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H. David Rosenbloom

Stanley Langbein

University of Miami School of Law, slangbei@law.miami.edu

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United States Tax Treaty Policy: An Overview*

H. DAVID ROSENBLOOM† AND STANLEY I. LANGBEIN†

EDITOR'S NOTE: The following is a slightly revised transcript of an April 29, 1980 statement by the then-International Tax Counsel of the Department of the Treasury before the Subcommittee on Oversight of the House Ways and Means Committee. Except for some minor stylistic changes and non-substantive abridgements, it conforms to the Department of the Treasury News release of April 29, 1980, which originally reported the testimony. In the view of the Journal, the discussion of tax treaty policy and provisions appearing in the statement — which has not received wide dissemination — merits its inclusion in this International Tax Issue. Permission to reprint the statements was secured from the authors.

In order to enhance the value of the following discussion to readers wishing to do further research in this area, the transcript has been supplemented by citations to various sources supporting the propositions and identifying the materials mentioned in the statement. The authors have co-operated in the preparation of these citations, but responsibility for their accuracy remains solely that of the Journal. Special thanks are due to the staff of the Journal for their research in the preparation of these citations.

Richard E. Andersen
Professional Articles Editor
International Tax Issue

* Mr. Rosenbloom's testimony, without citations and followed by questions and answers, is reprinted in *Income Tax Treaties: Hearings Before the Subcomm. on Oversight of the House Comm. on Ways and Means*, 96th Cong., 2d Sess. 57-88, 107-130 (1980).

† Member, District of Columbia and New York Bars. J.D., Harvard University, 1966. Mr. Rosenbloom served as International Tax Counsel to the United States Treasury Department, 1978-81.

† Associate, Williams & Connolly, Washington, D.C. Member, District of Columbia Bar. J.D., Harvard University, 1973.

I. INTRODUCTION

Tax treaties represent a highly developed area of international cooperation. Few fields come to mind in which international groups have worked so consistently for so long. The model treaties produced through these efforts — by, for example, the Organization for Economic Cooperation and Development — constitute major achievements. Indeed, one is tempted to address questions in the area by referring only to the treaty materials that exist today, including the U.S. model treaties, and to review outstanding policy issues simply by comparing models and discussing their differences. The existing models do not, however, speak to the question of what tax treaty policy might be. Because they reflect more than half a century of experience among nations, the models tend to assume answers to some fundamental questions.

These fundamental questions are: What is the purpose of tax treaties? Are bilateral treaties the optimum means of carrying out those purposes? Is the basic approach employed by existing models the best form of bilateral agreement? A serious review of United States tax treaty policy must begin with these questions. Accordingly, the first part of this article describes the history of international efforts to achieve "tax harmonization". This part ends with a summary of the highlights of the OECD model income tax treaty, which forms the essential basis of current United States tax treaty policy.

The second part of the article focuses upon the United States experience: (1) our treaties currently in force; (2) the present U.S. model income tax treaty and its differences from the OECD model; and (3) the major "collateral" issues which are of significance in current negotiations. Because most of the attention in the field is focused on income taxation, estate and gift tax treaties are not discussed. This omission should not be taken as downplaying the significant activities currently underway with respect to such treaties.

In concluding, the discussion shifts to the overall "management" of the tax treaty program; the process of designing and modifying the U.S. model; how this country selects negotiation partners; the bargaining process involved in treaty negotiations; the implementation of a treaty once it enters into force; and the degree of public participation in the treaty process.

II. INTERNATIONAL EFFORTS TO ACHIEVE TAX HARMONIZATION

A. *The Antecedents*

What we now call “direct” taxes — taxes imposed directly on income or property — did not come into widespread use until the late eighteenth and early nineteenth centuries. From the first, states imposed such taxes on a dual basis, sometimes taxing because of a relationship to the person (*e.g.*, because he was a resident of the state), sometimes because of a relationship to the property or income (*e.g.*, because the property was located in the state’s territory). This dual basis of taxation obviously created a potential for two states to claim a right to impose the same kind of tax on the same base. But in early times this did not generally pose a practical problem, because international commerce was not highly developed and tax rates were relatively modest.

Double taxation was a problem, however, for states that were closely connected by language, history, or custom, and for political subdivisions of the same state. Quite frequently, in these situations, important commercial relations were threatened by direct taxes imposed on a dual basis. These situations gave rise to the earliest forms of “tax harmonization” laws and interstate or international tax agreements, particularly among the Germanic states of Central Europe in the late nineteenth and early twentieth centuries.

During and shortly after World War I, double taxation became a matter of worldwide significance. Rates of direct taxation, particularly income taxation, were increasing, as was the volume of international business. In the United States, this led to the enactment, in the Revenue Act of 1918,¹ of provisions embodying a “foreign tax credit”, which allowed a deduction from the U.S. income tax for amounts paid to foreign governments as income taxes.² In 1920, a conference of representatives of most members of the League of Nations recommended to the League’s Financial Committee that it study international double taxation and recommend means of alleviating it.

A 1923 report³ commissioned by the League from four econo-

1. Act of February 24, 1919, § 222, 238, 40 Stat. 1057.

2. The allowable “foreign tax credit” was limited in the next revenue act, the Revenue Act of 1921, to an amount equal to the U.S. tax attributable to the taxpayer’s foreign income. Act of November 23, 1921, §§ 222(a)(5), 238(a), 42 Stat. 227.

3. Report on Double Taxation, submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman, and Sir Josiah Stamp, League of Nations Doc. E.F.S.73 F 19,

mists, from the United States, the United Kingdom, the Netherlands and Italy,⁴ discussed the economic consequences of international double taxation; the principles governing the competence of states to impose taxes on "international" property or income; and the application of those principles in developing technical means of eliminating double taxation. For the first point — the economic analysis — the economists used the model of a tax imposed in an "origin" or source country which supplements a pre-existing tax imposed by the country of the investor's "residence". They concluded that the principal consequence of such a tax for pre-existing investments was a diminution of the value of the investment, and thus a penalty on the foreign investor. With respect to new investments, the tax was not a burden on the investor, since it would be discounted in making the investment and the investor could, if necessary, forego the investment altogether. Rather, the "penalty" was ultimately on the source state itself, or its consumers: the tax would raise the rate of return that an investor would demand before investing in that state. The "double" tax was, in effect, a protective tariff on the importation of capital into the source state.⁵

In regard to international competence to tax, the economists described two broad principles of modern direct taxation: "ability to pay" and "economic allegiance".⁶ The first point was simply that taxpayers should bear their share of the burden of government revenue needs in proportion to their ability to pay. The problem posed by this concept in an international context was identifying the group of persons whose ability to pay should be taken into account in allocating tax burdens. The economists concluded that this group should comprise those persons who owed the taxing power "economic allegiance" with respect to the property or income being taxed.⁷

Four elements of economic allegiance were identified: (1) where wealth originated; (2) where wealth, once produced, was kept; (3) where laws that created or protected enforceable rights to wealth existed; (4) where wealth was consumed, disposed of or enjoyed.⁸ The economists then discussed the implications of "eco-

reprinted in League of Nations Publications, II Economic and Financial (No. 28) (1923).

4. *Id.*

5. *Id.* at 3.

6. *Id.* at 7, 8.

7. *Id.* at 18-22.

8. *Id.* at 20.

conomic allegiance" for the rights of states to tax different categories of wealth or income.

With respect to wealth derived from *land*,⁹ the state where the land was located was the dominant factor in production; the land, of course, remained in the source state; that state's laws ordinarily protected rights to land; and therefore that state, as opposed to the state of the owner's residence, had a predominant right to tax. With respect to wealth derived from business property having a fixed location,¹⁰ and from personal property having a close relation to land,¹¹ the considerations were similar to those involved in the case of land and, consequently, the analysis favored the right of the source state to tax. Regarding wealth derived from tangible personal property not closely tied to land,¹² source or *situs* often played little part in the value of the property, and was in fact often determined arbitrarily; the state of the owner's residence, where the property was presumably enjoyed and where rights in the property were usually enforced, enjoyed the predominant claim to "economic allegiance".

