treaty (equivalent to Article 23(3) of the 2016 U.S. Model Treaty), an item of gross income derived by a resident of the United States but subject to tax by the United Kingdom is deemed to be U.K. source. Thus, the interest income should be considered U.K. source because it is considered derived by U.S. Corp., a U.S. resident, but is subject to taxation by the United Kingdom. However, under the reciprocal provision providing re-sourcing for the benefit of U.K. residents (Article 24(5)), income of a U.K. resident that may be taxed by the United States is deemed to arise from sources in the United States. Under U.K. law, the interest income is considered earned by U.K. Entity, but because it is subject to tax by the United States, it should be deemed U.S.-source income. Thus, the two provisions give circular, and diametrically opposed, results — depending on the starting point — the interest income can be viewed as U.S. source or U.K. source.

A workable resolution of this conflict would be to apply one or the other of the conflicting provisions, depending on which country's domestic tax law was implicated. Thus, in the example, U.K. Entity is considered a resident taxpayer of the United Kingdom under U.K. domestic tax law. It would thus be liable for U.K. income tax on its interest income. The United Kingdom would not consider U.S. Corp. as subject to the U.K. tax. The United States, by contrast, would treat U.K. Entity as a branch of U.S. Corp. (due to its disregarded status) and therefore consider U.S. Corp. to have paid the U.K. tax. Therefore, it would be appropriate to credit the U.K. tax against any U.S. tax due on the interest income, which would be foreign source under Article 24(2) of the U.S.-U.K Income Tax Treaty. Although this is a reasonable result, the provisions could be read to provide other results as well. For example, U.K. Entity could argue that the interest income was subject to U.S. tax and claim

[146] *See, e.g.,* U.S.-U.K. Income Tax Treaty, art. 24(5): "For the purposes of paragraph 4 of this Article, profits, income and chargeable gains owned by a resident of the United Kingdom which may be taxed in the United States in accordance with this Convention shall be deemed to arise from sources within the United States."

[147] A hybrid entity is an entity that is treated as fiscally transparent (i.e., a pass-through entity) under the tax law of one jurisdiction but as a separate taxpayer (i.e., an opaque entity) under the tax law of the other jurisdiction. For example, a U.S. shareholder may make a U.S. tax classification ("check the box") election to cause its wholly-owned foreign entity to be disregarded for U.S. federal income tax purposes. *See* Reg. §301.7701-3. But under the laws of the foreign treaty country, such entity may be treated as a separate taxpayer corporation. (Similarly, in a reverse hybrid situation, a U.S. entity may be recognized for U.S. federal tax purposes but disregarded as a separate entity under the laws of the other country.) The United States has entered into protocols to some of its treaties to clarify certain aspects of the treatment of hybrid entities under those treaties. *See, e.g.,* 2009 Protocol Amending U.S.-France Income Tax Treaty, art. 1(4) (adding new paragraph 3 to Article 4 of the existing U.S.-France Treaty); 2007 Protocol Amending U.S.-Canada Income Tax Treaty, art. 2(2) (adding paragraphs 6 and 7 to Article IV of the existing U.S.-Canada Treaty); 2013 Protocol Amending U.S.-Spain Treaty, art. 1(6), (adding new paragraph 6 to Article 1 on the existing U.S.-Spain Income Tax Treaty). *See also* 2016 U.S. Model Treaty, art. 1(6).

[148] Much of the following discussion and example is indebted to Philip D. Morrison, *Re-Sourcing Income Under Treaties — Issues With Hybrid Entities,* 36 Tax Mgmt. Int'l J. 385 (Aug. 10, 2007).

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a credit. Under Article 24(5), the interest income would be U.S. source because it is subject to U.S. tax.

In the case of the U.S.-U.K. Income Tax Treaty, the Notes exchanged between the two governments resolve this apparent conflict. The Notes recognize that the treaty may permit one treaty partner (in our example, the United States) to tax its citizens or residents on income derived through a fiscally transparent entity, and may permit the other country (the United Kingdom) to tax the fiscally transparent entity on the same income:

> Under such circumstances, the tax paid or accrued by the entity shall be treated as if it were paid or accrued by the first-mentioned person [in our example, U.S. Corp.] for the purposes of determining the relief from double taxation to be allowed by the State of which that first mentioned person is a resident (or, in the case of the United States, a citizen) [in our example, the United States] … . It is further understood that paragraphs 2 and 5 of Article 24 shall apply to such an item of income, profit or gain to the extent necessary to provide relief from double taxation.[149]

In other words, the diplomatic Notes resolve the issue by adopting the first option in the preceding paragraph; the tax is treated as paid by U.S. Corp., with the income sourced to the United Kingdom for purposes of granting U.S. foreign tax credit relief to U.S. Corp. But in the absence of such clarifying diplomatic Notes, it would not be clear how the reciprocal re-sourcing provisions should be applied to effect double tax relief. It would be helpful if such clarification were provided in the case of other U.S. treaties containing similar reciprocal re-sourcing provisions for which competent authority agreements or guidance has not been published.[150]

5. Re-Sourcing Rules in the Code

a. Separate Foreign Tax Credit Limitation for Income Re-Sourced by Treaty

Since the Tax Reform Act of 1986, foreign-source income has generally been categorized into various "baskets," with the foreign tax credit limitation computed separately for each basket. This separate basket approach is intended to prevent taxpayers from averaging income subject to a high foreign tax rate with other, lower-taxed foreign-source income (thereby maximizing the total foreign tax credit available).[151] While the number and types of baskets have changed over the years, since 2010 there has been a separate basket for income re-sourced by treaty.[152] Specifically, under §904(d)(6), any income item re-sourced under a treaty is considered a separate limitation category for U.S. foreign tax credit purposes.[153] This separate treaty re-sourcing basket applies even if the income would ordinarily have fallen within the one of the other baskets absent having been re-sourced.[154]

Although the statutory language prescribes that such re-sourced income be separately basketed on an item-by-item basis, the Treasury regulations implementing §904(d)(6) permit (very) limited aggregation of re-sourced items as long as they (i) are re-sourced pursuant to the same treaty and (ii) represent the same type of primary basket income (e.g., passive).[155] For example, if a U.S. taxpayer had foreign-source income subject to tax in Japan, as well as U.S.-source income subject to tax in Japan that was re-sourced under the U.S.-Japan Treaty, the two items of income — although both now foreign-source income subject to Japanese income tax — could not be basketed together. The re-sourced income would fall within its own, standalone limitation basket. If, however, that U.S. taxpayer had two items of income subject to tax in Japan, and both were re-sourced under the treaty and both would be considered passive basket income (setting aside the re-sourced treaty income basket momentarily), they could be aggregated for purposes of the taxpayer's §904(d)(6) (i.e., U.S.-Japan Income Tax Treatyre-sourced passive) basket. Alternatively, if that U.S. taxpayer had two re-sourced items of income under the U.S.-Japan Income Tax Treaty, but one would ordinarily be considered passive basket income and the other general basket income, despite both being re-sourced under the same treaty, they would fall within two separate limitation baskets (U.S.-Japan Income Tax Treaty-resourced passive basket, and U.S.-Japan Income Tax Treaty re-sourced general basket).

There is a notable exception to the treaty re-sourced income basketing rule. For U.S. citizens resident in a foreign treaty country whose double taxation on U.S.-source income is relieved under a treaty's three-step rule,[156] separate basketing for such re-sourced income is not required.[157]

Re-sourcing generally applies only for purposes of eliminating only the double taxation with respect to foreign taxes imposed by the relevant treaty country, not other foreign countries.[158] In other words, foreign income taxes imposed on a U.S.

[149] There is an exception for income or gains derived from real property; in that case, tax paid or accrued by a person resident in the country where the real property is located is treated as if paid by the resident of the other country.

[150] See further discussion in Philip D. Morrison, *Re-Sourcing Income Under Treaties — Issues With Hybrid Entities,* 36 Tax Mgmt. Int'l J. 385 (Aug. 10, 2007), above.

[151] *See* §904(d). Before 1986, however, the foreign tax credit limitation was applied on a "per country" rather than a "per basket" basis. *See* 6060 T.M., *The Foreign Tax Credit Limitation Under Section 904.*

[152] §904(d)(6) was enacted by the legislation commonly referred to as the education Jobs and Medicaid Assistance Act in August 2010. Note that §904(d)(6) does not apply to any item of income to which §904(h)(10) or §865(h) applies. *See* §904(d)(6)(B).

[153] This requirement applies whether the U.S. taxpayer affirmatively claims the re-sourcing benefit under an applicable treaty or the Competent Authorities mutually agree to allow the taxpayer to treat the income as foreign-source income. Treas. Reg. §1.904-4(k)(1)(iv)(B).

[154] Treas. Reg. §1.904-4(l). Currently, the primary foreign tax credit limitation "baskets" are the GILTI, foreign branch, passive, and general baskets. *See* §904(d)(1).

[155] Treas. Reg. §1.904-4(k)(1)(ii).

[156] The treaty three-step rule is found in most treaties (typically in the Relief from Double Taxation article) and applies sequential crediting and a re-sourcing rule in the specific situation of a U.S. citizen residing abroad who receives U.S.-source income subject to U.S. withholding tax under a treaty, such as a dividend paid by a U.S. company. In short, the foreign treaty country must provide a credit against the taxpayer's foreign taxes for the U.S. withholding tax allowed by the treaty. The U.S. then provides a U.S. foreign tax credit against their U.S. tax (since worldwide tax is still payable on the basis of the individual's citizenship) for the foreign tax paid to the foreign country after accounting for the credit in step one. Finally, the U.S. income subject to the withholding from step one is re-sourced to the extent necessary to avoid double tax in the application of these rules. *See, e.g.,* 2016 U.S. model treaty, art. 23(4).

[157] *See* Treas. Reg. §1.904-4(k)(1)(iv)(A).

[158] There is a narrow exception to this general rule in the event the same item of re-sourced income is subject to triple tax (i.e., by the U.S., a foreign treaty country, and another foreign country). Under these circumstances, while

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taxpayer by a high-tax country that were re-sourced under a treaty with that country generally cannot be used to increase that taxpayer's overall foreign source income and thus its overall foreign tax credit availability. For example, the U.S.-Canada Income Tax Treaty provides: "The provisions of this Article relating to the source of profits, income or gains shall not apply for the purpose of determining a credit against United States tax for any foreign taxes other than income taxes paid or accrued to Canada."[159] Further, under §904(d)(6), because each re-sourced income item (or each narrow category of re-sourced items) must be separately basketed for each treaty under which benefits are claimed, the practical effect is not only a country-by-country limitation, but an item-by-item limitation within each country for U.S. foreign tax credit purposes.

As can be seen from the above, the overlay of U.S. foreign tax credit limitations under domestic law can and does affect the extent to which double tax is actually relieved. In practice, there is commonly at least some "leakage." The following example illustrates how the separate basketing requirement can affect the foreign tax credit allowed and result in some double taxation, even where treaty re-sourcing applies.

Under U.S. sourcing rules, individual I is a U.S. citizen who under U.S. law sourcing rules has $600 of U.S.-source income, $0 of Country A-source income, and $100 of Country B-source income. Of the $600 U.S.-source income, $100 is subject to tax under the domestic law of Country A. The U.S.-Country A Income Tax Treaty cedes primary taxing jurisdiction over that income to Country A and contains a re-sourcing provision identical to that contained in the 2016 U.S. Model Treaty. There is no U.S.-Country B Income Tax Treaty. The United States imposes tax on the income in question at a flat 35% rate; Country A at a 25% rate; and Country B at a 45% rate.

Under U.S. domestic law, without a treaty (and leaving aside foreign tax credits for a moment), individual I would owe $245 of U.S. tax (35% of $700 total income), $25 of Country A tax, and $45 of Country B tax. I's maximum potential foreign tax credit under U.S. law would be $70, but the U.S. foreign tax credit limitation would reduce that amount to $35.[160] Thus, I would pay a total of $280 tax to the three countries[161] and would be subject to $35 of double taxation.

The U.S.-Country A Income Tax Treaty would modify this result because the $100 of income subject to tax by Country A would be re-sourced to Country A. Because of §904(d)(6), that Country A income is separately limited, having the effect of providing a credit for only these Country A taxes (and not Country B taxes), so individual I would still end up bearing some double tax in the amount of $10.[162] (Without §904(d)(6), re-sourcing the $100 to Country A could mean $200 of foreign-source income and a foreign tax credit limitation of $70,[163] thus potentially enabling I to claim a foreign tax credit for the full $70 of foreign taxes actually paid.)

b. Source Maintenance Rules Under Section 904(h)

There is an interesting interplay between the treaty re-sourcing rules and §904(h), which provides its own set of statutory re-sourcing rules.[164] The §904(h) rules, sometimes referred to as "source-maintenance" rules, were designed to prevent U.S. taxpayers from avoiding U.S. tax by converting U.S.-source income to foreign-source income (to increase their foreign tax credit limitation by effectively routing the income through a foreign corporation that would then pay dividends to the U.S. shareholder.[165] These rules generally re-source a certain portion of what would otherwise be foreign-source income (e.g., interest and dividends paid by a foreign corporation) as U.S.-source income; thus, they can be viewed as the converse of the 2016 U.S. Model Treaty Article 23(3) re-sourcing rule. These provisions apply in the case of "United States-owned foreign corporations," defined as foreign corporations, 50% or more of whose vote or value is owned directly or indirectly by U.S. persons.[166] The source-maintenance rules add complexity to the Code and are now generally viewed as unnecessary in light of subsequent changes to U.S. law, but they nevertheless continue in effect.

the item will still comprise a separate §904(d)(6) category (i.e., stand-alone "basket") for U.S. foreign tax credit limitation purposes, the taxes imposed on this particular re-sourced item of income by both the foreign treaty country and the third country would be allocated to that basket for purposes of calculating the U.S. foreign tax credit. *See* Treas. Reg. §§1.904-4(k)(1)(iii), 1.904-6(a), 1.861-20(a). In the authors' experience, it is very rare to come across such a fact pattern in the wild.

[159] U.S.-Canada Income Tax Treaty, art. XXIV(9); *see also* U.S.-Austria Income Tax Treaty, art. 22(4); U.S.-India Income Tax Treaty, art. 25(3) (virtually identical to the Austrian treaty language); U.S.-Sweden Income Tax Treaty, art. 23(3)(c) (same); U.S.-Thailand Income Tax Treaty, art. 25(3) (same); U.S.-New Zealand Income Tax Treaty, art. 22(4) (same). Further, the introductory phrase to the 2016 U.S. Model Treaty's general re-sourcing provision states that the provision applies "[f]or the purposes of applying [the provision granting double tax relief to U.S. citizens or residents via a U.S. credit for taxes paid to the treaty partner]," implying the re-sourcing provision applies for the purpose of granting double tax relief with respect to taxes paid to the particular treaty partner, not for taxes paid to other countries. *See also* the language in the specific re-sourcing provision applicable to United States citizens residing in the foreign treaty country, discussed immediately below, which applies "for the exclusive purpose" of relieving double taxation between the two treaty partners, with re-sourcing applied "to the extent necessary" to prevent such double taxation.

[160] That is, I would owe $70 total foreign tax ($25 to Country A and $45 to Country B), but the amount of foreign taxes creditable against U.S. tax could not exceed the ratio of foreign-source income ($100) to total income ($700); 1/7 of $245 is $35.

[161] That is, $210 U.S. tax ($245 − $35), plus $25 Country A tax, plus $45 Country B tax.

[162] For purposes of crediting the Country A tax, I would have $200 of foreign-source income and the foreign tax credit limitation would be $70, derived as explained above. Therefore, the $25 of Country A tax would be fully covered. For purposes of crediting the Country B tax, however, I would be considered to have only $100 of foreign-source income, meaning that the foreign tax credit limitation applicable to Country B tax would be $35. As I paid $45 of Country B tax, there would be double taxation with respect to $10.

[163] That is, the ratio of foreign-source income to U.S.-source income would increase to $200/$700; 2/7 of $245 is $70.

[164] Note that §402(a) of the AJCA redesignated former §904(g) as §904(h), effective for taxable years starting after 2006.

[165] *See* H.R. Conf. Rep. No. 98-861, at 918–19 (1984); S. Rep. No. 98-432, at 1346 (1984).

[166] §904(h)(6).