With respect to wealth derived from a category of property identified as "corporeal movables not ordinarily capable of a fixed location"¹³ — principally ships — the dominant claim to tax was ascribed to the state of registry, on the ground that that was the state which enforced property rights (the source state was frequently difficult to identify). Wealth derived from intangible property¹⁴ was analyzed under principles similar to those used in the context of tangible personal property: the result was a decision favoring the primacy of the residence state, except in the case of real property mortgages, which were deemed akin to land. Finally, regarding earnings and salaries,¹⁵ the residence state had virtually sole claim to "economic allegiance".

The report discussed four methods of avoiding double taxation. The first would unilaterally concede the primary right to tax to the source state.¹⁶ The second would concede exclusive taxing authority to the residence state through exemption in the state of

9. *Id.* at 22-24.

10. *Id.* at 28.

11. *Id.* at 32.

12. *Id.*

13. *Id.* at 34.

14. *Id.*

15. *Id.* at 38.

16. *Id.* at 42.

source.¹⁷ The third was a "proportionate division" method — dividing taxes between two states according to some predetermined formula.¹⁸ The fourth method was "classification and assignment" — classifying income according to type and assigning primary rights to tax certain types of income to one state and other types to the other.¹⁹ In formulating recommendations, the economists ruled out methods which accorded primary or exclusive taxing rights to the source state, largely on the ground that this would be contrary to modern progressive taxation based upon an "ability to pay" principle.²⁰ Approaches based on proportionate division and classification and assignment were also rejected, because the economists judged the theoretical problems involved in these approaches to be too great.²¹ Their preference was for the second method — exemption by the source state of nonresidents' income — both because it avoided theoretical complexities and because it accorded with what they viewed as economic reality: the source state should cede the right to tax when it sought investment from abroad.²² To the objection that this method would create an unbalanced treatment of "creditor" and "debtor" countries — the method would involve a substantial revenue sacrifice by the latter — the economists responded with a proposal to divide revenues based upon the relative magnitude of the different types of income deemed to have originated in each state. The taxpayer would not be affected.²³

In 1925 a Committee of Technical Experts organized by the League issued a further report on problems of double taxation.²⁴ This report distinguished between "impersonal" taxes — schedular taxes or taxes imposed on different types of income — and "personal" taxes, that is, global taxes imposed on total income.²⁵ With respect to personal taxes, the Experts recommended that the state of domicile be accorded a right to impose a tax on all income.²⁶ They further suggested, however, that the source state also be as-

17. *Id.*

18. *Id.*

19. *Id.*

20. *Id.* at 48.

21. *Id.* at 45.

22. *Id.* at 48.

23. *Id.* at 49.

24. Report and Resolutions submitted by the Technical Experts on Double Taxation and Tax Evasion to the Financial Committee of the League of Nations, League of Nations Doc. C.115. M.55. 1925 II (1925).

25. *Id.* at 12-13.

26. *Id.* Resolution II at 32.

signed a right to tax income from real property and from agricultural, commercial and industrial undertakings.²⁷ When such dual taxation occurred, "relief" would be given in the form of a reduction of tax, calculated according to prescribed formulae, in the state of residence.²⁸

The report of the Technical Experts also addressed, for the first time, the problem of international tax evasion. On the basis of the few existing arrangements between countries, the Committee concluded that "supply . . . [of] information . . . required for tax assessment" represented the best approach to combatting such evasion.²⁹

In 1927 the Technical Experts issued the first international draft model treaties: a model income tax treaty, a model covering succession duties, and a model governing administrative assistance in the collection of taxes.³⁰ These were followed in 1928 by five models issued by a General Meeting of Government Experts convened by the League to discuss the 1927 models. Three of these 1928 models were separate income tax models — one for use between states which employed both "personal" and "impersonal" income tax systems;³¹ a second for use between states wishing to cover only personal tax systems;³² and a third covering exclusively impersonal tax systems.³³ The 1928 models provided the framework for the negotiation of a wide network of tax treaties, particularly among European nations. The models also served as a framework for the earliest United States tax treaties.

From the foregoing review it is clear that the fundamental policy questions in the tax treaty area that are mentioned in the introduction to this article were addressed at an early date. The first question — what tax treaties are intended to achieve — was considered in the first report of the economists: double taxation represents an unfair burden on existing investment and an arbitrary barrier to the free flow of international capital, goods and persons. Nations should therefore seek to eliminate — or at least alleviate

27. *Id.* Resolution II (II) at 32.

28. *Id.*

29. *Id.* at 34.

30. Report Presented by the Committee of Technical Experts on Double Taxation and Tax Evasion, League of Nations Doc. C.216 M.85. 1927 II (1927).

31. Report Presented by the General Meeting Of Government Experts on Double Taxation and Tax Evasion, League of Nations Doc. C.562 M.178 1928 II, Draft Convention No. Ia at 7 (1928).

32. *Id.* Draft Convention No. Ib at 16.

33. *Id.* Draft Convention No. Ic at 19.

— these undesirable consequences of double taxation.³⁴ The second question concerned the choice of bilateral approaches to eliminating double taxation. The early work of the League³⁵ revealed the justification for bilateral approaches. Multilateral agreement is difficult when countries are in different legal or economic circumstances: unilateral measures, on the other hand, are almost inevitably ineffectual. After the first international models were issued, the Hoover Administration proposed modifications of the U.S. revenue laws under which the United States would have exempted all but realty and business income of any foreign person if that person's state of residence granted reciprocal treatment.³⁶ The measure was never enacted, but it is doubtful that it would have worked: foreign investment by U.S. persons at the time was some four times greater than investment by foreign persons in the United States.³⁷ Most countries would probably not have absorbed the revenue sacrifice involved in granting the reciprocal exemption envisioned by the proposal.

Perhaps the most significant aspect of the League's work was its ultimate choice of "classification and assignment" as the basic structure for a model bilateral agreement.³⁸ This structure is used today in virtually all tax treaties. While the League chose "classification and assignment" because of the differences between "debtor" and "creditor" countries, the approach has been used even between countries which believe that debits and credits between them are more or less in balance. The principal drawback of this method is the resultant need to classify and assign taxation rights during negotiations on an item-by-item basis.

In addition, the "economic allegiance" principle articulated in the League's work is the basis for most of the substantive rules — the actual classifications and assignments — in modern tax treaties. Real property income and income connected with a fixed business location are still the kinds for which the right to tax is most readily accorded to the source state.³⁹ Passive investment income

34. See note 3 *supra*.

35. See note 31 *supra*.

36. H.R. 10165, 71st Cong., 2d Sess., 72 CONG. REC. 4095 (1930).

37. A Bill to Reduce International Double Taxation: Hearings on H.R. 10165 before the Committee on Ways and Means, 71st Cong., 2d Sess. 1 (1930) at 37.

38. Model Bilateral Conventions for the Prevention of International Double Taxation and Fiscal Evasion, League of Nations Doc. C.2.M.2. 1945. II. A. (1945), reprinted in Manual for the Negotiation of Bilateral Tax Treaties Between Developed and Developing Countries, U.N. Doc. ST/ESA/94, at 161-64 (1979).

39. See Organization for Economic Co-operation and Development, Model Convention

remains the kind which under international practice is most commonly reserved to the owner's state of residence.⁴⁰

B. The Work of International Organizations Since 1928

At the conclusion of its work, the General Meeting of Government Experts recommended that the League appoint a permanent Fiscal Committee to monitor the development of an international network of tax treaties. The most significant product of this Committee's early work was a model treaty approved in 1934 governing the attribution of profits among different components of an integrated enterprise operating in different states.⁴¹ This model set forth for the first time an international "arm's-length" standard — that profits should be attributed to different components as if they were entirely separate enterprises dealing with each other at arm's length.