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Section 904(h)(10) provides a rule for coordinating the statutory rule with treaty re-sourcing provisions. In cases where a treaty would re-source an item of income that would otherwise be deemed U.S. source under these rules, the taxpayer can elect to treat such income as foreign-source income, even if §904(h) would otherwise cause the income item to be treated as U.S. source. If the election is made, a separate credit limitation is computed for such item of income, with the rules of §§904, 907, and §960 applying separately to that income.[167] Section 904(d)(6), enacted in 2010 and discussed in the immediately preceding section, was in part intended to effectively extend the separate basketing rule of section 904(h)(10) beyond just "U.S.-owned foreign corporations." When it applies, it has the effect of (further) limiting taxpayers' ability to bundle high-taxed foreign-source income with low-taxed re-sourced income to make excess foreign tax credits on the high-taxed foreign-source income available to offset U.S. tax on the low-taxed foreign-source income, including by using foreign branches and disregarded entities.[168]

In addition, although the §904 regulations and many treaties acknowledge the availability of the §904(h)(10) election,[169] Technical Explanations to a small number of older treaties provide that U.S. sourcing rules (including §904(h)) may apply instead of the general treaty re-sourcing rule, calling into question the availability of this election, at least under these treaties.[170]

c. Code Re-Sourcing for Gain from Certain Sales of Stock or Intangibles

Section 865(h)(2)(A) contains a special sourcing rule that allows taxpayers to elect to treat gains from the sale of foreign stock and certain intangibles — which would otherwise be U.S.-source income under the §865 sourcing rules — as foreign-source income, if such gains are treated as foreign-source income under an applicable tax treaty to which the United States is a party (applied without regard to §865). Thus, §865(h) permits taxpayers to elect to override the normal section 865 sourcing rules. If a taxpayer elects to apply §865(h), however, a separate foreign tax credit limitation regime applies similar to those applicable to §§904(d)(6) and 904(h)(10).[171] Therefore, while the relevant gain is respected for U.S. purposes as foreign-source income, the taxpayer generally cannot use the resulting foreign tax credit to offset U.S. tax on any other income.[172] The legislative history clarifies that a §865(h) election was intended to provide an exception to the rule that the §865 sourcing rules generally prevail over any conflicting pre-existing treaty sourc[ing] rules under the later-in-time rule.[173]

An example in the legislative history to §865(h) illustrates its application. The example contemplates gain resulting from sale of stock in a less-than-80%-owned foreign corporation by a U.S. resident, which is U.S.-source income under §865. An applicable treaty, however, would treat such gain as foreign-source income. The statutory provision permits the U.S. resident to elect to treat the gain as foreign-source income, although the U.S. resident may credit only the foreign tax imposed on that gain against the U.S. tax imposed on that gain.[174]

d. Code Re-Sourcing for Certain Dividends Under Section 245(a)

Section 245(a) generally provides a dividend received deduction (DRD) to certain U.S. corporate shareholders that own at least 10 percent of a qualifying foreign corporation with respect to the U.S. portion of dividends paid by such foreign corporation. Under these rules, the dividend (or relevant portion thereof) is deemed to be U.S.-source income.[175] Under §245(a)(10), however, if such U.S.-source portion of a dividend would

[167] §904(h)(10)(A); Treas. Reg. §1.904-5(m)(7)(i). An illustration of the consequences that flow from the §904(h)(10) election is set forth in Treas. Reg. §1.904-5(m)(7)(ii). In addition, the preamble to the regulation package that includes Treas. Reg. §1.904-5(m)(7) explains:

> [I]f the taxpayer elects the benefits of the treaty, the income shall be treated as foreign source but the foreign tax credit rules shall be applied separately with respect to income treated as foreign source pursuant to each treaty under which the taxpayer has claimed benefits … . For example, a taxpayer may not average general limitation income treated as foreign source under one treaty with general limitation income treated as foreign source under another treaty. A taxpayer also may not average general limitation income treated as foreign source under a treaty with passive income treated as foreign source under the same treaty.

T.D. 8412, 57 Fed. Reg. 20,639, 20,641 (May 14, 1992).

[168] *See* Staff of the Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions of the Senate Amendment to the House Amendment to the Senate Amendment to H.R. 1586 Scheduled for Consideration by the House of Representatives on August 10, 2010* (JCX-46-10) at 19, 111th Cong., 2d Sess. (2010).

[169] *See, e.g.*, Treas. Reg. §1.904-5(m)(7)(i) ("If any amount of income … would be treated as derived from sources within the United States under section 904(h) … and, pursuant to an income tax convention with the United States, the taxpayer chooses to avail itself of benefits of the convention that treat that amount as arising from sources outside the United States under a rule explicitly treating the income as foreign source, then that amount will be treated as foreign source income … ."); Technical Explanation to 2006 U.S. Model Treaty, article 23(3) (section 904(h)(10) election available); Technical Explanation to U.S.-Japan Income Tax Treaty, art. 23(2) (same); Technical Explanation to U.S.-U.K. Income Tax Treaty, art. 24 (same); Technical Explanation to U.S.-Belgium Income Tax Treaty, art. 22(3) (same). *See.*

[170] *See* Technical Explanation to the U.S.-Luxembourg Income Tax Treaty, art. 25(4) (§904(h)(10) election unavailable). In some treaties, particularly those with language making the Relief from Double Taxation provision expressly subject to domestic source rules, while there is no language that so clearly precludes a section 904(h)(10) election, its availability is certainly unclear. *See* Technical Explanation to U.S.-China Income Tax Treaty, art. 22(2) ("the amount of the credit to be allowed is determined in accordance with the limitations provided in the Code (*e.g.*, section 904(h).)"); Technical Explanation to U.S.-Czech Republic Income Tax Treaty, art. 24 ("Where … there is an inconsistency between [the treaty] and Code source rules, the Code source rules (e.g., §904(h)) will be used to determine the limits for the allowance of a credit under the [treaty]"); Technical Explanation to U.S.-Sweden Income Tax Treaty, art. 23(1) (same). *But see* Treas. Reg. §1.904-5(m)(7).

[171] *See* §865(h)(1)(B).

[172] *See* S. Rep. No. 100-445, at 239 (1988). In addition, taxpayers may elect to apply §865(h) to treat certain distributions from corporations organized in a U.S. possession as foreign-source income. *See* §865(h)(2)(B); S. Rep. No. 100-445, at 239–40.

[173] S. Rep. No. 100-445, at 237, 239 ("[T]he Act's source rule changes generally prevail over any conflicting [pre-existing] treaty source rules under the general later-in-time rule. The bill does provide, however, an exception to the general later-in-time rule. Under this exception, a taxpayer may elect to apply treaty source rules to treat as foreign source any gain derived from the sale of stock in a treaty country corporation or of an intangible which would otherwise be treated as U.S. source under the Act."). In general, in the case of treaties coming into force after the enactment of §865, the applicable treaty sourcing rule presumably trumps even without having to make an election under §865(h); so in practice this provision functions more as a foreign tax credit limitation than a pure sourcing rule. *See* §7852(d)(1). *See also* §894(a)(1).

[174] *See* §865(h)(1)(B); S. Rep. No. 100-445, at 239.

[175] §245(a)(9).

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be considered foreign source under an applicable treaty, no DRD is permitted, but a foreign tax credit is permitted and the domestic source rule is overridden by the treaty sourcing. Here, again, however, separate basketing rules apply with respect to such item of foreign-source income for U.S. foreign tax credit limitation purposes.

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III. The Saving Clause

A. *Purpose and Effect of the Saving Clause*

Treaties strive to alleviate double taxation when two countries claim the right to tax the same income or each country views a taxpayer as its own resident. There are times, however, when this goal clashes with the U.S. system of worldwide taxation. Therefore, all modern U.S. treaties contain a "Saving Clause," which — subject to a limited number of exceptions, discussed below — generally allows the U.S. to continue to tax its citizens and residents regardless of the benefits otherwise conferred by a treaty.

The Saving Clause is designed to preserve ("save") the ability of the United States to tax U.S. persons on their worldwide income, regardless of the treaty's existence — i.e., effectively overriding, in whole or in part, certain benefits that would otherwise be available.[176]

U.S. tax treaties do not always prevent double taxation. The existence of the Saving Clause, particularly in the case of treaties with a limited or absent re-sourcing provision, can have the effect of increasing the occurrences of double taxation — thus necessitating that U.S. taxpayers affirmatively seek relief by claiming foreign tax credits or in some cases, requesting competent authority relief.

The Saving Clause in the 2016 version of the U.S. Model Treaty reads:

> Except to the extent provided in paragraph 5 of this Article [listing specific benefits not overridden by the Saving Clause], this Convention shall not affect the taxation by a Contracting State of its residents (as determined under Article 4 (Resident)) and its citizens. Notwithstanding the other provisions of this Convention, a former citizen or former long-term resident of a Contracting State may, be taxed in accordance with the laws of that Contracting State.

The second sentence of the Saving Clause is intended to ensure certain former U.S. citizens and long-term residents are within the scope of the Saving Clause to permit the U.S. to impose tax on them under §877.

This language is similar to earlier versions of the U.S. Model Treaty[177] and is typically found either in the general scope or "miscellaneous" articles of U.S. tax treaties. Interestingly, the words "saving clause" do not appear in any U.S. treaties, so taxpayers and practitioners need to know to look for this concept buried in the text of other articles.

In short, the Saving Clause means that a Contracting State may tax its residents and citizens "notwithstanding any provisions of the Convention to the contrary."[178] For example, U.S. citizens living abroad simply will not be entitled to the same benefits conferred on other residents of the same foreign country who are not U.S. citizens because of the Saving Clause. The following example illustrates an application of the Saving Clause:

> *Example:* A is a U.S. citizen but considered a resident of FC pursuant to the residency article of the US-FC Income Tax Treaty. The US-FC Income Tax Treaty contains standard Saving Clause language as well as typical Business Profits and PE articles. A lives in FC but occasionally travels to the U.S. to perform professional services in his capacity as an independent contractor. Those services are not sufficient to give rise to, and are not otherwise attributable to, a U.S. PE for purposes of the US-FC Income Tax Treaty, nor do they generate fees of a type governed by any of the special income provisions of the US-FC Income Tax Treaty (such as directors fees or amounts earned by professional athletes or artists).[179] Accordingly, the Business Profits clause would ordinarily prevent U.S. taxation of any of the income A derives from these services because no PE exists, and such income would instead be taxable solely by FC — the country of which A is a resident. However, because A is a U.S. citizen, the Saving Clause overrides this result and enables the U.S. to (also) tax his service income because A remains subject to worldwide taxation under U.S. domestic tax rules. A must therefore claim a foreign tax credit on his U.S. return to mitigate the resulting double taxation — and will still generally be subject to U.S. income tax to the extent the U.S. income tax rate is higher than the FC rate.[180] (Additionally, if there is no re-sourcing provision[181] in the US-FC Income Tax Treaty, A will likely suffer double taxation on any portion of his service income considered U.S.-source income under §861(a).)[182]

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[176] In most U.S. treaties the Saving Clause is reciprocal, but in some the Saving Clause applies specifically to (only) U.S. citizens and residents or has more limited application to residents of the other contracting state. *See, e.g.*, U.S.-Germany Income Tax Treaty, Article 1(4)(a) (Saving Clause applicable only to US persons: "… this Convention shall not affect the taxation *by the United States* of its residents … and its citizens …" (emphasis added)); U.S.-France Income Tax Treaty, Article 29(2) (Saving Clause reciprocally applied to French persons only with respect to entities with a place of effective management and subject to tax in France, and to former citizens and long-term residents of France).

[177] Certain older treaties do not have an explicit Saving Clause instead preserving the U.S. right to tax its citizens and residents is achieved definitionally by another provision. For example, in the U.S.-Pakistan treaty, which was signed in 1957 and remains in effect, the term "resident of [Pakistan]" excludes U.S. citizens. *See* U.S.-Pakistan Income Tax Treaty, art. 2(1)(i).

[178] *See* Technical Explanation to the 2006 U.S. Model Treaty, Article 1(4).

[179] *See generally* 6000 T.M., *Foundations of U.S. International Taxation* for discussion of PEs.

[180] *See* Technical Explanation to the 2006 U.S. Model Treaty, Article 1(4).

[181] *See* discussion of treaty re-sourcing provisions and their role in alleviating double taxation in Part II.D., above (Relief from Double Taxation).

[182] *See, e.g.*, U.S.-Pakistan Treaty, art. 2(1)(i). *See also Maximov v. United States*, 299 F.2d 565 (2d Cir. 1962), aff'd, 373 U.S. 49 (1963) (under U.S.-U.K. Treaty in force at the time, effect of Saving Clause was performed by the exclusion of U.S. citizens, residents, and corporations from the definition of "resident of the United Kingdom"). *But cf. Am. Trust Co. v. Smyth*, 247 F.2d 149 (9th Cir. 1957) (omission of Saving Clause from U.S.-U.K. Treaty was evidence of intent to exempt capital gains beneficially belonging to U.K. residents from U.S. tax, notwithstanding that under U.S. tax law the capital gains were deemed earned by a trust not resident in the United Kingdom). *See also Savary v. Commissioner*, T.C. Summary Opinion 2010-150, 8–11 (Saving Clause in the U.S.-France Income Tax Treaty meant worldwide income earned by a U.S. citizen treated as a resident of France was subject to U.S. taxation despite also being taxed by France, and no U.S. foreign tax credit was available for the portion of the income treated as U.S. source income).

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B. Application of the Saving Clause

The Saving Clause has been considered by the courts and the IRS with respect to a variety of types of income.

1. Capital Gains

In *Cole v. Commissioner*,[183] a U.S. citizen and resident of Israel sold stock in a U.S. company. Although Article 15 of the U.S.-Israel Income Tax Treaty explicitly exempts Israeli residents from U.S. tax on gains from the sale of capital assets (and so, too, U.S. residents from Israeli tax on such gains), the court ruled that the Saving Clause operated to deny the benefit of the treaty's otherwise applicable capital gain exemption since the taxpayer was a U.S. citizen. The U.S. citizen was therefore liable for full U.S. income tax on the gain from the stock sale.

2. Compensation for Services

In *Filler v. Commissioner*[184] the Tax Court confirmed that, notwithstanding the Dependent Personal Services provision in the then-applicable U.S.-France Income Tax Treaty permitting an employee's wages to be taxed by only the country in which he or she is a resident (barring certain circumstances not relevant here), for U.S. citizens residing in France, the Saving Clause "completely eliminated" the effect of this provision. Accordingly, the court held that the petitioner, a U.S. citizen residing in France, was subject to U.S. taxes on his wages received from his French employer — notwithstanding that France was entitled to, and did, (also) tax them.

In *Abrahamsen v. Commissioner*[185] the Tax Court ruled that the Government Service provision of the U.S.-Finland Income Tax Treaty, which generally operates to prevent U.S. taxation of wages paid to qualifying employees of the Finnish government (and vice versa), was trumped by the Saving Clause. Specifically, the court upheld the imposition of U.S. income tax on the compensation paid to a Finnish citizen and employee under the Saving Clause notwithstanding the Government Services treaty provision because she was a lawful permanent resident of the U.S. (i.e., green card holder).[186]

The Tax Court similarly held in *Savary v. Commissioner*[187] that compensation earned by a flight attendant who was a French resident and U.S. citizen was subject to U.S. tax due to the operation of the Saving Clause. This was despite such income also being taxed by France pursuant to the Dependent Services article of the U.S.-France treaty, which generally entitled only the taxpayer's country of residence to tax such income. *See also Letourneau v. Commissioner*[188] and *Ready v. Commissioner*[189] for similar cases (with the same outcome).

The IRS explained in PLR 9628024 that a settlement payment received by a resident alien in satisfaction of amounts owed under an employment agreement was taxable, even if the payment would otherwise be exempt under the relevant treaty, due to the Saving Clause "preserving the right of the United States to tax its residents as if the Treaty had not come into effect."

3. Pensions and Similar Payments

The IRS concluded in a 1993 FSA[190] that, due to the Saving Clause, a U.S. citizen resident in the United Kingdom would be subject to U.S. income tax on certain U.S. government pension and social security payments she received, despite that the payments were otherwise taxable by only the United Kingdom under the "government service" and "other income" articles of the then-applicable U.S.-U.K. Income Tax Treaty.[191]

PMTA 2010-002 similarly clarified that IRA distributions received by a U.S. citizen resident in Switzerland were subject to U.S. taxation. Under the U.S.-Switzerland Income Tax Treaty, even though the taxpayer's state of residence, Switzerland, had primary taxing jurisdiction over IRA distributions, the Saving Clause effectively overruled this provision by giving the U.S. the right to tax his IRA distributions as if the Treaty had not come into effect.