In 1943, the Fiscal Committee sponsored meetings in Mexico City which drafted new international models governing income and estate taxes and administrative assistance in collection.⁴² These "Mexico models" were substantially more detailed and precise than the 1928 models. Another series of meetings was held in London under the Fiscal Committee's auspices in 1946: a model income tax treaty similar to but more refined than the 1943 Mexico model was drafted.⁴³ Rules governing the double taxation of capital were introduced.⁴⁴

In 1956, acting at the urging of the international business community, the Organization for European Economic Co-operation (OEEC) — an entity devoted to the study and resolution of interstate economic problems faced by European nations — formed a Fiscal Committee and charged it with the task of exploring the possibility of achieving a uniform multilateral treaty for the avoid-

for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital, *reprinted in* [Current Binder] 1 TAX TREATIES (CCH) ¶ 151 [hereinafter cited as OECD Model].

40. *See id.* arts. 10-13.

41. League of Nations Fiscal Committee, Report of the Fourth Session of the Committee, League of Nations Doc. No. C.339 M.204.1933.II.A (June 26, 1933). A revision of this convention was published by the Committee in League of Nations Fiscal Committee, Report of the Fifth Session of the Committee, League of Nations Doc. No. C.252.M.124.1935.II.A (1935).

42. London and Mexico Model Tax Conventions-Commentary and Text, League of Nations Doc. No. C.88.M.88. 1946.II.A (1946) [hereinafter cited as London and Mexico Models].

43. *Id.*

44. The rules governing double taxation of capital are set forth in *id.* art. XV.

ance of double taxation. In its first report, in July of 1958, the Fiscal Committee recognized that the task of preparing a multilateral treaty was, of necessity, a long one: it proposed first to issue a series of articles aiming toward a "Model Bilateral Convention acceptable to all Member countries."⁴⁵

The OEEC Fiscal Committee proceeded to issue 30 articles in five installments, which were then collected as a model treaty in 1963.⁴⁶ Meanwhile, in 1961, the OEEC was re-constituted as the Organization for Economic Co-operation and Development (OECD), with the addition of the United States and Canada as members. Other developed non-European countries, including Japan, Australia and New Zealand, have joined the organization.

The 1963 OECD Model income tax treaty was accompanied by lengthy and elaborate commentaries which explained particular provisions. The commentaries also indicated matters not addressed in the model which might be covered in particular negotiations; the relationship of the model to the London and Mexico models, as well as the early work of the League; and the relationship of the model to prevailing practices of member states.

The OECD followed this work with the publication in 1966 of a comparable model estate tax treaty.⁴⁷ In August 1977, the OECD issued a revised model income tax treaty,⁴⁸ with revised commentaries, both updated in light of the experience of member and non-member states in working with the provisions of the 1963 model. Currently, the OECD is endeavoring to revise the 1966 estate tax model, to incorporate into that model provisions respecting gift taxes, and to produce a new model governing reciprocal administrative assistance in tax matters.

The OECD efforts were principally directed at tax treaty negotiations between developed countries. Shortly after completion of the first OECD model, the United Nations Economic and Social Council instituted efforts to develop principles for negotiations be-

45. FISCAL COMMITTEE OF THE O.E.E.C., 1ST REPORT, THE ELIMINATION OF DOUBLE TAXATION 16-17 (1958).

46. *Id.*; FISCAL COMMITTEE OF THE O.E.E.C., 2D REPORT, THE ELIMINATION OF DOUBLE TAXATION (1959); FISCAL COMMITTEE OF THE O.E.E.C., 3D REPORT, THE ELIMINATION OF DOUBLE TAXATION (1960); FISCAL COMMITTEE OF THE O.E.E.C., 4TH REPORT, THE ELIMINATION OF DOUBLE TAXATION (1961). The text of the 1963 model appears in FISCAL COMMITTEE OF THE O.E.C.D., 5TH REPORT, THE ELIMINATION OF DOUBLE TAXATION 35-58 (1963) [hereinafter cited as 1963 OECD Model].

47. Organisation for Economic Co-operation and Development Draft Convention for the Avoidance of Double Taxation with Respect to Taxes on Estates and Inheritances, reprinted in 1 TAX TREATIES (CCH) ¶ 152.

48. OECD Model, *supra* note 39.

tween developed and developing countries. In 1967, the Council adopted a resolution expressing the view that tax treaties between developed and developing countries could serve to promote the flow of productive investment to the latter and noting that, despite the widespread proliferation of treaties between developed countries, there were still very few treaties between developed and developing countries.⁴⁹ The Council therefore requested the Secretary General to establish an *ad hoc* group of experts to study the problem of tax treaties between developed and developing countries and to recommend guidelines for the negotiation of such treaties.⁵⁰

The experts come from both developed and developing countries. They are recommended by their governments, but serve in their private capacities rather than as representatives of their governments. Since 1968, the group has met on a regular basis and has issued eight reports on its work to the Secretary General;⁵¹ the reports provide a comprehensive discussion of the kind of problems raised by developed-developing country treaties. In 1974 the group issued preliminary guidelines for negotiations,⁵² which were superseded in 1979 by the issuance of a manual containing a new set of guidelines.⁵³ The group intends to issue, in the near future, a model developed-developing country treaty representing a refinement of the guidelines set forth in the 1979 manual.

C. *The 1977 OECD Model*

The OECD model can best be described by a brief summary of its principal categories of rules.

1. Scope

All income taxes of the contracting states are covered, including taxes imposed by local authorities and political subdivisions.⁵⁴

49. E.S.L. Res. 1273, 43 U.N. ESCOR, Supp. (No. 1) 5, U.N. Doc. E/4429 (1967).

50. *Id.*

51. First Report, U.N. Doc. E/4614 ST/ECA/110 (1969); Second Report, U.N. Doc. E/4936 ST/ECA/137 (1970); Third Report, U.N. Doc. ST/ECA/166 (1972); Fourth Report, U.N. Doc. ST/ECA/188 (1973); Fifth Report, U.N. Doc. ST/ESA/18 (1975); Sixth Report, U.N. Doc. ST/ESA/42 (1976); Seventh Report, U.N. Doc. ST/ESA/79 (1978); Eighth Report, U.N. Doc. ST/ESA/101 (1980).

52. Guidelines for Tax Treaties Between Developed and Developing Countries, U.N. Doc. ST/ESA/14 (1974) [hereinafter cited as U.N. Guidelines].

53. Manual for the Negotiation of Bilateral Tax Treaties Between Developed and Developing Countries, U.N. Doc. ST/ESA/94 (1979).

54. OECD Model, *supra* note 39, art. 2(1).

Capital taxes are also covered, and a separate article is devoted to such taxes.⁵⁵ Coverage extends to residents of one or both of the contracting states.⁵⁶ It does not generally extend to cases where both states claim a right to tax on a source basis, or to cases where one state taxes on the basis of citizenship.⁵⁷

2. Classes of Income

Real property and permanent establishment income. The OECD model retains the League principle that the source state should have the right to tax real property income.⁵⁸ However, the model assimilates mortgage income to interest, not real property income.⁵⁹ The model also allows a source state to tax business income fully if such income is attributable to a permanent establishment in the source state.⁶⁰ This rule also descends from the early League work, but is now subject to exceptions which have evolved over time; moreover, there are special provisions for cases where business is conducted through an agent, providing for insulation from source basis taxation where the agent is independent and allowing source taxation if the agent is dependent but conducts significant business on behalf of the enterprise.⁶¹ The allocation rules used in these provisions explicitly rely upon the "arm's length" principle.⁶² A special exemption for international transportation income grants exclusive taxation rights to the state where the "place of effective management" of the enterprise is located.⁶³

Passive investment income. With respect to dividends and interest, the OECD model adopts the device of a limited or partial right to tax at source.⁶⁴ Dividends may generally be taxed by the source state at a rate no higher than fifteen percent;⁶⁵ if, however, the payee is a corporation controlling more than twenty-five percent of the payor's capital, the maximum source tax rate is reduced to five percent.⁶⁶ This special reduction is designed to harmonize

55. *Id.* art. 22.

56. *Id.* art. 1.

57. *Id.* arts. 23A, 23B.

58. *Id.* arts. 6, 13, 22.

59. *Id.* art. 11(3).

60. *Id.* arts. 5, 7.

61. *Id.* arts. 5(5), 5(6).

62. See notes 60-61 *supra*.

63. *Id.* art. 8.

64. *Id.* arts. 10, 11.

65. *Id.* art. 10(2)(b).

66. *Id.* art. 10(2)(a).

with features of the laws of many states giving relief from double corporate-level taxation of intercorporate distributions. The interest article reserves to the source state a right to tax at a maximum rate of ten percent of the interest payment.⁶⁷ The royalty article provides for reciprocal exemption of royalties at source.⁶⁸

With respect to capital gains, the model generally reserves the right to tax to the state of residence⁶⁹—with the exception of property closely associated with the source state — land and permanent establishment business property.⁷⁰ Taxation of gains from the disposition of ships and aircraft used in international operations is reserved to the state in which the effective management of the enterprise is located.⁷¹

Personal service income. The general rule in the OECD model is that personal service income is taxable in the state where the services are performed;⁷² but there is also a variety of special rules. With respect to “dependent” services, the state of residence has exclusive taxing rights as long as the taxpayer was present in the other state for less than half of the taxable year and was not working under conditions such that the other state would likely be obliged to allow a deduction for his salary.⁷³ “Independent” services, on the other hand, are taxable only to the extent that they are connected to a “fixed base” in the source state⁷⁴ — a concept which parallels the permanent establishment criterion used for determining when business profits may be taxed at source. Directors’ fees are taxable in the source state — that is, the state of the paying corporation’s residence.⁷⁵ Artists’ and athletes’ income is invariably subject to taxation in the state where the personal services are rendered;⁷⁶ and if the income from such services is deflected to another person, that person may be taxed in the source state irrespective of whether he has a permanent establishment or fixed base there.⁷⁷ Pensions are taxable only in the state of residence;⁷⁸ income from government service generally in the state paying the

67. *Id.* art. 11(2).

68. *Id.* art. 12.

69. *Id.* arts. 13(4), 22(4).

70. *Id.* arts. 13(1), 13(2), 22(1), 22(2).

71. *Id.* arts. 13(3), 22(3).

72. *Id.* arts. 14, 15.

73. *Id.* art. 15.

74. *Id.* art. 14(1).

75. *Id.* art. 16.

76. *Id.* art. 17(1).

77. *Id.* art. 17(2).

78. *Id.* art. 18.

income;⁷⁹ and a special provision exempts payments to students for their maintenance, education or training.⁸⁰

Nonclassified income. The OECD model ultimately recognizes the primacy of the resident state in two ways. First, unclassified income not specifically covered in the model is taxable exclusively by that state.⁸¹ Second, a residual right to tax is generally accorded to the state of residence even when the primary right to tax is granted to the source state.⁸² The residence state is required to bear the burden of eliminating double taxation for any income assigned to the source state;⁸³ but it may tax the income in full if the source state does not tax it, or does not tax it at a level equal to that of the residence state.⁸⁴

3. Double Taxation Provisions

The OECD model provides for alternative methods of avoiding double taxation. The first, the "ordinary credit" method,⁸⁵ is patterned on the United States foreign tax credit provisions.⁸⁶ The residence state allows a reduction of its tax for that paid to the other state, but is not required to allow a greater reduction than an amount bearing the same proportion to its total tax as the amount of income which the source state is allowed to tax bears to the taxpayer's total income.⁸⁷ The second method, "exemption with progression", requires the residence state to exempt the income which the source state may tax, but permits it to determine its tax on the remaining income at a progressive rate which takes account of the income taxable by the source state.⁸⁸

4. Other Provisions

Nondiscrimination. This provision forbids states from discriminating against nationals of the other state in tax matters — guaranteeing the principle of "national treatment".⁸⁹ Nondiscrimination provisions were common in tax treaties from an early pe-

79. *Id.* art. 19.

80. *Id.* art. 20.

81. *Id.* art. 21(1).

82. *Id.* art. 23A(3).

83. *Id.* arts. 23A(1), 23A(2).

84. *Id.* art. 23A(3).

85. *Id.* art. 23B(1).

86. I.R.C. §§ 901-908.

87. OECD Model, *supra* note 39, art. 23B(2).

88. *Id.* art. 24(1).

89. *Id.* art. 24.

riod, but the 1963 OECD model⁹⁰ introduced two novel forms of such provisions. The first forbids discrimination against a "permanent establishment" of a national of the other state.⁹¹ The second prohibits discrimination against an enterprise based on the fact that its capital is owned in substantial part by nationals of the other state.⁹²

Exchange of information. The OECD model contains relatively liberal exchange-of-information provisions which, however, include limitations deriving from the early work of the League: the restriction to information in the requested state's possession or available under its laws;⁹³ and a guarantee that a requested state need not take steps contrary to its security, sovereignty, or public policy.⁹⁴

Mutual agreement procedure. The Model provides a mechanism for the resolution of disputes; each state designates a "competent authority" who serves as its representative for interpreting and implementing the treaty.⁹⁵ The model provides for consultation among competent authorities, but does not require that they come to an agreement; nor does it provide any mechanism for binding them to a decision.⁹⁶ The procedure is supplementary to others, including recourse to the courts, which are available to a taxpayer under domestic law.⁹⁷

II. UNITED STATES TREATY POLICY

A. *Existing United States Treaties*

The United States presently has thirty independently negotiated income treaties in force. Several of these have been extended to territories of the treaty partner, and in some instances these territories have since become independent and assumed their obligations under the treaty. While a comprehensive review of U.S. treaties is not possible here, a general survey may be useful.

In part because U.S. treaties have been heavily influenced by the international models outstanding at the time of their negotiation, and in part because they have been influenced by develop-

90. 1963 OECD Model, *supra* note 46.

91. OECD Model, *supra* note 39, art. 24(4).

92. *Id.* art. 24(6).

93. *Id.* art. 26(2)(b).

94. *Id.* art. 26(2)(c).

95. *Id.* art. 25.

96. *Id.* art. 25(3).

97. *Id.* arts. 25(1), 25(2).

ments in domestic law, the treaties tend to follow patterns corresponding to the periods when they were negotiated. Roughly speaking, there are four principal "periods".

The first general U.S. tax treaty — after certain limited purpose treaties, chiefly governing the taxation of shipping profits — was with France, signed in 1932.⁹⁸ The principal purpose of this treaty was to mitigate the broad territorial reach of French taxation of U.S. business enterprises operating in Paris. The treaty did not deal generally with many of the subjects covered by the 1927-28 League models. It contained rules governing only income from government service, war pensions, private pensions and annuities, royalties and business profits. The treaty contained no provisions concerning administrative cooperation or exchange of information, and none governing nondiscrimination.

Much broader was a treaty signed by the United States with Sweden in 1939⁹⁹ and a new treaty signed in the same year with France.¹⁰⁰ The Swedish treaty was ratified in 1940, but the French treaty, which replaced the 1932 treaty entirely, was not ratified until the end of the Second World War. In these two treaties, the United States established some important principles which have remained cornerstones of U.S. tax treaty policy. The first was that tax treaties should not generally affect taxation by the United States of its citizens and residents. The second was the emphasis given to administrative cooperation, particularly exchange of information: this principle is in accord with the heavy emphasis on free access to information that the domestic tax system lays on the collection process.