4. Royalties

The court in *Dacey v. Commissioner*[192] held that the taxpayer, a U.S. citizen and Irish resident, was not eligible to claim the treaty exemption from U.S. tax for royalty income received by Irish residents. Although the U.S.-Ireland Income Tax Treaty in force at the time did not include modern Saving Clause language, the same result was achieved by explicitly excluding U.S. citizens from the definition of residents of Ireland.

5. Annuities

Perkins v. Commissioner[193] held that a U.S. citizen resident in Italy was liable for U.S. income tax because of the Saving Clause on certain income received regardless of whether it properly met the treaty definition of a "life annuity." Although life annuities received by Italian residents were exempt from U.S. taxation under the then-applicable U.S.-Italy Income Tax Treaty, this exemption was trumped by the Saving Clause.

6. Income from the Sale of Real Property

Citing the Saving Clause in the then-applicable U.S.-Finland Income Tax Treaty, the IRS outlined in PLR 8127063 that income from the sale by a U.S. resident of real estate located in Finland was not exempt from U.S. tax, despite that the sale proceeds were also subject to tax by Finland as permitted by treaty.

The IRS explained in Rev. Rul. 59-56 that income derived by a U.S. citizen or resident from cutting and selling timber

[183] T.C. 2016-22.

[184] 74 T.C. 406 (1980).

[185] 142 T.C. 405 (2014).

[186] *See also* 2020 Competent Authority Agreement, U.S.-Italy Income Tax Treaty, art. 19 ("Pursuant to the Saving Clause … the United States retains its right to tax the income of its citizens and lawful permanent residents as if there were no convention … . As such, a U.S. citizen or lawful permanent resident would not be entitled to claim the benefit of [the Government Services article of the U.S.-Italy Income Tax Treaty] to exempt remuneration from U.S. federal income tax. Rather the individual would be subject to tax in both the United States and Italy.").

[187] T.C. Summary Opinion 2010-150.

[188] T.C. Memo. 2012-45.

[189] T.C. Summary Opinion 2012-12.

[190] 1993 FSA LEXIS 263 (May 20, 1993).

[191] The current U.S.-U.K. treaty would likely yield a different result for social security payments, as it contains a dedicated social security provision that is exempted from application of the Saving Clause. *See* U.S.-U.K. Income Tax Treaty, art. 17(3) and art. 1(5)(a).

[192] T.C. Memo. 1992-187.

[193] 40 T.C. 330 (1963).

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in Germany was (also) subject to U.S. tax due to the Saving Clause, despite the provision in the then-applicable U.S.-Germany Income Tax Treaty providing that income from real property situated in Germany was taxable "only" by Germany.

Adams v. Commissioner[194] relied on the Saving Clause to hold that a U.S. resident was subject to U.S. tax on capital gains realized on the sale of U.S. real estate, despite the petitioner's argument that she was also a resident of Canada and therefore exempt from U.S. tax on such gains. (This case pre-dated the enactment of FIRPTA.)

7. Trust Income

Crerar v. Commissioner[195] relied on the Saving Clause in the then-applicable U.S.-Canada Income Tax Treaty to reject the contention of a U.S. citizen and Canadian resident that should be taxed on certain trust income at the beneficial rate provided by the treaty rather than under the usual U.S. domestic law rates. The court ruled that subject to a small number of exceptions to the Saving Clause, the convention does not infringe on the ability of the U.S. to tax its citizens and residents, nor the manner in which it chooses to do so. "Under [U.S. law], such taxpayers are liable upon their income from all sources whether derived from within or without the United States. To avoid double taxation, the United States income tax allows them a credit against the Federal income tax for income taxes paid to foreign countries."

C. Exceptions to the Saving Clause

A limited number of provisions are carved out from application of the Saving Clause. Meaning the benefits they confer are not overridden by the Saving Clause. The particular provisions exempted vary by treaty — and can sometimes further change depending on whether the relevant taxpayer is a U.S. citizen or U.S. lawful permanent resident.[196] The U.S. Model treaty contains a lengthy list (detailed below), but many of the treaties currently in effect have fewer exemptions.

Below are the Saving Clause exceptions grouped into four categories set forth in the 2016 U.S. Model Treaty:[197]

1) Fundamental Exceptions

U.S. treaties generally exempt the following core articles from the Saving Clause. If the Saving Clause were to override these fundamental benefits, the value of having treaties at all would be significantly diminished.[198]

Article 23 (Relief from Double Taxation). If the Saving Clause "turned off" access to this provision, the treaty's primary purpose, relief from double tax, would be frustrated.

Article 24 (Non-Discrimination). Necessary to protect residents and nationals of one Contracting State against the adoption of discriminatory practices in the other Contracting State.

Article 25 (Mutual Agreement (MAP) or Competent Authority Procedure). The purpose of MAP is to offer an additional avenue of relief from double taxation if the terms of the treaty alone cannot provide such relief. Such coordinated relief generally would be impossible if the Saving Clause turned off this provision. Without it, taxpayers would generally be forced to try to challenge instances of double taxation through the countries' respective administrative and/or judicial proceedings.

2) Procedural/Compatibility Exceptions

This category of exceptions to the Saving Clause consists of more mechanical provisions that are generally necessary to prevent certain punitive outcomes in connection with a transfer pricing adjustment or following an expatriation from the U.S. under §877.

Articles 7(3) (Business Profits) and 9(2) (Associated Enterprises). These exceptions relate to transfer pricing adjustments made between related parties, including the right to a correlative adjustment by one Contracting State with respect to the tax due on reallocated profits in the other Contracting State.

Article 13(7) (Gains). This exception entitles an individual to a basis adjustment in one Contracting State if, by reason of expatriating from the other Contracting State, the individual was treated as having sold his or her property for fair market value. This is generally intended to prevent double taxation upon the ultimate sale of such property.

3) Substantive Exceptions — Available to U.S. Citizens and Permanent Residents

Generally these exceptions reflect benefits intended for citizens and residents of a country, even if the domestic law of such country does not provide such corresponding benefits. Accordingly, these are policy decisions and it would not be appropriate for the Saving Clause to override such intended benefits.

Articles 17(1)(b) and (2), 17(3), and 17(6) (Pensions, Social Security, Annuities, Alimony and Child Support). These exceptions to the Saving Clause ensure exemptions from taxation conferred by a treaty for cer-

[194] 46 T.C. 352 (1966).

[195] 26 T.C. 702 (1956).

[196] For example, the US-U.K. Income Tax Treaty partly or wholly exempts 11 articles from application of the Saving Clause (generally tracking the exemptions set forth in the U.S. model treaty), while the U.S.-Morocco treaty exempts only 5 articles and the U.S.-Greece Income Tax Treaty exempts none. *See* U.S-UK Income Tax Treaty, Art. 1(5), U.S.-Morocco Income Tax Treaty, Art. 20(4), U.S.-Greece Income Tax Treaty, Art. 14(1).

[197] Art. 1(5).

[198] Not all treaties currently in effect contain all (or any) of these exemptions. *See, e.g.,* U.S.-Greece Income Tax Treaty, art. 14(1). *But see* Rev. Rul. 91-58 (concluding that the Saving Clause does not overrule the non-discrimination provision even in a treaty where the Saving Clause does not contain a specific exception to that effect); GCM 34616 (Sept. 22, 1971) ("a savings clause does not apply when its application would contravene policies reflected in the convention"); Technical Explanation to the U.S.-China Income Tax Treaty, art. 1 (clarifying that it is understood that the benefits of the Relief from Double Taxation, Non-discrimination and MAP provisions are not subject to the Saving Clause despite the U.S.-China Income Tax Treaty not containing express exemptions from the Saving Clause for U.S. citizens).

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tain pension distributions, social security payments and child support are preserved.[199]

Article 18(3) (Pension Funds). Article 18(3) provides benefits for contributions by or for a U.S. citizen to a foreign pension fund.

4) Substantive Exceptions — Available to Individuals Temporarily Present in the U.S. (Not a U.S. Citizen or Permanent Resident)

This final set of limited exceptions applies to treaty benefits granted to temporary residents of a Contracting State other than citizens or persons who have obtained permanent residence status. According to the 2006 Technical Explanation:

> [i]f beneficiaries of these provisions travel from one of the Contracting States to the other, and remain in the other long enough to become residents under its internal law, but do not acquire permanent residence status (i.e., in the U.S. context, they do not become 'green card' holders) and are not citizens of that State, the host State will continue to grant these benefits even if they conflict with the statutory rules.

This is appropriate because such temporary "residents" generally remain under the primary taxing jurisdiction of the other country. Accordingly, the Saving Clause does not apply to turn off the targeted benefits conferred on individuals in these (narrow) categories.

Article 18(1) (Pension Funds). This exemption relates to certain benefits granted for pension plan contributions.

Article 19 (Government Service). This exemption applies to certain government salaries and pensions.[200]

Article 20 (Students and Trainees). This article provides an exemption from host country taxation for certain income of visiting students, researchers and trainees.[201]

Article 27 (Diplomats). This provision generally permits the exemption of taxation on income earned by diplomats and consular agents while stationed in the host state.

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[199] *See, e.g.,* U.S.-France Income Tax Treaty, Art. 29(3)(a) and Technical Explanation to 2009 Protocol to U.S.-France Income Tax Treaty, Art. VI ("notwithstanding the saving clause … and pursuant to the [Saving Clause exemptions provision], France has the exclusive jurisdiction to tax payments under its social security or similar legislation to a resident of France who is a citizen of the United States").

[200] *See, e.g.,* Rev. Rul. 84-174 (individual working for the French government in the U.S. not subject to U.S. tax on his wages under the then-applicable U.S.-France Income Tax Treaty even though he was a resident of the United States because he was neither a U.S. citizen nor permanent resident and the relevant treaty article was exempted from the Saving Clause). *Cf.* PLR 200002026 (when alien employee of foreign government became a permanent resident of the United States, the Saving Clause took effect and the employee's wages became subject to U.S. tax); *Abrahamsen v. Commissioner*, 142 T.C. 405 (U.S. green card holder who was a Finnish citizen working for the Finnish government was subject to U.S. tax on his remuneration because the Government Services article was overridden by the Saving Clause).

[201] *See, e.g.,* PLR 7742070 (Japanese pathologist exempt from U.S. income tax on remuneration for research activities performed while temporarily present in the United States for up to two years pursuant to U.S.-Japan treaty, notwithstanding that being present in the U.S. for such period would ordinarily result in U.S. resident status and U.S. taxation under domestic law as Saving Clause did not apply).

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IV. Residence Country Benefits for Individuals

A. Remuneration for Government Service

Article 19 of the 2006 and 2016 U.S. Model Treaties provides special rules for compensation received in connection with government service. Generally, the article provides that salaries, wages, and other similar remuneration paid to an individual by the government of a Contracting State in respect of services performed for that State (the "employing state") (or for a political subdivision or local authority thereof) are taxable only by the employing Contracting State.[202] Thus, the income is not taxable by the other Contracting State, even if the services are performed in that other Contracting State. Note that this rule applies to a person providing services to the government of the employing state regardless of the capacity in which such services are rendered, i.e., as a direct government employee, independent contractor, or employee of an independent contractor.[203]

Some treaties in force may cover a narrower range of compensation arrangements by referring to compensation for "employment" only.[204]

There is an exception to this general rule, however, if (i) the services are rendered in the other Contracting State, (ii) the individual performing services is a resident of the other Contracting State, and (iii) the individual is also either a citizen[205] of the other Contracting State, or did not become a resident of the other Contracting State solely for the purpose of rendering the services. In these circumstances, the exception applies and such income becomes taxable by only the other Contracting State in which the employee is resident (i.e., the income is not (also) taxable by the employing Contracting State).[206]

> *Example:* Individual I is a citizen of Country A and employed by the government of Country A. Under Model Treaty article 19(1), I's compensation for the services she provides to Country A is taxable solely by Country A, even if I subsequently moves to Country B to provide the services and becomes a resident of Country B. However, if I were instead a Country B citizen, Country B would have sole taxing jurisdiction with respect to compensation for the services rendered to Country A in Country B after moving to Country B. Alternatively, even if I were not a citizen of Country B, Country B would have sole taxing jurisdiction with respect to services rendered for Country A in Country B, if I were a resident of Country B and had become a resident of Country B before, and for reasons unrelated to, her employment for Country A.

There are limits to the scope of the government services article. Article 19(3) of the 2006 and 2016 U.S. Model Treaties provides that salaries, wages, and other remuneration paid for services rendered to a Contracting State in connection with *a business* carried on by that Contracting State are subject to taxation under the general compensation rules of Articles 14, 15, and 16. In other words, the special benefit for compensation paid to government employees otherwise provided under Article 19 does not apply to the extent the government is engaged in a business; compensation related to such business operations is instead subject to the rules that would ordinarily apply to compensatory income in the non-government context. This approach is embodied in several U.S. treaties in force.[207]

The term "business" is not defined in the 2016 U.S. Model Treaty, Article 3(1)(e) simply provides only that "the term 'business' includes the performance of professional services and of other activities of an independent character." However, it seems logical that in mentioning a business carried on by a government, the drafters intended to cover activities carried on for profit, as opposed to core governmental activities such as road building or law enforcement.[208]

Although not explicitly stated, the policy behind this exception would seem to be that the Contracting States are entitled to special treatment with respect to compensation paid to their employees (or other service providers) while acting in their capacity as governments, but not when they are conducting commercial activities. In the latter case, the compensation paid to their employees should be subject to tax in the other state in the same manner as compensation received from other businesses.[209]

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[202] 2006 and 2016 U.S. Model Treaty, art. 19(1)(a); *see also* U.S.-France Income Tax Treaty, art. 19(1); U.S.-Germany Income Tax Treaty, art. 19(1)(a), art. 19(1)(b); U.S.-Luxembourg Income Tax Treaty, art. 20(1); U.S.-Netherlands Income Tax Treaty, art. 20(1).

[203] 2006 Technical Explanation of Article 19(1). *See also* U.S.-Chile Income Tax Treaty, art. 19 and the Technical Explanation thereto.

[204] *See, e.g.,* U.S.-Republic of Korea Income Tax Treaty, art. 22; U.S.-Greece Income Tax Treaty, art. 11(1) (heading refers to "Government Service").

[205] For this and other purposes of the 2016 U.S. Model Treaty, Article 3(1)(j)(i) defines an individual "national" of a Contracting state as "any individual possessing the nationality or citizenship of that Contracting State."

[206] 2006 and 2016 U.S. Model Treaties, art. 19(1)(b). U.S. treaties in force are not uniform and take various approaches to this exception, so the specific applicable treaty provision should be consulted. *See, e.g.,* U.S.-Egypt Income Tax Treaty, art. 21 (applies a different standard); U.S.-Italy Income Tax Treaty, art. 19(1)(b) (contains a separate carve-out for certain spouses and dependent children of an individual receiving such remuneration); U.S.-Sweden Income Tax Treaty, art. 20(2) (applies the exception to current compensation but not to pension income for government services).

[207] *See, e.g.,* U.S.-Canada Income Tax Treaty, art. 19; U.S.-Japan Income Tax Treaty, art. 18(3); U.S.-U.K. Income Tax Treaty, art. 19(3); U.S.-Sri Lanka Income Tax Treaty, art. 20. Note that the 1996 U.S. Model Treaty did not provide a provision comparable to Article 19(3) of the 2016 U.S. Model Treaty.

[208] *Cf.* §892(a)(2) and regulations thereunder generally provide that the tax exemption for investment income of foreign governments, generally available under §892(a)(1), does not apply to income derived from a commercial activity. Inter alia, "governmental functions," which are not commercial activities for this purpose, are defined as "activities performed for the general public with respect to the common welfare or which relate to the administration of some phase of government." Reg. §1.892-4T(c)(4). *See generally* 6250 T.M., *U.S. Income Taxation of Foreign Governments, International Organizations, Central Banks, and Their Employees.*

[209] This principle parallels the domestic U.S. rules concerning "unrelated business taxable income" in the tax-exempt organization context. That is, certain types of charitable organizations are exempt from tax on their exempt activity income, but not with respect to income earned from business activities unrelated to their exempt purpose. *See* §512; 462 T.M., *Tax-Exempt Organizations — Unrelated Business Income Tax (Sections 511, 512 and 513)* (Estates, Gifts and Trusts Series).

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Whether a given activity is more business-like or governmental in nature, or whether the service recipient is a Contracting State, is not always clear. The IRS has addressed these issues in a variety of circumstances.

The IRS ruled in one private letter ruling that the salary paid to a Canadian citizen resident in the United States was exempt from U.S. taxation under the government services article of the U.S.-Canada Income Tax Treaty because the employer, an organization formed to promote exchanges in industry, trade, tourism, education, and the arts, was "in essence, a public relations office" for a political subdivision of Canada, and therefore was a political subdivision of Canada for purposes of the treaty's government services article.[210] The IRS ruled in another private letter ruling that an entity engaged in advertising activities, making contacts in the financial community, and serving as a liaison with U.S. government agencies, apparently in connection with an underlying banking activity, was not conducting a commercial banking business in the United States, but instead qualified as a governmental entity under the government services article of the applicable treaty.[211]

In a technical advice memorandum addressing an unspecified treaty's governmental services article, the IRS outlined that effectively technical services provided in connection with flood control, navigation, hydro-electric power, reforestation, and similar matters were not of a type customarily attributable to and carried on by private enterprises for profit.[212] Therefore, such activities would be characterized as government functions for treaty purposes.

Questions have also arisen as to what entities constitute a Contracting State employer for purposes of these treaty benefits. In Rev. Rul. 84-174, the IRS explained that the governmental services article of the 1967 U.S.-France Income Tax Treaty (no longer in force) provided an exemption to compensation paid to a French national who resided in the United States and rendered services to a U.S. corporation wholly owned by the French government. The corporation's operations were governmental, not commercial, in nature. The IRS determined that the treaty provision applied to remuneration "paid by, or out of funds created by" the government "in respect of services rendered" to the government. Thus, the IRS reasoned, the exemption applied not only to payments made directly by the government, but also to payments made by separate entities conducting activities that are governmental and noncommercial in nature.[213]

Another private letter ruling addressing the 1967 U.S.-France Income Tax Treaty similarly dealt with a French company wholly owned by the French government.[214] The company was formed to help the French government develop an unspecified industry and was tasked with monitoring developments in the industry, facilitating contacts, and arranging for technological and marketing studies. The ruling concluded that an individual's salary received from the company was exempt under the treaty, thus implying that these were all governmental functions and the wholly-owned company constituted a qualifying employer.

B. Government Pensions

Article 19(2) of the 2006 and 2016 U.S. Model Treaties addresses pensions paid by, or out of funds created by, a Contracting State (i.e., the employing Contracting State) or a political subdivision thereof to an individual in respect of services rendered to that State. Paralleling Article 19(1)'s rule with respect to compensation for government services, Article 19(2)(a) provides that such pension income is likewise generally taxable only by the employing Contracting State. Thus, as with current compensation, even if the government employee (or other recipient of such government employee's pension) is a resident of the other Contracting State at the time he or she receives the pension income, such income is taxable by only the employing Contracting State.

Also in parallel to Article 19(1), Article 19(2)(b) contains an exception for individuals who are both a resident and citizen of the other Contracting State. In that case, only the other Contracting State can tax the pension income — the employing Contracting State does not have a right to tax their pension income. Note, however, that this exception for pensions differs from the exception for current compensation, in that for this exception to apply, the recipient must be *both* a citizen and resident of the other Contracting State. By contrast, current compensation is (also) taxable by the other Contracting State if the recipient is *either* (i) a citizen of the other Contracting State, or (ii) a resident of the other Contracting State who established residency for purposes other than the rendering of such government services.

Finally, Article 19(3)'s exception in respect of services rendered in connection with businesses carried on by a Contracting State extends to pension benefits, generally applying just as it does to current compensation.[215]

C. Pensions, Social Security, Annuities, Alimony and Child Support Payments to Individuals

With some variation, Article 17 of the 2006 and 2016 U.S. Model Treaties addresses payments to residents of a Contracting State from private pension plans, government-sponsored retirement plans such as social security, annuities, alimony payments, and child support. Such payments received by individual taxpayers typically receive special tax treatment under domestic law. Article 17 responds to the unique tax treatment of these payments by providing generally that they will be taxed in only one of the two Contracting States. With the primary

[210] PLR 8718030.

[211] PLR 200111010 (although not disclosed in the ruling, the relevant treaty appears to be the U.S.-Luxembourg Income Tax Treaty).

[212] TAM 7105271110A (May 27, 1971).

[213] GCM 39311 (Dec. 6, 1984). Rev. Rul. 84-174 and GCM 39311 assume that the functions are governmental and noncommercial in nature. Note that Reg. §1.892-2T(a)(3)(ii), issued in 1980, provides that an entity owned by a foreign government is not eligible for tax exemption under §892 unless it is organized under the laws of the foreign country. Rev. Rul. 84-174, above, can be read to relax this requirement in the case of the treaty exemption; however, GCM 39311 noted that the treaty provision in question had been adopted prior to before the regulation. Thus, it is not clear whether Rev. Rul. 84-174 is good law on that point with respect to subsequently adopted treaty provisions, though there is nothing in the text of the ruling itself that would suggest it is inapplicable to such later provisions.

[214] PLR 8334012 *supplemented by* PLR 8430136.

[215] *See Constantine v. Commissioner*, T.C. Memo. 1981-727, holding that pension income received by a U.S. resident for services provided to the Bank of Greece was not eligible for the treaty exemption because the bank was a private legal entity, not a subsidiary of the Greek government.

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exceptions of Article 17(3), providing for exclusive taxation of social security benefits by the Contracting State making the payment, and Article 17(6), exempting child support payments from taxation in either state, Article 17 of the 2016 U.S. Model Treaty generally permits taxation of these payments by only the Contracting State in which the recipient is a resident. Many treaties in force, however, include provisions that do not follow, and in some cases are the opposite of, the rules found in the 2016 U.S. Model Treaty.

1. *Private Pension Distributions*

a. *General Rule*

Article 17(1) of the 2016 U.S. Model Treaty provides that where a resident of a Contracting State receives a private pension distribution or "other similar remuneration," the distribution is taxable only in that state. The 1996 and 2006 U.S. Model Treaties contained the same general rule. As discussed below, however, the 2016 U.S. Model Treaty has clarified certain limitations on the taxation of pension distributions and has incorporated new Article 18, which provides more detailed guidance on the tax treatment of pension fund beneficiaries and participants before the pension funds are distributed.

Because these treaty benefits are accorded to residents of a Contracting State upon receipt of the pension income, residence is determined by reference to the time the benefit is received — typically after retirement or on the date of death — without regard to residence at the time services were performed or contributions were made to the plan.[216]

Without the benefit of Article 17(1), recipients of pension distributions could also be subject to tax by the Contracting State from which the payment is made on the portion of the pension benefit attributable to services provided in that Contracting Sate. Absent the treaty benefit, for example, nonresident aliens receiving pension payments from §401 qualified U.S. plans with respect to employment services performed in the United States would be taxed under the principles of §864(c)(6). Thus, nonresident aliens not eligible for treaty protection must distinguish among payments in respect of: (1) U.S. employer contributions to the plan arising from services performed in the United States, which are subject to wage withholding under §3405; (2) U.S. employer contributions with respect to employment outside the United States, which are not subject to U.S. income tax; and (3) plan earnings, which are subject to U.S. withholding at a 30% rate under §1441.[217]

b. *Limitation on the General Rule*

The 1996, 2006, and 2016 U.S. Model Treaties all include a limitation on the general rule that applies to the pension recipient's state of residence. Under Article 17(1)(b) of the 2006 and 2016 U.S. Model Treaties (as well as under Article 18(1) of the 1996 U.S. Model Treaty), pension distributions that would not be taxable in the state in which they arise are also exempt from taxation in the recipient's state of residence. Specifically, Article 17(1)(b) of the 2016 U.S. Model Treaty provides that if the amount of any pension or remuneration arising in a Contracting State would be exempt from taxation in that state if the recipient were a resident of such state, then the pension or remuneration is also exempt from taxation in the other Contracting State in which the recipient is a resident.[218]

This limitation on taxation applies, for example, to Roth individual retirement account (Roth IRA) distributions to nonresident aliens. Under §408A(c) and §408A(d), specifically, individuals who have contributed after-tax income to a Roth IRA may receive tax-free distributions of these contributions and any earnings thereon in retirement if certain conditions are satisfied. Because such distributions are tax free in the United States, Article 17(1) of the 2006 and 2016 U.S. Model Treaties would exclude them from taxation by the other Contracting State of which the individual is a resident. The 2006 Technical Explanation confirms that "a distribution from a U.S. 'Roth IRA' to a resident of the other Contracting State would be exempt from tax in the other Contracting State to the same extent the distribution would be exempt from tax in the United States if it were distributed to a U.S. resident.[219] The same is true with respect to distributions from a traditional IRA to the extent that the distribution represents a return of non-deductible contributions."[220] The United Kingdom has provided guidance to its taxpayers confirming this treatment, stating that a distribution from a Roth IRA is "exempt from tax in the UK, to the extent it would be exempt in the US."[221]

Although neither the 1996 U.S. Model nor the 1996 Technical Explanation addresses Roth IRAs (because the legislation creating Roth IRAs was not enacted until 1997), the same result would presumably apply. Under Article 18(1) of the 1996 U.S. Model Treaty, the recipient's state of residence may tax a distribution "only to the extent not included in taxable income in the [Contracting State in which the income arises] before the distribution."[222] This limitation has the effect of preventing double taxation of pension benefits and should apply to Roth IRAs as well as other arrangements where the amount contributed

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[216] *See* Rev. Rul. 71-478 (discussed below); PLR 8837054.

[217] *See* 6400 T.M., *U.S. Income Taxation of Nonresident Alien Individuals*, for further discussion of U.S. income tax consequences of pension payments to nonresident aliens from U.S. plans.

[218] *See* PLR 201122034 for an example of applying §72 to pension payments excluded under this limitation. *See also* PLR 201130017.

[219] As discussed further below, the U.S.-Canada Income Tax Treaty was amended in 2008 to provide explicitly that Roth IRAs would be included in the definition of "pensions." The Technical Explanation of Articles 17 (pensions) and 18 (pensions) of the U.S.-Malta Income Tax Treaty and U.S.-Chile Income Tax Treaty, respectively, also specifically address Roth IRAs. *See* U.S.-Malta Income Tax Treaty, Technical Explanation, art. 17 ("Thus, for example, a distribution from a U.S. "Roth IRA" to a resident of Malta would be exempt from tax in Malta to the same extent the distribution would be exempt from tax in the United States if it were distributed to a U.S. resident."); U.S.-Chile Income Tax Treaty, art. 18 (similar). It is worth noting that, in December 2021, the U.S. and Maltese governments entered into a competent authority arrangement that significantly limited the types of Maltese pensions (referred to as Malta personal retirement scheme transactions) that qualify for treaty benefits under the U.S.-Malta Treaty. In 2023, the IRS and Treasury issued proposed regulations under §6011 identifying such pensions as listed transactions. *See* RIN 1545-BQ61, 88 Fed. Reg. 37186 (June 7, 2023).

[220] 2006 Technical Explanation, art. 17(1).

[221] H.M. Revenue & Customs Question and Answer document released January 13, 2009, *available at* http://src.bna.com/H24.

[222] Some older treaties phrase the rule in accordance with the 1981 U.S. Model Treaty. *See, e.g.*, U.S.-Canada Income Tax Treaty, art. 18(1) (before amendment by Protocol, June 14, 1983): "[T]he amount of any pension included in income for the purposes of taxation in that other State shall not exceed the amount that would be included in the first-mentioned State if the recipient were a resident thereof."

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has already been subject to tax. Thus, for example, as explained in the 1996 Technical Explanation, "if a Contracting State had imposed tax on the resident with respect to some portion of a pension plan's earnings, subsequent distributions to a resident of the other State would not be taxable in that State to the extent the distributions were attributable to such amounts."[223]

c. *Pensions Eligible for Treaty Benefit*

The provisions discussed above apply only to payments by private pensions.[224] The term "pension" is not defined in the 2006 or 2016 U.S. Model Treaties, although the term "pension fund" is defined in both.[225] It is not unusual for treaties in force to provide no definition for the term "pension." An exception to this general rule is found in the U.S.-Canada Income Tax Treaty, however, which defines "pensions" in Article 18(3) to include "any payment under a superannuation, pension or other retirement arrangement, Armed Forces retirement pay, war veterans pensions and allowances and amounts paid under a sickness, accident or disability plan, but does not include payments under an income-averaging annuity contract or, except for the purposes of [the Government Service Article], any benefit referred to in paragraph 5 [social security]."[226] Other (particularly older) treaties define "pensions and other similar remuneration" as "periodic payments made by reason of retirement or death, in consideration for services rendered, or by way of compensation paid after retirement for injuries received in connection with past employment."[227]

U.S. Model Treaties' inclusion of "other similar remuneration" among the types of distributions covered by the treaty benefit suggests that the benefit is not limited strictly to distributions from traditional pensions. The inclusive phrase "similar remuneration" suggests it is intended to encompass, among other things, some distributions from U.S. IRAs, which would typically not qualify as pensions because employers do not provide them.[228]

In the context of the U.S.-UK Income Tax Treaty, the IRS has defined a pension as "a stated allowance or stipend paid by an employer in consideration of services rendered, to a retired employee, payment being conditioned on retirement."[229] Bonuses paid to employees in respect of years of service, for example, do not qualify as pensions unless also conditioned on retirement.[230] Despite the requirement for a "stated allowance or stipend," the IRS has accepted both defined benefit and defined contribution plans as "pensions" for treaty purposes.[231]

d. *Periodic vs. Lump Sum Payments*

When a treaty does not distinguish between periodic and lump sum payments, both types of payment may qualify for treaty benefits. Article 17(1) of the 2006 and 2016 U.S. Model Treaties does not explicitly refer to lump sum payments, but the 2006 Technical Explanation states that "single sum" payments are included.[232] Article 18(1) of the 1996 U.S. Model Treaty similarly states that distributions may qualify for treaty benefits "whether paid periodically or as a single sum."[233] While many treaties in force do not include this phrase,[234] the 1996 Technical Explanation clarifies that at least for U.S. purposes even if a treaty does not distinguish between periodic and lump sum payments, "the same result is understood to apply."[235]

Some U.S. income tax treaties such as the U.S.-Australia Income Tax Treaty[236] as well as some older treaties[237] expressly define pension distributions as "periodic payments." There is some uncertainty here, as the IRS has taken inconsistent positions as to whether lump sum distributions from pensions may qualify for benefits under treaties that contain such language.[238]

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[223] 1996 Technical Explanation, art. 18(1).

[224] See Article 19(2) of the 2006 and 2016 U.S. Model Treaties, discussed above, for the treaty approach to pensions for government service.

[225] 2006 U.S. Model Treaty, art. 3(1)(k); 2016 U.S. Model Treaty, art. 3(1)(k).

[226] *See also* Technical Explanation to Article 13, ¶1 of the 2008 Canada Protocol (discussing the definition of a pension). Article 18(3)(b) of the U.S.-Canada Income Tax Treaty further provides that a "Roth IRA, within the meaning of section 408A of the Internal Revenue Code, or a plan or arrangement created pursuant to legislation enacted by a Contracting State after September 21, 2007 that the competent authorities have agreed is similar" is considered a "pension" for purposes of the treaty. It also admonishes that "[n]otwithstanding the provisions of the preceding sentence, from such time that contributions have been made to the Roth IRA or similar plan or arrangement, by or for the benefit of a resident of the Other Contracting State (other than rollover contributions from a Roth IRA or similar plan or arrangement described in the previous sentence that is a pension within the meaning of this subparagraph), to the extent of accretions from such time, such Roth IRA or similar plan or arrangement shall cease to be considered a pension for purposes of the provisions of this Article [18]." The Technical Explanation to Article 13 of the 2008 Canada Protocol explains the meaning of this sentence: "if an individual who is a resident of Canada makes contributions to his or her Roth IRA while a resident of Canada, other than rollover contributions from another Roth IRA (or a similar plan described below), the Roth IRA will cease to be considered a pension at that time with respect to contributions and accretions from such time, and accretions from such time will be subject to tax in Canada in the year of accrual. Thus, the Roth IRA will in effect be bifurcated into a 'frozen' pension that continues to be subject to the rules of Article XVIII and a savings account that is not subject to the rules of Article XVIII." The Technical Explanation to Article 13 of the 2008 Canada Protocol provides an example illustrating this result. *See also* Staff of the Joint Committee on Taxation, Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Canada (JCX-57-08) at 62–63, 110th Cong., 2d Sess. (2008).