In 1942 the United States signed a general treaty governing double taxation and administrative cooperation with Canada.¹⁰¹ This treaty differed from the 1939 treaties with France and Sweden in that it covered items of investment income: the French and Swedish treaties did not apply, in particular, to interest income.

98. Convention for the Avoidance of Double Taxation with Respect to Income, Apr. 27, 1932, United States-France, 49 Stat. 3145 T.S. No. 885.

99. Convention for the Avoidance of Double Taxation and the Establishment of Rules of Reciprocal Administrative Assistance in the Case of Income and Other Taxes, Mar. 23, 1939, United States-Sweden, 54 Stat. 1759, T.S. No. 958, *reprinted in 2 TAX TREATIES* (CCH) ¶¶ 7305-28.

100. Convention for the Avoidance of Double Taxation with Respect to Income, July 25, 1939, United States-France, T.S. 988.

101. Convention for the Avoidance of Double Taxation with Respect to Income, Mar. 4, 1942, United States-Canada, 56 Stat. 1399, T.S. No. 983, *reprinted in 1 TAX TREATIES* (CCH) ¶ 1203.

These treaties — with France, Sweden and Canada — represent our “early” period conventions. The 1939 treaty with France was superseded by a new treaty signed in 1967,¹⁰² which itself was subject to substantial revision by 1970¹⁰³ and 1978 protocols.¹⁰⁴ The 1939 Swedish treaty was substantially revised by a 1963 protocol,¹⁰⁵ but the treaty signed in 1939 is still in effect and is our oldest. The 1942 Canadian treaty was substantially revised in 1950;¹⁰⁶ but it too is still in effect.

The “second period” of U.S. income tax treaties was inaugurated with the 1945 treaty with the United Kingdom.¹⁰⁷ This treaty generally covered items of passive investment income, but distinguished among particular categories of such income. Notably, it provided for exemption of interest from tax at source.¹⁰⁸ The treaty was regarded as a major advance for the United States because of the United Kingdom’s acceptance of broad exchange of information and administrative cooperation provisions. This treaty was substantially revised by a protocol negotiated in 1966,¹⁰⁹ and was ultimately replaced by a new treaty signed in 1975¹¹⁰ and en-

102. Convention for the Avoidance of Double Taxation with Respect to Income, July 28, 1967, United States-France, 19 U.S.T. 5280, T.I.A.S. No. 6518, *reprinted in 1 TAX TREATIES* (CCH) ¶ 2803.

103. Protocol to the Convention of July 28, 1967, with Respect to Taxes on Income and Property, United States-France, Oct. 12, 1970, 23 U.S.T. 20, T.I.A.S. No. 7270 *reprinted in 1 TAX TREATIES* (CCH) ¶ 2839.

104. Protocol to the Convention with Respect to Taxes on Income and Property, United States-France, Nov. 24, 1978, 19 U.S.T. 5280, T.I.A.S. No. 9500, *reprinted in 1 TAX TREATIES* (CCH) ¶ 2836A.

105. Convention Supplementing the Convention and Protocol of Mar. 23, 1939, United States-Sweden, Oct. 22, 1963, 15 U.S.T. 1824, T.I.A.S. No. 5656 *reprinted in 2 TAX TREATIES* (CCH) ¶ 7328A.

106. Convention Modifying and Supplementing the Convention Accompanying the Protocol of March 4, 1942 for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion in the Case of Income Taxes, United States-Canada, June 12, 1950, 2 U.S.T. 2235, T.I.A.S. No. 2347.

107. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Apr. 16, 1945, United States-United Kingdom, 60 Stat. 1377, T.I.A.S. No. 1546, *reprinted in 2 TAX TREATIES* (CCH) ¶¶ 8106-29.

108. *Id.* art. XV.

109. Supplementary Protocol Amending the Convention of April 16, 1945, as Modified, for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Mar. 17, 1966, United States-United Kingdom, 17 U.S.T. 1254, T.I.A.S. No. 6089, *reprinted in 2 TAX TREATIES* (CCH) ¶ 8131A.

110. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, Dec. 31, 1975, United States-United Kingdom, 80 DEPT. STATE BULL. (No. 2038) 70 (May 1980), 2 TAX TREATIES (CCH) ¶¶ 8103A-CC.

tered into force in April of 1980.¹¹¹ The original treaty remains in force, however, with approximately fifteen jurisdictions with respect to which it was extended, with modifications, in 1958.¹¹²

The first United Kingdom treaty established a model for U.S. treaties negotiated between the end of World War II and the commencement of double tax treaty work by the OEEC and, later, the OECD. During this period we negotiated treaties with most of the states of the developed world, including twelve treaties with European countries (the United Kingdom,¹¹³ the Netherlands,¹¹⁴ Denmark,¹¹⁵ Norway,¹¹⁶ Ireland,¹¹⁷ Greece,¹¹⁸ Switzerland,¹¹⁹ Italy,¹²⁰ Germany,¹²¹ Austria,¹²² Finland,¹²³ and Belgium¹²⁴); four with non-European developed countries (South Africa,¹²⁵ Australia,¹²⁶ Ja-

111. *Id.*, entered into force April 25, 1980.

112. See note 132 *infra*.

113. See note 107 *supra*.

114. Convention with Respect to Taxes on Income and Certain Other Taxes, Apr. 29, 1948, United States-Netherlands, 62 Stat. 1757, T.I.A.S. No. 1855, reprinted in 2 TAX TREATIES (CCH) ¶¶ 5804-32.

115. Convention for the Avoidance of Double Taxation with Respect to Income, May 6, 1948, United States-Denmark, 62 Stat. 1730, T.I.A.S. No. 1854, reprinted in 1 TAX TREATIES (CCH) ¶ 2103.

116. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Estates and Inheritances, June 13, 1949, United States-Norway, 2 U.S.T. 2353, T.I.A.S. No. 2358, reprinted in 2 TAX TREATIES (CCH) ¶¶ 6104-25.

117. Convention for the Avoidance of Double Taxation with Respect to Income, Sept. 13, 1949, United States-Ireland, 2 U.S.T. 2303, T.I.A.S. No. 2356, reprinted in 1 TAX TREATIES (CCH) ¶ 4103.

118. Convention for the Avoidance of Double Taxation with Respect to Income, Feb. 20, 1950, United States-Greece, 5 U.S.T. 47, T.I.A.S. No. 2902, reprinted in 1 TAX TREATIES (CCH) ¶ 3103.

119. Convention for the Avoidance of Double Taxation with Respect to Income, May 24, 1951, United States-Switzerland, 2 U.S.T. 1751, T.I.A.S. No. 2316, reprinted in 2 TAX TREATIES (CCH) ¶¶ 7403-23.

120. Convention for the Avoidance of Double Taxation with Respect to Income, Mar. 30, 1955, United States-Italy, 7 U.S.T. 2999, T.I.A.S. No. 3679, reprinted in 1 TAX TREATIES (CCH) ¶ 4303.

121. Convention for the Avoidance of Double Taxation with Respect to Income, July 22, 1954, United States-Germany, 5 U.S.T. 2768, T.I.A.S. No. 3133, reprinted in 1 TAX TREATIES (CCH) ¶ 3003.

122. Convention for the Avoidance of Double Taxation with Respect to Income, Oct. 25, 1956, United States-Austria, 8 U.S.T. 1699, T.I.A.S. No. 3923, reprinted in 1 TAX TREATIES (CCH) ¶ 503.

123. Convention for the Avoidance of Double Taxation with Respect to Income, Mar. 3, 1952, United States-Finland, 3 U.S.T. 4464, T.I.A.S. No. 2595, reprinted in 1 TAX TREATIES (CCH) ¶ 2703.

124. Convention for the Avoidance of Double Taxation with Respect to Income, Aug. 7-Sept. 9, 1952, United States-Belgium, 4 U.S.T. 1647, T.I.A.S. No. 2833, reprinted in 1 TAX TREATIES (CCH) ¶ 587.

125. Convention for the Avoidance of Double Taxation with Respect to Income, July 15, 1952, United States-South Africa, 3 U.S.T. 3821, T.I.A.S. No. 2510, reprinted in 2 TAX

pan,¹²⁷ and New Zealand¹²⁸); and one with a developing country (Pakistan¹²⁹). The treaties with Japan and Finland were superseded by new treaties in the early 1970's.¹³⁰ The treaties with the United Kingdom and Belgium were also superseded, insofar as the developed country treaty partner is concerned,¹³¹ but remain in force with respect to territories or former territories of those countries.¹³² And several other treaties of this period have been substantially revised by protocol.¹³³

The treaties negotiated in this general period cover the basic range of subjects in the present OECD and U.S. models, although there are omissions in some of them. But the content of some of these treaties often differs from what we would seek today. Among these differences, the most important concerns the typical "business profits" article. Before 1966, domestic law made the United States a "force of attraction" jurisdiction — *i.e.*, if a foreign person was engaged in trade or business in the United States, *all* his U.S.-source income was subject to tax, regardless of whether the income was attributable to the business; and we taxed *none* of that person's foreign-source income even if, in an economic sense, such in-

TREATIES (CCH) ¶¶ 7903-21.

126. Convention for the Avoidance of Double Taxation with Respect to Income, May 14, 1953, United States-Australia, 4 U.S.T. 2274, T.I.A.S. No. 2880, *reprinted in* 1 TAX TREATIES (CCH) ¶ 403.

127. Convention for the Avoidance of Double Taxation with Respect to Income, Apr. 16, 1954, United States-Japan, 6 U.S.T. 149, T.I.A.S. No. 3176, *reprinted in* 1 TAX TREATIES (CCH) ¶ 4403.

128. Convention for the Avoidance of Double Taxation with Respect to Income, Mar. 16, 1948, United States-New Zealand, 2 U.S.T. 2378, T.I.A.S. No. 2360, *reprinted in* 2 TAX TREATIES (CCH) ¶¶ 5903-25.

129. Convention for the Avoidance of Double Taxation with Respect to Income, July 1, 1957, United States-Pakistan, 10 U.S.T. 984, T.I.A.S. No. 4232, *reprinted in* 2 TAX TREATIES (CCH) ¶¶ 6203-23.

130. Convention for the Avoidance of Double Taxation with Respect to Income, Mar. 6, 1970, United States-Finland, 22 U.S.T. 40, T.I.A.S. No. 7042, *reprinted in* 1 TAX TREATIES (CCH) ¶ 2651; Convention for the Avoidance of Double Taxation with Respect to Income, Mar. 8, 1971, United States-Japan, 23 U.S.T. 967, T.I.A.S. No. 7365, *reprinted in* 1 TAX TREATIES (CCH) ¶ 4393.

131. Agreement Amending the Convention of Dec. 31, 1975, Apr. 13, 1976, United States-United Kingdom, 2 TAX TREATIES (CCH) ¶ 8103CC; Convention for the Avoidance of Double Taxation with Respect to Income, July 9, 1970, United States-Belgium, 23 U.S.T. 2687, T.I.A.S. No. 7463, *reprinted in* 1 TAX TREATIES (CCH) ¶ 587.

132. Agreement Relating to the Application of the Income Tax Convention of April 16, 1945 to Specified British Territories, Aug. 19-Dec. 3, 1958, United States-United Kingdom, 9 U.S.T. 1459, T.I.A.S. No. 4141, *reprinted in* 2 TAX TREATIES (CCH) ¶ 8103.

133. See, *e.g.*, Protocol Supplementing the Convention of December 13, 1946, July 15, 1952, United States-South Africa, 3 U.S.T. 3821, T.I.A.S. No. 2510.

come was attributable to the U.S. business.¹³⁴ In accordance with this statutory law, most of our treaties from this period provided that permanent establishments could be taxed in a source state on, and only on, income arising in the source state. When we changed our law in 1966,¹³⁵ in addition to relieving non-“effectively connected” income from U.S. tax, we also subjected to tax “effectively connected” income having a foreign source.¹³⁶ The existing treaties undermine the current statutory pattern of taxation, because by statute we no longer tax the non-“effectively connected” U.S.-source income — even though we have the right to do so by treaty — while the treaties preclude us from applying our domestic law to tax “effectively connected” income of foreign source.

Most of the treaties of this period allow a person earning real property income in the United States the right to elect annually to be taxed on a “net basis” — *i.e.*, at progressive rates and with deductions — rather than at the gross (30%) rate applicable in the absence of such an election. The Internal Revenue Code has permitted such an election since 1966, but that election is *irrevocable* unless consent to change is given by the Internal Revenue Service.¹³⁷ Treaty provisions permitting the election to be made on an annual basis create certain tax avoidance opportunities for persons investing in U.S. real property.

Most of these treaties also concede the right of the United States to impose its “second dividend” and “second interest” taxes — the taxes we apply to dividends and interest paid by foreign corporations doing substantial business in the United States. Most contain personal service articles different in significant detail from those we would seek today; few contain the special provisions now included in U.S. treaties governing the earnings of artists and athletes. Most have exchange of information and mutual agreement provisions that are more restrictive than those we like to negotiate now. Most have imprecisely-drafted provisions governing the mechanism for crediting “source country” taxes. Most contain provisions conferring benefits upon teachers, which we no longer view as appropriate. Although many of these treaties have been modi-

134. The “force of attraction” rules were originally enacted as 211(b) and 231(b) of the Revenue Act of 1936, ch. 690, 49 Stat. 1648. They were carried forward in the same section numbers of the Internal Revenue Code of 1939, and later as sections 871(c) and 882(a) of the Internal Revenue Code of 1954.

135. P.L. 89-909, § 102, 80 Stat. 1541-1543 (1966).

136. I.R.C. § 864(c); Treas. Reg. § 1.864-3 - 1.864-5 (1972).

137. I.R.C. § 871(d); Treas. Reg. § 1.871-10 (1974).

fied by subsequent protocols or new treaties, many outdated provisions continue in force.

This "second period" of the U.S. tax treaty program also witnessed the entering of a tax treaty relationship with smaller countries. Under some conventions negotiated between European states, a treaty could be extended to territories of one of the parties by notice given through diplomatic channels to the other party. Our 1945 treaty with the United Kingdom¹³⁸ contained such a "territorial extension" provision, as did several other treaties signed shortly after the Second World War. In the process of seeking ratification of those treaties, however, understandings were reached between the Executive Branch and the Senate Foreign Relations Committee that no such extension would be effected without separate ratification of each extension by the Senate. In 1955, pursuant to a request by the Kingdom of the Netherlands, the United States for the first time extended a tax treaty to an overseas territory of a treaty partner: the Netherlands Antilles.¹³⁹ In 1957, the Belgian treaty was extended to three Belgian territories which are now Rwanda, Burundi, and Zaire.¹⁴⁰ In 1958, the United Kingdom treaty was extended to 20 overseas territories of the United Kingdom.¹⁴¹

At the same time, the United States, under the Eisenhower Administration, inaugurated a program of negotiating tax treaties which included a "tax sparing" provision. Many developing countries have, in the past and at present, relied upon special tax incentive legislation to attract foreign investment. The idea of "tax sparing" developed in the 1950's. Under this concept, a developed country would agree by treaty to give a credit not only for taxes imposed by a developing country, but for taxes which would have been imposed in the absence of tax holiday legislation. This idea won widespread support among business groups interested in the double taxation problem, such as the National Foreign Trade

138. See note 107 *supra*.

139. Protocol Supplementing the Convention with Respect to Taxes on Income and Certain Other Taxes for the Purpose of Facilitating Extension to the Netherlands Antilles, June 15, 1955, United States-Netherlands, 6 U.S.T. 3696, T.I.A.S. No. 3366, reprinted in 2 TAX TREATIES (CCH) ¶ 5832A.