[227] *See, e.g.,* U.S.-Australia Income Tax Treaty, art. 18(4); U.S.-Egypt Income Tax Treaty, art. 19(4) (similar); U.S.-South Korea Income Tax Treaty, art. 23(3); U.S.-Trinidad and Tobago Income Tax Treaty, art. 22(3) (similar); former U.S.-Japan Income Tax Treaty, art. 23(2) (defining "pensions and other similar remuneration" as in the U.S.-Australia Income Tax Treaty, but including U.S. and Japanese social security benefits) (no longer in force; replaced by current U.S.-Japan Income Tax Treaty). *See also* U.S.-Austria Income Tax Treaty, art. 18(5)(b)(i) (defining a "pension scheme" to include "an arrangement in which the individual participates to secure retirement benefits payable in respect of the dependent personal services").

[228] *See* 1996 Technical Explanation, art. 18(1); 2006 Technical Explanation, art. 17(1).

[229] Rev. Rul. 71-478 (*quoting Hooker v. Hoey*, 27 F. Supp. 489, 490 (S.D.N.Y. 1939), aff'd per curiam, 107 F.2d 1016 (2d Cir. 1939)).

[230] Rev. Rul. 71-478.

[231] Rev. Rul. 71-478.

[232] 2006 Technical Explanation, art. 17(1).

[233] The Technical Explanation to Article 18 of the U.S.-Chile Income Tax Treaty also contains similar language, *viz.*, "The term 'pension payments and other similar remuneration' includes both periodic and single sum payments."

[234] *See, e.g.,* U.S.-Germany Income Tax Treaty, art. 18(1); U.S.-Netherlands Income Tax Treaty, art. 19(1).

[235] 1996 Technical Explanation, art. 18(1).

[236] U.S.-Australia Income Tax Treaty, art. 18(4).

[237] *See, e.g.,* 1971 U.S.-Japan Income Tax Treaty, art. 23(2) (no longer in force). In contrast, article 17(1) of the U.S.-Japan Income Tax Treaty currently in force is silent on this point, containing instead language similar to the more modern U.S. Model Treaties.

[238] *See, e.g.,* PLR 9041041 (in discussing the former U.S.-Switzerland Income Tax Treaty, the IRS observed that the "definition of a pension as a periodic payment does not preclude a lump sum payment from qualifying as a pension. In the absence of a specific provision covering lump sum payments,

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e. U.S. Pensions Covered by Treaties

(1) Qualifying Plans and Distributions

Determining what constitutes a qualifying "pension" for purposes of a treaty, the 2006 Technical Explanation clarifies that qualified tax-deferred plans under U.S. tax law will generally qualify for treaty benefits.[239] It explains that "pensions and other similar remuneration" are intended to encompass payments made by qualified private retirement plans — including qualified plans under §401(a), individual retirement plans (including individual retirement plans that are part of a simplified employee pension plan that satisfies §408(k), individual retirement accounts, and §408(p) accounts), §403(a) qualified annuity plans, and §403(b) plans.[240] The 1996 Technical Explanation includes a similar discussion listing the same types of plans, including as "pension distributions" payments on retirement or death from qualified §401(a) trusts (including §401(k) deferred plans), §457 government deferred compensation plans of state and local governments, qualified annuity plans under §403(a) and §403(b), and "individual retirement plans" such as IRAs as defined in §408.[241]

(2) Roll-overs to IRAs

While IRAs may qualify as pensions under the 1996, 2006 and 2016 U.S. Model Treaties,[242] there had been uncertainty about the tax treatment of certain rollovers by non-U.S. residents before retirement. In a 1982 PLR, for example, the IRS explained that when a resident of non-U.S. Contracting State with a treaty that would otherwise permit lump sum distributions to qualify for treaty benefits chose to roll over pension benefits into a U.S. IRA, the rollover was not a pension payment. Thus, distributions from the rollover could be taxed without benefit of the treaty's pension article.[243] The IRS's rationale for this result was that "[t]he U.S. attaches a condition of retirement to its meaning of the term 'pension.'" Because one can withdraw funds from an IRA at any time (subject to certain penalties), the IRS concluded that IRAs were not pensions.[244] Later private letter rulings took more lenient positions, however.[245]

Although the 1996 U.S. Model Treaty contemplated the inclusion of IRAs as pensions, it did not clearly address the rollover issue. The definition of qualified pension distributions in the technical explanation to the 1996 U.S. Model Treaty provided that "[a] distribution from a pension plan solely due to termination of the pension plan is not a distribution falling under paragraph 1 [of Article 18]."[246] It further provided that qualifying pension distributions must be made to employees who are either at least 62 years old or have been employed by the same employer for at least five years. Thus, while IRAs were generally qualified plans, it was unclear whether rollovers that did not meet the Technical Explanation's definition of qualified distributions were entitled to the benefits of Article 18(1) under the 1996 U.S. Model Treaty.

This uncertainty, however, is addressed in the Technical Explanation to the 2006 U.S. Model Treaty. It first describes the general rule that a distribution that would be tax-exempt under the law of the state in which the pension is established, if made to a resident of that state, must also be exempt when made to a resident of the other country. The Technical Explanation then states "if the distribution were not subject to tax when it was 'rolled over' into another U.S. IRA (but not, for example, to a pension fund in the Other Contracting State), then the distribution would be exempt from tax in the Other Contracting State."[247]

f. Non-U.S. Pensions Covered by Treaties

In addition to identifying several types of U.S. pension plans that qualify as "pensions" under the 1996 U.S. Model Treaty (as discussed immediately above), the Technical Explanation to the 1996 U.S. Model Treaty identifies general criteria for plans and distributions with respect to which treaty benefits may be available.[248] For example, in order for a non-U.S. plan to be considered a "pension" within the scope of the U.S. Model Treaty, it must be in consideration of past employment. Further, the competent authorities may agree that distributions from other plans qualify as pensions, and the U.S. competent authority will agree that distributions from non-U.S. plans qualify as pensions only when the plans meet conditions generally similar to §401(a) requirements for qualified (U.S.) plans:

1. The plan must be written;

2. Employer-maintained plans must not "discriminate," i.e., they must provide significant benefits to all types of employees;

3. Employer-maintained plans must "severely" limit non-retirement uses of plan distributions; and

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the term 'periodic' is simply descriptive of a pension payment generally, not a restriction on the manner of payment. A pension payment in the form of a lump sum payment is made in consideration for services rendered and is in the nature of a periodic payment as intended by the [treaty]"). *But see* INFO 2001-0063 (Feb. 15, 2001) ("Depending on circumstances, lump sum distributions might not qualify as periodic payments, and another article of the Treaty might apply."); FSA 1995 WL 1918565 (July 20, 1995) ("Under some treaties, the pension exemption may only be available for periodic payments" even though "lump sum distributions are permissible distributions from qualified plans generally.").

[239] 2006 Technical Explanation, art. 17(1). Other than new Article 17(2), the 2016 Model contains the same rules as the 2006 Model, so the 2006 Technical Explanation remains helpful for interpretation purposes.

[240] 2006 Technical Explanation, art. 17(1).

[241] 1996 Technical Explanation, art. 18(1).

[242] *See* 1996 Technical Explanation of Article 18(1); 2006 Technical Explanation of Article 17(1).

[243] PLR 8718023 (interpreting the U.S.-Canada Income Tax Treaty, before amendment by the 2007 Protocol).

[244] PLR 8718023. The PLR outlined that the distribution was instead governed by the "Other Income" article of the treaty, which prescribed a maximum 15% U.S. tax.

[245] For example, in PLR 8904036, the IRS concluded in 1988 that when an employee rolled over pension funds into a segregated IRA after more than five years of continuous service, at age 55 and in contemplation of imminent retirement, the employee could receive the benefits of the pension provision of the former U.S.-Italy Income Tax Treaty (no longer in force), notwithstanding the fact that the rollover lost its character as a pension. *See also* PLR 9626055 (concluding that a transfer of IRAs to a taxpayer-spouse pursuant to a divorce did not change the character of amounts in the IRAs as pensions).

[246] This limitation is consistent with PLR 9253049.

[247] 2006 Technical Explanation, art. 17(1).

[248] 1996 Technical Explanation, art. 18(1).

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4. The plan must provide for payments of reasonable benefits at death, a stated age, or "an event related to work status," and must otherwise provide that benefits paid to a participant's survivors are "merely incidental" to benefits paid to the participant.[249]

The 1996 Technical Explanation further provides that distributions from otherwise qualified plans must meet certain requirements before they come within the scope of the U.S. Model Treaty. Distributions are considered eligible distributions only if made on account of death or disability, as part of a series of substantially equal payments over the employee's life expectancy, or after the employee attains age 55. In addition, such distributions must be received after employment terminates or the employee reaches age 65.[250] In general, therefore, eligible non-U.S. plans and distributions must have restrictions similar to those found in qualifying U.S. plans.

The Technical Explanation to the 2006 U.S. Model Treaty takes a different approach, omitting any discussion of general criteria for a non-U.S. plan. Instead, it leaves the issue to be resolved by negotiations between the relevant competent authorities, without providing guidance concerning the meaning of "similar criteria."[251]

Observation: In order for a retirement plan to be considered a "pension fund" within the meaning of the 2006 and 2016 U.S. Model Treaties, the plan must be "generally exempt from taxation in [the relevant] Contracting State."[252] Therefore, reference must be made to the pronouncements of the tax authorities of treaty partners to determine whether a given retirement plan and the benefits thereunder may be eligible for the benefits of an applicable treaty.

g. *Deduction and Exclusion of Cross-Border Contributions, Earnings, and Rollovers*

(1) *Cross-Border Contributions, Earnings, and Rollovers Under the 1996 U.S. Model Treaty*

Modern U.S. Model Treaties contain provisions dealing with cross-border pension contributions.[253] These provisions are generally intended to remove additional barriers for personal services that could otherwise result from differences in the laws of the Contracting States regarding the treatment of pension contributions.

The 1996 U.S. Model Treaty, Article 18(6), affords certain protections to employees who participate in pension plans in one Contracting State while performing personal services in the other Contracting State. Such benefits are generally available to all treaty-eligible employees participating in otherwise eligible plans, regardless of which Contracting State in which they are resident.[254] Specifically, if the employee contributes to a plan in one Contracting State while performing services in the other Contracting State (or if an employer contributes to such a plan on his or her behalf), such other Contracting State must permit the employee to deduct or exclude the contribution from taxable income.[255] And earnings on such contributions are not taxable until distribution.[256]

To protect cross-border rollovers from immediate taxation, a distribution from an eligible plan in one Contracting State is not taxable under the 1996 U.S. Model Treaty if the employee contributes such distribution to a plan in the other Contracting State in accordance with the requirements for tax-free rollovers in such other Contracting State.[257] To qualify for these benefits, such contribution must be made to a qualified plan before that employee arrives in the other Contracting State, and the competent authority of the other Contracting State must also agree that the pension plan in the first Contracting State "generally corresponds" to the pension plan in the other Contracting State.[258]

In a case interpreting a provision of the U.S.-France Income Tax Treaty similar to article 18 of the 1996 U.S. Model Treaty, the Tax Court narrowly construed the "general corresponds" requirement. For the years at issue (the treaty language has since been amended), then Article 18(2)(a) of the U.S.-France Income Tax Treaty provided that when a resident of one Contracting State (who is not a citizen of that Contracting State) contributes to a plan in the other Contracting State, contributions will be treated for tax purposes in the Contracting State of residence the same way they would be treated by the other Contracting State, provided the competent authority of the Contracting State of residence agrees that the pension arrangement in question "generally corresponds" to a pension arrangement recognized for tax purposes by that Contracting State. In *Bichindaritz v. Commissioner*,[259] a French national who was a U.S. resident for treaty purposes contributed to a French pension plan and deducted these contributions from her U.S. income as if they were traditional IRA contributions. The taxpayer argued that the French pension plan "generally corresponded" to a U.S. trust as described in §501(c)(18),[260] to which contributions were deductible. The Tax Court, however, could find no evidence that the French plan was a trust or that the plan resembled §501(c)(18) trusts in other material respects. As such, even though contributions to the plan may have been de-

[249] 1996 Technical Explanation, art. 18(1).

[250] 1996 Technical Explanation, art. 18(1).

[251] 2006 Technical Explanation, art. 17(1).

[252] *See* 2006 U.S. Model Treaty, art. 3(1)(k); 2016 U.S. Model Treaty, art. 3(1)(k).

[253] *See* 2016 U.S. Model Treaty, art. 18; 2006 U.S. Model Treaty, art. 18; 1996 U.S. Model Treaty, art. 18(6).

[254] *See* 2006 Technical Explanation to Article 18(2), which is generally similar to Article 18(6) of the 1996 U.S. Model Treaty.

[255] 1996 U.S. Model Treaty, art. 18(6)(a).

[256] 1996 U.S. Model Treaty, art. 18(6)(b). As discussed below, the 2006 and 2016 U.S. Model Treaties incorporated this rule in article 18(1) and article 17(2), respectively.

[257] 1996 U.S. Model Treaty, art. 18(6)(c). Cross-border rollovers subject to Article 18(6)(c) must be distinguished from rollovers by non-U.S. residents between two U.S. plans, which in some cases may be subject to tax. *See* 1996 Technical Explanation, Article 18, ¶6 (acknowledging that IRAs would qualify as plans subject to Article 18(6)). The 2006 and 2016 U.S. Model Treaties may limit taxpayers' ability to roll over amounts between cross-border pension plans. *See also* IRS INFO 2008-0043 (opining that under the U.S.-U.K. Income Tax Treaty, a "transfer of funds from a U.K. occupational pension scheme to a U.S. IRA or other U.S. qualified pension plan will be taxed as a distribution to the participant unless the transfer qualifies as an 'eligible rollover distribution' within the meaning of section 402(c)(4) of the Code.").

[258] 1996 U.S. Model Treaty, art. 18(6)(d).

[259] T.C. Memo. 2005-298. *Bichindaritz* interpreted the U.S.-France Income Tax Treaty, before amendment by the 2004 and 2009 Protocols.

[260] §501(c)(18) covers pre-June 25, 1959 trusts that are part of pensions funded solely by employee contributions with benefits payable in a non-discriminatory manner to employees under a non-discriminatory classification.

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ductible in France, the taxpayer could not deduct such contributions for U.S. tax purposes.[261]

(2) Cross-Border Contributions and Earnings Under the 2006 and 2016 U.S. Model Treaties

Article 18(6) of the 1996 U.S. Model Treaty has been incorporated into few treaties in force. The OECD Model Treaty does not include a similar provision. Nevertheless, the 2006 U.S. Model Treaty incorporated and expanded upon Article 18(6) in a new, stand-alone "Pension Funds" article.[262] The 2016 U.S. Model Treaty also contains this provision.[263]

Article 17(2) in the 2016 U.S. Model Treaty and Article 18(1) in the 2006 U.S. Model Treaty generally provide that if an individual resident in one Contracting State is the beneficiary of a pension fund established in the other Contracting State, the first Contracting State may tax income of the pension fund as income of the individual only when and to the extent it is paid to (or for the benefit of) the individual from the pension fund.

> *Example:* While Individual I is a U.S. resident working in the United States, he contributes to a U.S. qualified pension plan. Later, I moves to Country X, which is a party to a tax treaty with the United States that contains a provision corresponding to Articles 17 and 18 of the 2016 U.S. Model Treaty. Article 18(1) prevents Country X from taxing I with respect to the pension plan's earnings as they accumulate in the plan. If the plan later makes a distribution to I, Country X can tax I on the distribution, but only to the extent permitted under Article 17(1); that is, Country X could not tax the distribution to the extent it would be exempt from tax in the United States if I were still a resident of the United States.[264]

Article 18 of the 2006 and 2016 U.S. Model Treaties provides the same benefit, generally subject to the same conditions as provided by Article 18(6)(a) of the 1996 U.S. Model Treaty. That is, regardless of which treaty country in which an employee is resident, contributions made on behalf of that employee in one Contracting State with respect to personal services performed in the other Contracting State must be deductible or excludible from the employee's taxable income in that other Contracting State.[265]

2. Annuity Payments

Article 18(3) of the 1996 U.S. Model Treaty, Article 17(3) of the 2006 U.S. Model Treaty, and Article 17(4) of the 2016 U.S. Model Treaty all provide that "[a]nnuities derived and beneficially owned by an individual resident of a Contracting State shall be taxable only in that [Contracting] State." The general rule for annuities is therefore the same as the general rule for private pension distributions. Most U.S. income tax treaties, including those with the United Kingdom,[266] Japan,[267] and Germany,[268] follow the U.S. Model Treaty approach. In contrast, the U.S.-Canada Income Tax Treaty permits the Contracting State in which annuities arise to (also) tax such amounts at a rate of up to 15%.[269]

The 2006 and 2016 U.S. Model Treaties define an annuity as "a stated sum paid periodically at stated times during a specified number of years, or for life, under an obligation to make the payments in return for adequate and full consideration (other than services rendered)."[270] The definition in the 1996 U.S. Model Treaty is identical, except the phrase "or for life" is not included.[271] Similar definitions are found in many treaties in force.[272] Under this broad definition, if interpreted literally, certain payments made to individual holders of a wide variety of debt instruments could theoretically be considered annuities. Longstanding caselaw, however, has generally restricted the definition of "annuities" for U.S. treaty purposes to "the contractual type of annuity, for example, the kind that might be purchased from an insurance company."[273] The same caselaw noted that the general purpose of taxing annuities in the state of the beneficiary's residence is to prevent individual residents of a Contracting State from shopping for the best available tax rates for annuities sold in other countries.[274]

3. Social Security Benefits

The 2016 U.S. Model Treaty, Article 17(3), generally provides that benefits received under social security or any "similar legislation" of the Contracting State making the payment and received by a resident of the other Contracting State (or a citizen of the United States), may be taxed only by the Contracting State making the payment. The same general rule appears at Article 17(2) of the 2006 and Article 18(2) of the 1996 U.S. Model Treaty. The reference to U.S. citizens is included to ensure that social security payments made by the other Contracting State to a U.S. citizen will not be taxable by the United States.[275]

Such a "source state" approach to the taxation of social security and similar public pension-type benefits is fairly common in U.S. treaties in force. For example, U.S. treaties with the Netherlands[276] and China[277] follow the U.S. Model Treaty

[261] *Bichindaritz v. Commissioner*, T.C. Memo. 2005-298. The Tax Court also held that the taxpayer had untimely raised this issue.

[262] 2006 U.S. Model Treaty, art. 18.

[263] 2016 U.S. Model Treaty, art. 18.

[264] *See* 2006 Technical Explanation of Article 17(1); the Technical Explanation provides as an example a distribution from a Roth IRA, which would be exempt from U.S. tax; accordingly, such distribution is also exempt from Country X tax.

[265] As with the 1996 U.S. Model Treaty, this benefit is conditioned on the employee having commenced contributions before he began to exercise employment in the other State, and on the competent authority's agreement that the plan in question generally corresponds to a pension plan in its jurisdiction.

[266] U.S.-U.K. Income Tax Treaty, art. 17(4).

[267] U.S.-Japan Income Tax Treaty, art. 17(2).

[268] U.S.-Germany Income Tax Treaty, art. 18(2).

[269] U.S.-Canada Income Tax Treaty, art. 18(2)(b). Note, however, that the amount subject to this tax in the Contracting State of residence is limited to the portion of such payment that would not be excluded from taxable income in the Contracting State in which it arose (if the recipient were a resident of the Contracting State in which it arose). *See* Article 18(4)(a) of the U.S.-Canada Income Tax Treaty for the definition of an "annuity."

[270] 2006 U.S. Model Treaty, art. 17(3); 2016 U.S. Model Treaty, art. 17(4).

[271] 1996 U.S. Model Treaty, art. 18(3).

[272] *See, e.g.,* U.S.-U.K. Income Tax Treaty, art. 17(4); U.S.-Japan Income Tax Treaty, art. 17(2); U.S.-Germany Income Tax Treaty, art. 18(2).

[273] *Kimball v. Commissioner*, 6 T.C. 535, 540 (1946).

[274] *Kimball v. Commissioner*, 6 T.C. at 539.

[275] 2006 Technical Explanation, art. 17(2).

[276] U.S.-Netherlands Income Tax Treaty, art. 19(4).

[277] U.S.-China Income Tax Treaty, art. 17(2).

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approach.[278] Not all U.S. treaties in force, however, follow the U.S. Model Treaty's treatment of social security benefits. The U.S. income tax treaties with the United Kingdom, Germany, Japan, and Egypt, for example, contain the opposite rule and permit taxation of social security benefits by only the Contracting State in which the recipient is a resident.[279] Yet other treaties take different approaches. For example, under the U.S.-Israel Income Tax Treaty, social security benefits and all other "public pensions" paid by one of the Contracting States to a resident of the other Contracting State are wholly exempt from taxation in both Contracting States.[280] Under the U.S.-Canada Income Tax Treaty, social security benefits are taxed slightly differently depending on whether the recipient is a Canadian resident or U.S. resident.[281] And some U.S. treaties in force grant both Contracting States the right to tax such benefits;[282] but in these situations the Contracting State in which the recipient is a resident would be required to provide double taxation relief.[283]

4. *Alimony and Child Support*

Before the enactment of the 2017 tax act, U.S. domestic tax law distinguished between alimony and child support. As in effect with respect to divorce or separation instruments executed before January 1, 2019, alimony payments were includible in the recipient's gross income under former §71(a) and deductible by the payor under former §215(a). Alimony payments made pursuant to divorce or separation agreements executed after December 31, 2018, however, are neither includible in the recipient's income nor deductible by the payor.[284] Such payments are therefore treated the same as child support payments, which are neither deductible nor includible in either party's income.[285] Because U.S. tax law previously distinguished between alimony and child support payments, the 1996, 2006 and 2016 U.S. Model Treaties likewise distinguished between these types of income.

The 1996, 2006, and 2016 U.S. Model Treaties each define alimony as "periodic payments made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support, which payments are taxable to the recipient under the laws of the Contracting State of which he is a resident."[286] Thus, a payment does not qualify as alimony for treaty purposes if it is not taxable to the recipient.

Article 18(4) of the 1996 U.S. Model Treaty provides that a deductible alimony payment made by a resident of one Contracting State, to a resident of the other Contracting State, is taxable only by that other Contracting State (i.e., the recipient's state of residence). Article 17(4) of the 2006 and Article 17(5) of the 2016 U.S. Model Treaty take the same general approach but liberalize this rule. They provide that alimony payments are taxable only in the Contracting State of which the recipient is a resident, regardless of whether such payments are deductible in the other Contracting State.

Many U.S. treaties in force follow the U.S. Model Treaty approach that alimony is generally taxable solely by the Contracting State in which the recipient is a resident.[287] There are variations on this approach, however. For example, some U.S. treaties do not define alimony, leaving that issue to domestic law.[288] Some U.S. treaties provide that deductible alimony is taxable only in the recipient's state of residence, but that nondeductible alimony is exempt from tax in both Contracting States.[289] On the other hand, the U.S.-Mexico Income Tax Treaty provides for taxation of alimony payments exclusively by the payor's state of residence.[290] The U.S.-Australia Treaty likewise limits taxation to the Contracting State in which the alimony payments "arise."[291] Finally, a number of U.S. treaties in force do not separately deal with alimony as such.[292] Presumably, in these treaties alimony would fall into the category of "other income."

Observation: Unless and until existing treaties containing deductibility language in the alimony provisions are modified, the characterization of marital settlement payments as alimony or child support, while of no particular income tax significance with respect to post-2018 marital dissolutions for U.S. residents, may (continue to) have significance where one of the divorcing spouses is a resident of the other treaty country.

Article 17(5) of the 1996 and 2006 Model Treaties and Article 17(6) of the 2016 U.S. Model Treaty exempt child support payments from taxation in both Contracting States. For this purpose, the 1996, 2006, and 2016 U.S. Models apply to "[p]eriodic payments … for the support of a child made pursuant to a written separation agreement or a decree of divorce,

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[278] *See, e.g.,* U.S.-Australia Income Tax Treaty, art. 18(2); U.S.-Bangladesh Income Tax Treaty, art. 19(2); U.S.-Belgium Income Tax Treaty, art. 17(2); U.S.-Czech Republic Income Tax Treaty, art. 19(1)(b); U.S.-Luxembourg Income Tax Treaty, art. 19(1)(b); U.S.-Mexico Income Tax Treaty, art. 19(1)(b); U.S.-Sweden Income Tax Treaty, art. 19(2).

[279] U.S.-U.K. Income Tax Treaty, art. 17(3); U.S.-Germany Income Tax Treaty, art. 18(5) ("Social security benefits paid under the social security legislation of a Contracting State and other public pensions … paid by a Contracting State to a resident of the Other Contracting State shall be taxable only in that Other Contracting State."); U.S.-Japan Income Tax Treaty, art. 17(1) (including social security benefits among the pension distributions taxable only in the state of residence of the recipient); U.S.-Egypt Income Tax Treaty, art. 20 ("Social security payments and similar amounts paid by one of the Contracting States to an individual who is a resident of the Other Contracting State shall be taxable only in the Other Contracting State.").

[280] U.S.-Israel Income Tax Treaty, art. 21.

[281] U.S.-Canada Income Tax Treaty, art. 18(5).

[282] *See, e.g.,* U.S.-Portugal Income Tax Treaty, art. 20(1)(b); U.S.-Spain Income Tax Treaty, art. 20(1)(b).

[283] *See, e.g.,* Technical Explanation to Article 20 of the U.S.-Spain Income Tax Treaty; for discussion of double tax relief, *see generally* II., above.

[284] *See* Pub. L. No. 115-97, §11051 (repealing §215, together with various conforming amendments, effective for any divorce or separation instrument executed after December 31, 2018).

[285] Former §71(c). Former §71 applied to "separate maintenance payments" as well as alimony; as used herein for convenience, the term "alimony" also includes separate maintenance payments. *See generally* 515 T.M., *Divorce and Separation* (U.S. Income Series), for a more detailed discussion of the U.S. domestic tax law treatment of alimony and child support payments.

[286] 2016 U.S. Model Treaty, art. 17(5); 2006 U.S. Model Treaty, art. 17(4); 1996 U.S. Model Treaty, art. 18(4).

[287] *See, e.g.,* U.S.-Spain Income Tax Treaty, art. 20(3); U.S.-Netherlands Income Tax Treaty, art. 19(6); U.S.-Denmark Income Tax Treaty, art. 18(4).

[288] *See, e.g.,* U.S.-Australia Income Tax Treaty, art. 18(6) (alimony taxable only in source state; "alimony" undefined in treaty text); U.S.-Canada Income Tax Treaty, art. 18(6) (alimony taxable only in state of residence unless excludible under source state for source state residents; "alimony" undefined in treaty text).

[289] *See, e.g.,* U.S.-U.K. Income Tax Treaty, art. 17(5); U.S.-Italy Income Tax Treaty, art. 18(5).

[290] U.S.-Mexico Income Tax Treaty, art. 19(3).

[291] U.S.-Australia Income Tax Treaty, art. 18(6).

[292] *See, e.g.,* U.S.-China Income Tax Treaty; U.S.-Sweden Treaty.

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separate maintenance, or compulsory support." Some treaties in force follow the U.S. Model Treaty approach and provide for exemption in both states,[293] while others provide for a variation on this theme — for example exempting the payments from taxation if the payor is not entitled to a deduction,[294] or if the payment would have been exempt from source state taxation had the recipient been a resident of that country.[295] Some treaties, however, either permit taxation of child support by only the payor's (rather than recipient's) state of residence[296] or do not explicitly address child support payments and therefore such payments are subject to the rules applicable to "other income."[297]

5. Students and Trainees

U.S. treaties often contain favorable taxation rules for certain students and trainees who are temporarily present in a Contracting State. Under article 20 of the 2016 U.S. Model Treaty, amounts received by a student or trainee for his maintenance, education or training arising in the other Contracting State, as well as income earned from personal services (up to a prescribed amount), is generally exempt from taxation by the Contracting State in which he is temporarily residing (host state).[298] To qualify for the benefit, the individual must have been a resident of the other Contracting State at the time of their arrival or immediately before arriving in the host state, and the individual's purpose for being in the host state must be the full-time pursuit of such education or training.[299]

Article 20 contains additional terms specific to business trainees. A "business trainee" is an individual who is temporarily in the host state for the purpose of receiving training that is required for his/her profession or professional specialty, or who is an employee of an entity based in the other treaty state and is acquiring experience from a person unrelated to the employer.[300] The exemption from tax provided by article 20 expires after 12 months from the date of the trainee's arrival in the host state.[301]

6. Income from Employment

Article 14 of the U.S. Model Treaty addresses employment income. In general, salaries, wages and similar remuneration earned by an individual can be taxed by only the Contracting State in which the individual is a resident; if, however, the services are performed in the other Contracting State, the other Contracting State (source state) may tax the income as well.[302] Despite this general rule, there is an important, and material, exception that limits the source state's taxation rights that may apply in situations where an individual resides in one Contracting State but performs at least some services for their employer in the other Contracting State. Under this exception, the source state generally may not tax such compensation income if the employee is present in the source state for less than 183 days during the relevant period, the employer paying the compensation is not a resident of the source state, and the compensation is not borne as a deductible expense by a permanent establishment of the employer in the source state.[303] Article 14 does not apply to director's fees, pensions, social security, annuities or government service, which are addressed by other articles.[304] Article 14 is subject to the savings clause.

7. Other Income

U.S. Model Treaties and U.S. tax treaties in force typically contain an "other income" provision intended to address specific types of income not otherwise specifically addressed.[305] Article 21 in the 2006 and 2016 U.S. Model Treaties covers such income. Under the 2006 and 2016 U.S. Model Treaties, items of income in this category are taxable by only the recipient's state of residence. Income covered by this provision may include, for example, gambling winnings, punitive damages, and amounts received for covenants not to compete.[306] Note that the Saving Clause generally applies to the "other income" article in U.S. tax treaties.[307]

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[293] *See, e.g.*, U.S.-Austria Income Tax Treaty, art. 18(4) (subject to the Saving Clause); U.S.-Romania Income Tax Treaty, art. 16(3) (subject to the Saving Clause).

[294] *See, e.g.*, U.S.-Japan Income Tax Treaty, art. 17(3); U.S.-Italy Income Tax Treaty, art. 18(5).

[295] U.S.-Canada Income Tax Treaty, art. 18(6).

[296] *See, e.g.*, U.S.-Germany Income Tax Treaty, art. 18(4); U.S.-U.K. Income Tax Treaty, art. 17(5).

[297] *See, e.g.*, U.S.-China Income Tax Treaty.

[298] 2016 U.S. Model Treaty, art. 20. The 2016 U.S. Model Treaty caps the exemption for personal services income at $10,000, but the competent authorities may periodically adjust the amount.

[299] 2016 U.S. Model Treaty, art. 20(1).

[300] 2016 U.S. Model Treaty, art. 20(3); *See* Technical Explanation to the 2006 U.S. Model Treaty, art. 20, ¶1.

[301] 2016 U.S. Model Treaty, art. 20(1).

[302] 2016 U.S. Model Treaty, art. 14(1).

[303] 2016 U.S. Model Treaty, art. 14(2).

[304] Technical Explanation to article 14 of the 2006 U.S. Model Treaty, ¶2.

[305] *See, e.g.*, 2016 U.S. Model Treaty, art. 21; U.S.-Germany Income Tax Treaty, art. 21; U.S.-Canada Income Tax Treaty, art. 22.

[306] Technical Explanation to the 2006 U.S. Model Treaty, art. 21.

[307] *See* discussion of the Saving Clause above in III.

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V. Residence Country Benefits for Businesses

A. Associated Enterprises

Despite the substantive treaty provisions generally assigning primary taxing jurisdiction to one of the treaty countries and explicitly providing for relief of double taxation, there are still situations that inevitably arise in which both countries claim the right to tax the same item(s) of income, which results in double taxation.

The potential for double taxation arises probably most frequently in the transfer pricing context. The U.S. Model Treaty and modern U.S. treaties contain what is essentially a transfer pricing provision, which, in appropriate circumstances, generally (i) permits a Contracting State to make a transfer pricing adjustment, and (ii) requires the other Contracting State to make a correlative adjustment.

Specifically, Article 9(1) of the 2016 U.S. Model Treaty provides general guidelines for allocating income between or among related parties ("associated enterprises")[308] located in the two Contracting States. Article 9 is intended to effectively incorporate the "arm's-length" principle of transfer pricing — albeit without using that terminology[309] — pursuant to which each Contracting State is permitted to reallocate profits of related enterprises to reflect the results of arm's-length transactions. Importantly, Article 9(2) provides that in the case of a transfer pricing adjustment by one Contracting State allocating profits to an enterprise resident in that Contracting State, the other Contracting State "shall make an appropriate adjustment" (often referred to as a "correlative adjustment") to the amount of tax charged in the other Contracting State on those same profits. This is to prevent double taxation on the same profits and illustrated below:

> *Example:* Foreign Country automobile manufacturer M distributes its products through a U.S. subsidiary, S. S purchases the automobiles from M, imports them, and resells them to its U.S. customers. M charges S $40,000 per vehicle; S sells the vehicles to its customers for $41,000. S therefore makes only $1,000 gross profit per vehicle (for simplicity, assume no expenses further reduce this profit). On audit, the IRS makes a transfer pricing adjustment assessing additional tax on S on the theory that S paid M too much for the vehicles (i.e., artificially depressing taxable profits earned by S in the U.S.). According to the IRS, an arm's-length price of $39,000 per vehicle should have been charged by M, resulting in gross profit of $2,000 per vehicle for S. M must now pay U.S. tax on $2,000 per vehicle (rather than $1,000 per vehicle). Foreign Country, however, believes that the original pricing was correct and is not required under the applicable Foreign Country law to make any corresponding downward adjustment to M's Foreign Country tax bill to reflect the U.S. transfer pricing adjustment.