140. Agreement Relating to the Extension of the Operation of the Income Tax Convention of 1948, as supplemented to the Belgian Congo and the Trust Territory of Ruanda-Burundi, July 28, 1959, 10 U.S.T. 1358, T.I.A.S. No. 4280, reprinted in 1 TAX TREATIES (CCH) ¶ 504.302.

141. See note 132 *supra*.

Council and the International Chamber of Commerce.¹⁴²

When the first U.S. treaty with such a provision — the treaty with Pakistan¹⁴³ — was submitted to the Senate for ratification, the "tax sparing" idea was greeted with hostility by the Foreign Relations Committee. The Senators emphasized the traditional view of U.S. tax treaties — that they did not reduce or affect the tax burdens of United States persons — and that tax sparing was obviously a departure from this principle.¹⁴⁴ While the Pakistan treaty was under consideration, however, Pakistan repealed its tax incentive legislation, which mooted the treaty provision.¹⁴⁵ Nevertheless, the Committee, in reporting the treaty favorably, entered a reservation to the tax sparing provision,¹⁴⁶ and the treaty was approved by the Senate subject to the reservation.¹⁴⁷ Three other treaties with tax sparing provisions — with India, the United Arab Republic, and Israel — were never reported out by the Committee.

The third group of U.S. treaties comprises those twelve treaties in force that were negotiated since 1960, but prior to publication of the U.S. model treaty in 1976. Of these, six (Luxembourg,¹⁴⁸ France,¹⁴⁹ the United Kingdom,¹⁵⁰ Japan,¹⁵¹ Belgium,¹⁵² Iceland,¹⁵³ and Finland¹⁵⁴) are with OECD countries; two (Korea,¹⁵⁵ Trinidad and Tobago¹⁵⁶) are with Free World developing countries; and

142. See, e.g., *Double Taxation Conventions, Hearings Before the Senate Foreign Relations Committee*, 85th Cong., 2d Sess. 20-23 (1957).

143. See note 129 *supra*.

144. See *Double Taxation Convention with Pakistan, Hearings Before the Senate Committee on Foreign Relations*, 85th Cong., 1st Sess. 2-3 (1957) (statement of Professor Stanley Surrey).

145. S. EXEC. REP. NO. 1, 85th Cong., 2d Sess. 3 (1958).

146. *Id.*

147. 104 CONG. REC. 13242-44 (1958).

148. Convention for the Avoidance of Double Taxation with Respect to Income, Dec. 18, 1962, United States-Luxembourg, 15 U.S.T. 2355, T.I.A.S. No. 5726, *reprinted in* 1 TAX TREATIES (CCH) ¶ 5303.

149. See note 102 *supra*.

150. See note 131 *supra*.

151. See note 130 *supra*.

152. Convention for the Avoidance of Double Taxation with Respect to Income, July 9, 1970, United States-Belgium, 23 U.S.T. 2687, T.I.A.S. No. 7463, *reprinted in* 1 TAX TREATIES (CCH) ¶ 587.

153. Convention for the Avoidance of Double Taxation with Respect to Income, May 7, 1975, United States-Iceland, 26 U.S.T. 2006, T.I.A.S. No. 8151, *reprinted in* 1 TAX TREATIES (CCH) ¶ 3703.

154. See note 130 *supra*.

155. Convention for the Avoidance of Double Taxation with Respect to Income, June 4, 1976, United States-Korea, T.I.A.S. No. 9506, *reprinted in* 1 TAX TREATIES (CCH) ¶ 4803.

156. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and the Encouragement of International Trade

three (the USSR,¹⁵⁷ Poland,¹⁵⁸ and Romania¹⁵⁹) are with Communist countries. In addition, the United States during this period negotiated significant protocols to some of the earlier treaties — notably those with Germany,¹⁶⁰ Sweden,¹⁶¹ and the Netherlands.¹⁶²

Several features distinguish these treaties from those of the prior period. With the exception of the quite unusual treaty with the USSR, these treaties tend to follow closely the structural format of the international model; but they contain special provisions, found neither in the earlier treaties nor in the OECD model, reflecting a unique approach by the United States. The most important of these provisions are those dealing with “general rules of taxation” and source of income. The general rules of taxation provide, typically, that the treaty is not to restrict any allowances, credits, or deductions permitted under domestic law; and that a contracting state is permitted to tax the income of a resident of the other contracting state only to the extent that income is from sources within the first state. The source provision includes detailed rules governing when income is deemed to arise in the source state; these rules, which typically expand to some extent upon the

and Investment, Dec. 22, 1966, United States-Trinidad and Tobago, 18 U.S.T. 3091, T.I.A.S. No. 6400, *reprinted in* 2 TAX TREATIES (CCH) ¶¶ 7603-07, *terminated* December 31, 1969, *superseded by* Convention for the Avoidance of Double Taxation, the Prevention of Fiscal Evasion with Respect to Taxes on Income, and the Encouragement of International Trade and Investment, Jan. 9, 1970, United States-Trinidad and Tobago, 22 U.S.T. 164, T.I.A.S. No. 7047, *reprinted in* 2 TAX TREATIES (CCH) ¶¶ 7608-37.

157. Convention for the Avoidance of Double Taxation of Income, and the Prevention of Fiscal Evasion with Respect to Taxes on Income, and the Elimination of Obstacles to International Trade and Investment, June 20, 1973, United States-Union of Soviet Socialist Republics, 27 U.S.T. 1, T.I.A.S. No. 8225, *reprinted in* 2 TAX TREATIES (CCH) ¶¶ 8002B-2Q.

158. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Oct. 8, 1974, United States-Poland, 28 U.S.T. 891, T.I.A.S. No. 8486, *reprinted in* 2 TAX TREATIES (CCH) ¶¶ 7003-29.

159. Convention for the Avoidance of Double Taxation of Income, the Prevention of Fiscal Evasion with Respect to Taxes on Income, and the Elimination of Obstacles to International Trade and Investment, Dec. 4, 1973, United States-Romania, 27 U.S.T. 165, T.I.A.S. No. 8228, *reprinted in* 2 TAX TREATIES (CCH) ¶¶ 7254-82.

160. Protocol Respecting the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Sept. 17, 1965, United States-Federal Republic of Germany, 16 U.S.T. 1875, T.I.A.S. No. 5920, *reprinted in* 1 TAX TREATIES (CCH) ¶ 3015.

161. Protocol Respecting the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Oct. 22, 1963, United States-Sweden, 15 U.S.T. 1824, T.I.A.S. No. 5656, *reprinted in* 2 TAX TREATIES (CCH) ¶ 7328.

162. Protocol Respecting the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Oct. 23, 1963, United States-Netherlands, 15 U.S.T. 1900, T.I.A.S. No. 5665, *reprinted in* 2 TAX TREATIES (CCH) ¶ 5832B.

"source" rules set forth in the Internal Revenue Code,¹⁶³ are designed to guarantee that the classification and assignment of substantive taxing rights will avoid double taxation in practice.