In the absence of an income tax treaty, S may be left with no recourse; it would be liable for the additional U.S. tax due on the income now being allocated to S without an offsetting decrease in M's Foreign Country tax liability. Therefore, the M–S group would bear double tax, because both M and S end up including the same $1,000 per vehicle (the amount reallocated) in the computation of their taxable income.

A treaty with a provision like Article 9(2) of the U.S. Model Treaty in the example above, the Foreign Country would be required to reduce M's income by $1,000 per vehicle, generating an offsetting Foreign Country tax refund for the affected tax years. Note, however, that this requirement generally applies only if the second Contracting State agrees with the first Contracting State's transfer pricing adjustment — that is, that the price as adjusted by the first Contracting State is consistent with the arm's-length standard. In cases where the two Contracting States disagree — which is not uncommon — the taxpayer must resort to the mutual agreement procedure provided in most U.S. treaties for relief.[310]

In the above example (assuming Foreign Country agreed with the U.S.-initiated transfer pricing adjustment and granted correlative relief), M will have in its possession funds in excess of the amount it should have if the transaction had been conducted on an arm's-length basis (because it would have received a lower price for the automobiles than it actually received). The general practice in the U.S. in these situations is to treat such excess funds in accordance with U.S. domestic tax law. In the example above, the excess funds in M's hands would be characterized as having resulted from a distribution from S to its parent M.[311] In that case (assuming sufficient earnings and profits), S would be deemed to have paid a dividend to M, and secondary tax results such as withholding tax[312] could apply. U.S. treaties generally specify that making such secondary adjustment (deemed transactions) should take into account the other provisions of the treaty, as relevant. In other words, if the effect of such a secondary adjustment is to treat a U.S. corporation as having made a distribution of profits to its parent corporation in the other Contracting State, the treaty's dividend provision will apply to limit the amount of withholding tax that may be imposed on such deemed dividend.

B. Mutual Agreement Procedure

Double taxation arises if the Contracting States disagree on the proper application of the arm's-length standard to income earned by an enterprise (including a PE) in their respective jurisdictions. Double taxation can also arise from incon-

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[308] The term "enterprise" is defined in the 2016 U.S. Model Treaty, art. 3(1)(c) and (d), as "the carrying on of any business" and includes such an enterprise even if carried on "through an entity that is treated as fiscally transparent in that Contracting State." Accordingly, an enterprise can be conducted by an individual, through a legal entity including a hybrid entity or a PE/branch.

[309] *See* 2006 Technical Explanation to U.S. Model Treaty, Art. 9.

[310] *See* 2016 U.S. Model Treaty, Art. 25, and the discussion in the next section, V.B. Mutual Agreement Procedure.

[311] If the adjustment flowed the other way (in favor of the United States), M would generally be deemed to have made a capital contribution to S to account for the excess funds in the hands of S.

[312] *See* §1442; Technical Explanation to the 2006 U.S. model treaty, Art. 9(2). Note, however, that U.S. law provides exceptions to such treatment under certain circumstances. *See* Rev. Proc. 99-32, which allows such excess income to be repatriated on a tax-free basis as an account payable if certain requirements are met.

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sistent sourcing rules, residency determinations, or other asymmetric applications of domestic tax laws or interpretations of treaty terms. In such circumstances, U.S. treaties provide that affected taxpayers may generally invoke the "mutual agreement procedure" (MAP) to seek assistance from the "competent authority" of either Contracting State.[313] Although MAP is available to both individuals and businesses, in practice it tends to be invoked most often in transfer pricing disputes by multinational companies.

Usually, the competent authority is the government official granted the authority to negotiate with his or her counterpart(s) in the other Contracting State on behalf of a taxpayer to relieve double taxation or otherwise resolve issues that have arisen under a treaty.[314] In the United States, the competent authority is the Secretary of the Treasury or his or her delegate.[315] The Secretary has designated the Deputy Commissioner (International) of the Large Business and International (LB&I) division to serve as the U.S. competent authority, and in 2011, the IRS integrated its Advance Pricing Agreement (APA) Program with the MAP — resulting in the Advance Pricing and Mutual Agreement program (APMA). Thus, the competent authority function is now administered as part of the APMA program.[316]

The 2006 and 2016 U.S. Model Treaties provide that a resident of either Contracting State may seek assistance from either competent authority. Every U.S. tax treaty in force provides a competent authority process whereby a taxpayer can seek assistance to relieve double taxation or resolve other issues arising under the treaty. However, most U.S. treaties in force allow the taxpayer to seek assistance only from the competent authority in its state of residence (or citizenship or nationality).[317] Even if the more liberal 2016 U.S. model treaty language were to apply, it stands to reason that in most cases the taxpayer would seek assistance from its own country's competent authority. However, the 2006 Technical Explanation notes that a U.S. PE of a corporation that is a resident of the other Contracting State would be free to seek assistance from the U.S. competent authority, thus illustrating the utility of the more liberal approach.

A competent authority can provide relief on either a unilateral or bilateral basis. If the competent authority from which relief is initially sought agrees that its domestic taxing authority has interpreted the treaty incorrectly, it could simply make a unilateral adjustment. Thus, in the previous example[318] involving transfer pricing with respect to a Foreign Country manufacturer's sales to its U.S. subsidiary, the U.S. competent authority could decide that the IRS adjustment was incorrect; in that case, the U.S. competent authority would simply grant relief and there would be no need to involve the Foreign Country's competent authority.[319]

If, however, the competent authority cannot resolve the case unilaterally, it then seeks to resolve the case by mutual agreement[320] with the other country's competent authority. Thus, in the aforementioned example, the U.S. competent authority would contact the Foreign Country's competent authority and seek to agree on the appropriate transfer price through bilateral negotiations.[321] Some modern treaties contain mandatory arbitration provisions generally providing for the competent authorities to submit to arbitration in the event they are unable to resolve a taxpayer's issue(s) under the traditional MAP negotiation process within a specified period of time.[322]

The IRS issues detailed procedures to be followed by taxpayers seeking U.S. competent authority assistance.[323] Taxpayers should be careful to consult the most up-to-date version of the procedures when requesting assistance from the U.S. competent authority.

A couple procedural caveats should be noted. The first relates to the statute of limitations on seeking tax adjustments and refunds. The 2016 U.S. Model Treaty states that any agreement reached by the competent authorities "shall be implemented despite any time limits or other procedural limitations in the domestic law of the Contracting States."[324] (This provision can

[313] *See, e.g.*, 2016 U.S. Model Treaty, art. 25; U.S.-UK Income Tax Treaty, art. 26; U.S.-Canada Income Tax Treaty, art. 26; U.S.-France Income Tax Treaty, Art. 26; U.S.-Germany Income Tax Treaty, art. 25.

[314] For example, the competent authorities could attempt to resolve an issue where both governments claim that a taxpayer is their resident, where the governments differ as to the characterization of an item of income or an entity, or the meaning of terms used in the treaty. For other examples, see 2016 U.S. Model Treaty, art. 25(3)(c). As an example of characterization of an item of income, the 2006 Technical Explanation offers a payment treated as deferred compensation by one Treaty Partner, but as a pension benefit by the other. 2006 Technical Explanation of Article 25, ¶3. The listing of examples is not exclusive and the competent authorities may reach agreement on other issues as necessary to avoid double taxation.

[315] The Secretary previously designated the Assistant Commissioner (International) to serve as competent authority. At that time, the role was assigned to the Deputy Commissioner (International), Large and Mid-Sized Business Division (LMSB), with day-to-day business administered by the Office of Tax Treaty Division in LMSB. In 2010, the competent authority function was redelegated to reflect the renaming of LMSB to the Large Business and International (LB&I) division. Delegation Order 4-12 (Rev. 3); IRS News Release IR-2010-88 (Aug. 4, 2010).

[316] IRS News Release IR-2011-81 (July 27, 2011). For MAP and competent authority issues unrelated to transfer pricing, the U.S. competent authority's office of Treaty Assistance and Interpretation Team (TAIT) has primary responsibility.

[317] For example, the U.S.-Canada Income Tax Treaty, art. 26(1), provides that an aggrieved taxpayer "may present his case in writing to the competent authority of the Contracting State of which he is resident or, if he is a resident of neither Contracting State, of which he is a national." There is considerable variation among the treaties in force, depending on when they were negotiated and the specific tax systems and procedures of the given Treaty Partner.

[318] *See* V.B., above.

[319] *See* 2016 U.S. Model Treaty, art. 25(2), which contemplates unilateral resolution if possible: "The competent authority shall endeavor, if the objection appears to it to be justified and *if it is not itself able to arrive at a satisfactory solution*, to resolve the case by mutual agreement with the competent authority of the Other Contracting State." (emphasis added).

[320] Hence the nomenclature "mutual agreement procedure," sometimes shortened to "MAP," as noted above.

[321] In addition to case-by-case resolution, competent authorities sometimes enter into general agreements designed to address recurring instances of double taxation. For example, a 1997 agreement between the U.S. and French competent authorities alleviates double taxation for compensation received for services rendered to the French government by a U.S. permanent resident; the agreement requires that the United States grant a foreign tax credit for French taxes on such compensation, even though the income would be considered U.S. source under U.S. domestic law. Announcement 97-61.

[322] *See, e.g.*, U.S.-Canada treaty, Art. 26(6); U.S.-France Income Tax Treaty, Art. 26(5); 2016 U.S. Model Treaty, art. 25(6).

[323] The current procedural guidance is set forth in Rev. Proc. 2015-40; prior versions included Rev. Proc. 2006-54, Rev. Proc. 2002-52, Rev. Proc. 96-13 and Rev. Proc. 91-23. *See also* Rev. Proc. 98-21 (for certain issues specific to the U.S.-Canada Income Tax treaty).

[324] 2016 U.S. Model Treaty, art. 25(2). *See also* Rev. Rul. 72-437 (even without such explicit language in the MAP Article, the then-effective U.S.-Germany Income Tax Treaty required the U.S. to make refunds or allow credits

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work only in the taxpayer's favor; a statute of limitations cannot be reopened or a treaty otherwise invoked to assess *more* tax.)[325] This liberal rule, however, does not always apply under treaties in force. Several either defer to the other country's domestic law limitations period, or provide a separate treaty-specific limitations period for seeking competent authority relief (commonly three or six years).[326] Thus, taxpayers potentially in need of competent authority assistance cannot assume that the liberal model treaty rule applies, but instead must be careful to review the relevant treaty to make sure that they request assistance in a timely manner. Needless to say, a taxpayer should look not only to the terms of the treaty itself but also to the technical explanation as well any protocols, notes and other ancillary documents to the relevant treaty.

The second procedural issue relates to exhaustion of remedies. The U.S. competent authority expressly states in its procedural guidance that "taxpayers should bear in mind that forgoing U.S. competent authority assistance may adversely affect the availability of the foreign tax credit."[327] In other words, failure to seek competent authority assistance to reduce or eliminate a foreign country's imposition of a tax that is arguably imposed in violation of a treaty may preclude a U.S. foreign tax credit with respect to such tax. This rule, which stems from the rule that a foreign tax is not creditable unless it is compulsory,[328] is viewed as necessary to preserve the U.S. tax base. (Otherwise, a U.S. taxpayer with foreign operations might be indifferent in the face of an upward adjustment in foreign tax because U.S. foreign tax credits may be claimed to offset its U.S. taxes by approximately the same amount.)[329] The assertion in the guidance that such failure "may" (rather than will) adversely affect foreign tax credits is hedged because there could be administrative or judicial forums in the foreign country through which a taxpayer can challenge the foreign tax assessment other than, or in addition to, seeking MAP relief — or there could be a valid reason why competent authority relief in a particular instance cannot be sought, or sought at that time.[330]

For a detailed review of U.S. competent authority procedures, *see* 6880 T.M., *U.S. Income Tax Treaties — U.S. Competent Authority Functions and Procedures.* For a detailed review of competent authority procedures of selected U.S. Treaty Partners, see 6885 T.M., *Income Tax Treaties — Competent Authority Functions and Procedures of Selected Countries (A–C),* 6887 T.M., *Income Tax Treaties — Competent Authority Functions and Procedures of Selected Countries (D–G),* 6890 T.M., *Income Tax Treaties — Competent Authority Functions and Procedures of Selected Countries (H–K),* 6892 T.M., *Income Tax Treaties — Competent Authority Functions and Procedures of Selected Countries (L–N),* and 6895 T.M., *Income Tax Treaties — Competent Authority Functions and Procedures of Selected Countries (O–Z).*

C. Advance Pricing Agreements

Advance Pricing Agreements (APAs) are designed to resolve actual or potential transfer pricing disputes in a principled, cooperative manner, as an alternative to the traditional adversarial processes.[331] An APA is a legally binding contract between a taxpayer and a competent authority, typically for multiple years, that establishes the appropriate transfer pricing for one or more intercompany transactions and the allocation of profits and other tax items between or among the related parties located in the Contracting States. An APA will specify the relevant transaction(s), years covered, agreed upon transfer-pricing method(s) and acceptable range of arm's-length results.

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to implement a mutual agreement, notwithstanding that such refunds or credits would otherwise be barred by the U.S. statute of limitations under §6511).

[325] *See* 2016 U.S. model treaty, Art. 1(2); Technical Explanation to 2006 U.S. model treaty, Art. 1(2) ("the Convention may not increase the tax burden on a resident of a Contracting States beyond the burden determined under domestic law") and Art. 25(2) ("temporal or other procedural limitations can be overridden only for the purpose of making refunds and not to impose additional tax").

[326] *See, e.g.,* U.S.-Canada Income Tax Treaty, art. 26(2) ("agreement reached shall be implemented notwithstanding any time or other procedural limitations in the domestic law of the Contracting States, provided that the competent authority of the Other Contracting State has received notification that such a case exists within six years from the end of the taxable year to which the case relates"); U.S.-Netherlands Income Tax Treaty, art. 29(2) (providing that any "agreement reached shall be implemented notwithstanding any time limits or other procedural limitations in the domestic law of the States, provided that the competent authority of the other State has received notification that such a case exists within six years from the end of the taxable year to which the case relates"); U.S.-Italy Treaty, Article 25(1) (case must be presented to the relevant competent authority within three years from the first notification of the action resulting in double taxation).

Additional procedural requirements or limitations may potentially impede a taxpayer's ability to obtain MAP relief. For example, while a closing agreement could previously be reopened to implement the terms of a mutual agreement, the current position of the U.S. competent authority is that while a closing agreement is not necessarily a procedural bar to MAP relief, the U.S. competent authority will endeavor only to seek a correlative adjustment from the other country. Technical Explanation to 2006 U.S. Model Treaty, Art. 25(2); Rev. Proc. 2015-40, § 6.03(2). *See also* Rev. Proc. 2015-40, §6.03 (taxpayer must satisfy a number of conditions for an issue originally presented to IRS Appeals to be accepted for MAP relief, including that the taxpayer file its competent authority request no later than 60 days after its opening conference with IRS Appeals and that the taxpayer not have already executed a closing agreement or any other similar agreement concerning the same issue), and CCA 20240011 (April 11, 2024) ("However the right to competent authority assistance is not absolute, and certain requirements must be satisfied before the competent authorities may accept a case and commence bilateral negotiations.").

[327] Rev. Proc. 2015-40, §6.03(a) (citing Treas. Reg. §1.901-2(e)(5) and Rev. Rul. 92-75, 1992-2 C.B. 197).

[328] *See* Reg. §1.901-2(a)(2)(i); 6020 T.M., *The Creditability of Foreign Taxes — General Issues.*

[329] This is obviously a simplification given the complexities of the foreign tax credit limitations and how they may apply in a given taxpayer's circumstances.

[330] *See, e.g., Coca-Cola Co. v. Commissioner*, 149 T.C. 446 (2017). The extent to which a failure to seek competent authority relief precludes creditability of a foreign tax is sometimes unclear, and that uncertainty can be exacerbated by procedural considerations in a transfer pricing case. In *Coca-Cola*, for example, the IRS unsuccessfully asserted that a failure to invoke Mexican competent authority assistance prevented the taxpayer, a U.S. corporation, from claiming a U.S. foreign tax credit for Mexican taxes paid by its subsidiary. The IRS had taken the position in an ongoing audit that a non-arm's length royalty payment to the taxpayer resulted in an overpayment of Mexican tax. Despite the Mexican taxing authority having approved the amount of the Mexican deduction taken for such payment in prior years, the taxpayer's Mexican advisor having opined that the Mexican taxing authority would not accept an increased deduction amount, and the fact that U.S. competent authority assistance was unavailable because the case had been designated for litigation, the IRS argued that the subsidiary nevertheless should have sought Mexican competent authority assistance. The Tax Court granted summary judgment in favor of the taxpayer on the foreign tax credit issue, noting that the IRS was "in a poor position to contend that [taxpayer] has failed to exhaust its remedies when [the IRS], by his unilateral action, has made it impossible for [taxpayer] to pursue the only remedy that exists." 149 T.C. at 461.

[331] *See* IRS Announcement 2000-35.

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APAs can be either unilateral or bilateral.[332] A bilateral APA combines an agreement on a particular transfer pricing method between the taxpayer and the IRS with an agreement between the U.S. and the competent authority of the other Contracting State that such method is correct. Bilateral APAs are undertaken pursuant to the authority granted by the Associated Enterprises and Mutual Agreement Procedure articles of modern U.S. treaties.[333]

To obtain an APA (which is always voluntary), a taxpayer must file an APA request with the appropriate competent authority/ies setting forth the relevant transactions, facts, full economic analysis and supporting documents. Just as with MAP requests, APA requests have their own detailed procedures and requirements, which vary (sometimes greatly) from country to country.[334] The competent authorities then evaluate the materials and proposed transfer pricing (often requesting additional information along the way), before reaching an agreement on the appropriate transfer pricing. As with MAP negotiations, an agreement (or a satisfactory agreement from the taxpayer's perspective) is not guaranteed.[335]

For a detailed review of Advance Pricing Agreements, *see* 6920-1st T.M., *Transfer Pricing: Advance Pricing Agreements.*

[332] Multilateral APAs are also possible, but far less common.

[333] *See* 2016 U.S. Model Treaty, Art. 9 and 25; IRS Announcement 2000-35.

[334] The current guidelines and procedures for seeking an APA with the U.S. competent authority are contained in Rev. Proc. 2015-41.

[335] The U.S. competent authority introduced new internal procedures for handling APA requests in 2023 that may make it more difficult for some APA requests to be accepted. *See* LB&I-04-0423-0006, Memorandum for Treaty and Transfer Pricing Operations Employees from the Director of Treaty and Transfer Pricing Operations (April 25, 2023).

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VI. Non-Discrimination

Article 24 of the 2016 U.S. Model Treaty embodies the principle: Contracting States may not discriminate against one another's nationals or residents[336] in matters of taxation. This concept can be difficult in implementation, as evidenced by the fact that Article 24 has seven numbered paragraphs, and its equivalent in the 2006 U.S. Model Treaty received some six pages of commentary in the 2006 Technical Explanation. Also of note, Article 24 of the 2016 U.S. Model Treaty is significantly broader than the other treaty provisions considered herein in two respects: (1) its benefits extend to "nationals" of the Contracting States as well as persons who are not resident of one or both Contracting States, not just "residents"; and (2) it protects against discriminatory taxes of all types (non-income as well as income) imposed at all levels (state and local as well as federal).[337]

Article 24(1) states the general rule that nationals of a Contracting State shall not be subject in the Other Contracting State "to any taxation or any requirement connected therewith that is more burdensome than the taxation and connected requirements to which nationals of that other Contracting State in the same circumstances, in particular with respect to tax on residence are or may be subjected." The key concepts are "more burdensome" and "same circumstances." As to the "more burdensome" language, the 2006 Technical Explanation states, "only differences in tax treatment that materially disadvantage the foreign person relative to the domestic person are properly the subject of the Article."[338] The "same circumstances" language limits the non-discrimination requirement to those taxpayers who are "comparably situated."[339] This somewhat vague formulation is further explained by negative reference: the "underlying premise is that if the difference in treatment is directly related to a tax-relevant difference in the situations of the domestic and foreign persons being compared, that difference is not to be treated as discriminatory."[340] The prime example of a permitted tax-relevant difference is the fact that U.S. citizens are taxable on worldwide income.[341] Thus, the 2016 U.S. Model Treaty, Article 24(1), does not require the United States to apply the same tax regime to a nonresident U.S. citizen and a nonresident citizen of the Other Contracting State.[342]

The 2016 U.S. Model Treaty, Article 24(2), provides that a permanent establishment ("PE")[343] of a resident or enterprise of one Contracting State situated in the Other Contracting State may not be "less favorably levied" in that other state than the taxation levied on enterprises or residents of the other state "carrying on the same activities." However, as with Article 24(1), tax-relevant differences may be taken into account. The 2006 Technical Explanation states that the fact that a U.S. PE of an enterprise of the Other Contracting State is taxable only on income that is attributable to the PE, while a U.S. corporation is taxable on its worldwide income, is not a sufficient difference to justify discriminatory treatment to that PE.[344] Also, different information reporting requirements for non-U.S. taxpayers, and penalties for failure to comply therewith, are not discriminatory because their relevant information may not be as readily available to the IRS.[345] Similarly, the IRS has taken the position that the requirement of section 882(c) (that a foreign corporation timely file a return to claim any applicable deductions and credits) is not discriminatory.[346]

Article 24(3) of the 2016 U.S. Model Treaty provides that the treaty's non-discrimination provisions may not be construed to require a Contracting State to grant to residents of the

[336] For the meaning of "residents" in this context, see 2016 U.S. Model Treaty, art. 4.

[337] 2016 U.S. Model Treaty, art. 24(1) and (7) (protection applies "to taxes of every kind and description" imposed by a Contracting State or a political subdivision or local authority thereof).

[338] Curiously, the 1996 Technical Explanation misquotes Article 24(1) of that treaty as applying to any taxation or connected requirement "that is *other* or more burdensome" (emphasis added). The "other" reference is not found in the text of the 1996 U.S. Model Treaty, though that phrase is found in the OECD model. It was omitted from the 1996 U.S. Model Treaty because the drafters did not believe that imposing "different" requirements on foreign nationals was necessarily discriminatory and instead sought to prevent only differences that were "burdensome." 1996 Technical Explanation, art. 24. The "other or more burdensome" language was found in the 1981 U.S. Model Treaty, art. 24(1).

[339] 2006 Technical Explanation, art. 24.

[340] 2006 Technical Explanation, art. 24.

[341] *See e.g.*, Rev. Rul. 74-239, in which the IRS ruled that denying a "Canadian citizen who is both a resident and a nonresident of the U.S. during the taxable year the benefits of using the head of household tax rate schedule, optional tax tables, standard deduction, or a joint return" was not discriminatory. The rationale for this conclusion was that such a Canadian citizen would not have been subject to tax on his worldwide income to the same extent that a United States citizen would have been. Another example of a tax-relevant difference is residence. *Compare* Rev. Rul. 91-58, in which the IRS ruled that nationals of the United Kingdom who were resident in the United States were eligible for the exclusions and deductions provided for in §911 without having to satisfy the physical presence test by application of the non-discrimination provision in the U.S.-U.K. Income Tax Treaty in force at that time, *with* FSA 200002001, in which the IRS concluded that the denial of the standard deduction to a nonresident alien under §63(c)(6)(B) was compatible with the non-discrimination provision in the U.S.-Greece Income Tax Treaty because the Greek citizen was not a resident of the United States and thus the non-discrimination provision of such Treaty was inapplicable.

[342] 2006 Technical Explanation, art. 24, ¶1. Thus, for example, it would not be discriminatory for the United States to tax U.S.-source dividend income on a graduated rate basis if received by a U.S. citizen residing in a third country, but taxing the same income on a gross (withholding) basis if received by a citizen and resident of the Other Contracting State. 2006 Technical Explanation, art. 24, ¶1.

[343] The 1996 U.S. Model Treaty, art. 24(2), also includes fixed bases in this provision. The 1996 Technical Explanation, art. 14, ¶1 provides: "The term 'fixed base' is not defined in the Convention, but its meaning is understood to be similar, but not identical, to that of the term 'permanent establishment,' as defined in Article 5 (Permanent Establishment)."

[344] 2006 Technical Explanation, art. 24, ¶2.

[345] 2006 Technical Explanation, art. 24, ¶2. Similarly, the 2006 U.S. Model Treaty Technical Explanation states that §1446's requirement that partnerships with income effectively connected to a U.S. trade or business withhold tax on amounts allocable to a foreign partner does not violate the non-discrimination clause, even though no such withholding requirement applies to the distributive shares of U.S. partners. It reasons that the taxation applies equally to U.S. and non-U.S. partnerships and that withholding is merely a reasonable method of collecting tax from persons who are not in the United States.

[346] *See* FSA 199944026 (concluding that the requirements of §882(c) and Reg. §1.882-4 are merely procedural requirements and that such differences in procedural requirements are permitted because of the differences in enforcement problems presented by foreign corporations versus domestic corporations); TAM 199941007 (same). *See also Square D Co. v. Commissioner*, 118 T.C. 299 (2002), aff'd, 438 F.3d 739 (7th Cir. 2006). In that case, the Tax Court held that §267(a)(3) and Reg. §1.267(a)-3 were not discriminatory under the U.S.-France Income Tax Treaty in force for the taxable years at issue. This holding was based upon the Tax Court's reasoning that the applicability of §267(a)(3) rested on whether the interest paid to the related foreign party is effectively connected income and on whether the payee uses the accrual method, but not on whether the payee was a resident or national of France. *Square D Co.*, 118 T.C. at 315.

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Other Contracting State any personal allowances or other tax benefits "on account of civil status or family responsibilities" that it grants to its own residents. Thus, for example, a Country X resident subject to U.S. tax on income from a U.S. PE would not be entitled to use the personal exemption for the resident's spouse or other dependents[347] in computing the U.S. tax due on the income attributable to the PE, even though the resident would be entitled to do so if the resident were a U.S. resident.[348]

Article 24(4) of the 2016 U.S. Model Treaty provides in general[349] that interest, royalties, and "other disbursements"[350] paid by a resident of one Contracting State to a resident of the Other Contracting State are deductible to the same extent as if paid to a resident of the First Contracting State.[351] Of course, this potentially raises the issue as to whether the BEAT (section 59A), which effectively denies deductions for certain payments to non-U.S. recipients (but does not impact such payments to U.S. recipients) for taxpayers with sufficient gross receipts, is contrary to the non-discrimination language contained in U.S. tax treaties.

Article 24(5) of the 2016 U.S. Model Treaty provides that enterprises of a Contracting State that are owned by residents of the Other Contracting State cannot be subjected by the First Contracting State to any tax or tax-connected requirement more burdensome than the taxes or tax-connected requirements to which similar enterprises of the First State are subjected. Thus, a State 1 subsidiary of a State 2 parent may not be subject to more burdensome taxes or tax-related rules than a State 1 subsidiary of a State 1 parent. This rule seems straightforward, but on its face conflicts with several provisions in U.S. law imposing differing — may we suggest more burdensome — standards depending on a corporation's foreign ownership. For example, §332 generally exempts from tax liquidating distributions by 80% controlled corporations to their controlling parent. However, §367(e)(2) denies that tax-free treatment for a distribution to an 80% controlling foreign parent.[352] Similarly, a U.S. corporation that meets certain requirements can elect S corporation status, but this election is denied in the case of a U.S. corporation with one or more nonresident alien shareholders.[353]

The 2006 Technical Explanation takes the position that neither rule is discriminatory under the 2006 U.S. Model Treaty, the terms of which are identical in the 2016 U.S. Model Treaty. In the case of §367(e)(2), the 2006 Technical Explanation explains that the policy underlying §332 is that corporate-level tax on the appreciated assets is deferred, not eliminated, because the distributee parent will recognize the built-in gain upon selling or distributing the assets. This policy rationale would be frustrated in the case of a foreign parent not subject to U.S. taxation, and hence §367(e)(2) requires corporate-level gain on the liquidating distribution.[354] However, the 2006 Technical Explanation claims that such rule is not discriminatory because it also requires gain recognition when the liquidating distribution is made to a U.S. tax-exempt organization. Accordingly, the rule turns on a legitimate tax-relevant difference, not discrimination against foreign shareholders. Similarly, the 2006 Technical Explanation reasons that the Subchapter S prohibition is not discriminatory because foreign shareholders are not subject to U.S. net taxation; therefore it does not make sense to allow flow-through of loss, deductions, or credits. "Thus, the S corporation provisions do not exclude corporations with nonresident alien shareholders because such shareholders are foreign, but only because they are not net-basis taxpayers."[355]

Article 24(6) of the 2006 and 2016 U.S. Model Treaties states that the Non-discrimination article does not prevent either Contracting State from imposing a tax as described in the 2006 U.S. Model Treaty, Article 10(8) or 10(10), respectively (that is, the branch profits tax). The 1996 Technical Explanation takes the position that this result would obtain even without this provision, as the specific controls the general and Article 10(8) specifically permits a branch profits tax.[356]

Observation: The traditionally narrow interpretation of what constitutes prohibited "discrimination" makes it very difficult to predict when (some might add, if ever) the Non-discrimination article can be successfully invoked.

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[347] *See* §151, §873(b)(3). Under §873(b)(3), a nonresident alien is entitled to only one exemption under §151, unless he or she is a resident of a contiguous country or a national of the United States.

[348] 2006 Technical Explanation, art. 24, ¶3.

[349] There is an exception to the extent that Articles 9(1), 11(4), and 12(4) of the 2016 U.S. Model Treaty, relating to associated enterprises, interest, and royalties, respectively, apply. This exception is necessary because each cited paragraph permits the denial of deductions for amounts payable to related persons under some circumstances. The 2006 Technical Explanation claims that this exception also applies to the interest limitation imposed by former §163(j), though it is hard to find such coverage in the text of the 2006 or 2016 U.S. Model Treaties. 2006 Technical Explanation, art. 24, ¶4. *Cf.* 2006 Technical Explanation, art. 11, ¶5, which states: "Paragraph 5 provides that in cases involving special relationships between the payor and the beneficial owner of interest income, Article 11 applies only to that portion of the total interest payments that would have been made absent such special relationships (i.e., an arm's-length interest payment). Any excess amount of interest paid remains taxable according to the laws of the United States and the Other Contracting State, respectively, with due regard to the other provisions of the Convention." But it does not specifically reference former §163(j).

[350] Such other disbursements include "a reasonable allocation of executive and general administrative expenses, research and development expenses, and other expenses incurred for the benefit of a group of persons that includes the person incurring the expense." 2006 Technical Explanation, art. 24, ¶4.

[351] In addition, paragraph 3 provides that any debts payable by a resident of State 1 to a resident of State 2 shall, for purposes of determining taxable capital, be deductible under the same conditions as if they were owing to a resident of State 1. Debts are not deductible for U.S. federal income tax purposes, but this provision is necessary to provide protection in the case of state franchise taxes or other taxes based on net worth, as well as foreign wealth, capital, or other asset-based taxes.

[352] See GCM 35444 (Aug. 17, 1973), which although dealing with a prior version of §367, has a rationale that would be applicable to the current version of that statute. ("Code §367 operates to withdraw the transaction from the nonrecognition sections of the Code and thereby subjects the Japanese[foreign] corporations to tax on United States source income and capital gains under the generally applicable Code provisions. Such treatment, in our opinion, does not constitute discrimination against Japanese[foreign] taxpayers. Since both Japanese[foreign] taxpayers engaged in trade or business in the United States and United States taxpayers are subject to the same treatment under Code §367, a Japanese[foreign] taxpayer cannot complain of being subjected to more burdensome taxation under that section than that borne by a United States taxpayer.").

[353] §1361(b)(1)(C).

[354] 2006 Technical Explanation, art. 24, ¶5.

[355] 2006 Technical Explanation, art. 24, ¶5.

[356] 1996 Technical Explanation, art. 24, ¶5. SeveralSome older U.S. treaties in force, however, preclude imposition of a branch profits tax. *See* 6480 T.M., *The Branch-Related Taxes of Section 884.*

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