This "third period" of U.S. tax treaties saw another significant development in regard to U.S. tax relations with developing countries. Under the Kennedy and Johnson Administrations, the Treasury did not negotiate treaties with "tax sparing" provisions, because it viewed those provisions as creating an artificial bias in favor of foreign investment over domestic investment. In 1962, however, Congress adopted a statutory investment tax credit which, by its terms, was available only for investments in property placed in service in the United States.¹⁶⁴ The Treasury, by treaty with developing countries, agreed to allow a similar credit for property placed in service in the developing country treaty partner,¹⁶⁵ and treaties containing such provisions were signed with Thailand,¹⁶⁶ Brazil,¹⁶⁷ Israel,¹⁶⁸ and the Philippines.¹⁶⁹ This provision, too, was found unacceptable by the Foreign Relations Committee, which viewed the investment tax credit as designed to spur domestic investment and domestic employment, and which regarded it as inappropriate to extend the measure by treaty to stimulate foreign investment.¹⁷⁰ Of the treaties which contained an investment tax credit feature, the Committee reported only the one with Brazil, subject to a reservation on this point; the Senate approved the treaty subject to the reservation,¹⁷¹ but the treaty never entered into force.

163. I.R.C. §§ 861-864.

164. P.L. 87-834, § 2, 76 Stat. 962 (1962). The restriction on the availability of the investment tax credit for property placed in service outside the United States is codified at I.R.C. § 48(a)(2)(A).

165. See notes 166-69 *infra*. None of the four treaties listed *infra* has yet entered into force.

166. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Mar. 1, 1965, United States-Thailand, *reprinted in* 2 TAX TREATIES (CCH) ¶¶ 7503-33.

167. Convention for the Avoidance of Double Taxation with Respect to Income, Mar. 13, 1967, United States-Brazil, *reprinted in* 1 TAX TREATIES (CCH) ¶ 803.

168. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Nov. 20, 1975, United States-Israel, *reprinted in* 1 TAX TREATIES (CCH) ¶ 4202.

169. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Oct. 1, 1976, United States-Philippines, *reprinted in* 2 TAX TREATIES (CCH) ¶¶ 6603-33.

170. See, e.g., *Tax Convention with Thailand, Hearings Before the Subcommittee of the Senate Committee on Foreign Relations*, 89th Cong., 1st Sess. 101-04 (1965) (remarks of Senator Gore).

171. See note 165 *supra*.

The fourth group of U.S. treaties are those based more firmly on the 1976 U.S. model¹⁷² and the revised version of that model published in 1977.¹⁷³ Only one treaty currently in force, with Hungary,¹⁷⁴ falls in this group. But there are numerous treaties currently in the process of negotiation, translation, signature, or ratification that would fall in this group as well.

B. *The U.S. Model*

The point of reference for all United States income tax treaty negotiations undertaken today is the U.S. model income tax treaty, which follows the OECD model in most important respects. Issued publicly for the first time in December 1976,¹⁷⁵ the model was reissued, with relatively minor modifications, in May 1977.¹⁷⁶ Although some U.S. negotiating positions have changed since 1977, a new version of the model has not yet been issued. We attempt to take developments into account in actual negotiations.

The most important differences between the U.S. model and that of the OECD are as follows.

Citizenship basis taxation. The OECD model applies only to states which tax globally on the basis of domicile or residence.¹⁷⁷ We, of course, tax on a citizenship basis in addition to a residence basis.¹⁷⁸ We regard it as appropriate to attempt to relieve double taxation which occurs when a nonresident U.S. citizen is taxed on a source basis by a treaty partner. In addition, the U.S. model contains a "saving" clause permitting taxation of U.S. citizens (including former citizens) as if no treaty were in effect.¹⁷⁹ Since this rule is overbroad in certain respects, it is necessary to accompany the saving clause with specific exceptions.

Coverage of state and local taxes. Under the U.S. model, state and local taxes are not covered, except for the nondiscrimination

172. U.S. Treasury, Treasury Department's Model Income Tax Treaty, U.S. Treas. Press Release, May 18, 1976.

173. U.S. Treasury, Treasury Department's Model Income Tax Treaty of May 17, 1977, reprinted in 1 TAX TREATIES (CCH) ¶ 153 [hereinafter cited as U.S. Model].

174. Convention for the Avoidance of Double Taxation and Prevention of Fiscal Evasion with Respect to Taxes on Income, Feb. 12, 1979, United States-Hungary, T.I.A.S. No. 9560, reprinted in 1 TAX TREATIES (CCH) ¶ 3603.

175. U.S. Treasury, Treasury Department's Model Income Tax Treaty, U.S. Treas. Press Release, May 18, 1976.

176. U.S. Model, *supra* note 173.

177. See note 57 and accompanying text *supra*.

178. I.R.C. § 1; Treas. Reg. § 1.1-1(a)(1) (1954).

179. U.S. Model, *supra* note 173, art. 1(3).

article.¹⁸⁰ The OECD model provides for general coverage of the taxes of a political subdivision or local authority.¹⁸¹

Corporate residence. The United States treats place of incorporation as the test of corporate residence,¹⁸² and the U.S. model reflects this statutory rule.¹⁸³ Some other countries use a "managed and controlled" test.¹⁸⁴ The OECD model provides that when a corporation is, under the domestic law of the contracting states, deemed a resident of each state, its residence is determined by the place where its "effective management" is situated.¹⁸⁵ The U.S. model resolves such cases on the basis of place of incorporation.¹⁸⁶

Interest exemption. The U.S. model contains a reciprocal exemption of interest at source.¹⁸⁷ The OECD, in contrast, grants a right to the source state to tax at a rate not in excess of 10 percent.¹⁸⁸

Investment of holding companies. The U.S. model contains a provision not found in the OECD model, denying reductions of source basis taxation when a corporation of the other state is largely owned by nonresidents of that state and benefits in that state from special tax measures.¹⁸⁹ This provision, which places the United States at the forefront of the international effort to prevent treaty abuse, requires further thought and refinement.

Elimination of double taxation. The U.S. model contains detailed provisions for relief from double taxation, and an explicit assurance of a foreign tax credit for taxes covered.¹⁹⁰ Source rules are provided to permit the classification and assignment of substantive taxation rights to operate effectively. The model does not extend relief for the deemed paid credit below the first foreign subsidiary.¹⁹¹

Beyond these fundamental differences between the models lies a wide range of other differences. Some are merely matters of style, although an effort has been made to minimize differences without substance, for the sake of facilitating negotiations. An additional

180. See *id.* art. 2.

181. See note 54 *supra*.

182. I.R.C. §§ 7701(a)(4), 7701(a)(5); Treas. Reg. § 301.7701-5 (1954).

183. U.S. Model, *supra* note 173, art. 4(1).

184. This is the test of "corporate residence" employed by the United Kingdom.

185. OECD Model, *supra* note 39, art. 4(3).

186. U.S. Model, *supra* note 173, art. 4(3).

187. *Id.* art. 11(1).

188. See OECD Model, *supra* note 39, art. 11(2).

189. U.S. Model, *supra* note 173, art. 16.

190. *Id.* art. 23(1), 23(2).

191. See *id.* art. 23(1).

list of significant points in the U.S. model would include at least the following.

Penalty taxes. The model does not cover the accumulated earnings tax and the personal holding company tax.¹⁹² We wish to ensure that United States persons do not evade these penalty taxes through the formation of corporations in treaty countries.

Excise taxes on insurance premiums and private foundations. The U.S. model covers these taxes,¹⁹³ on the theory that they are, in effect, imposed in lieu of income taxes. In cases where the other country has similar taxes, we would insist upon reciprocity.

Coverage of taxes for non-discrimination and exchange of information provisions. The U.S. model covers all taxes, including state and local taxes, for purposes of the non-discrimination article.¹⁹⁴ It covers all national level taxes for purposes of the exchange of information article.¹⁹⁵ The first of these provisions represents a strong United States position against discriminatory tax measures. Since there is a long tradition in the United States of state adherence to standards of non-discrimination, we attempt to secure comparable coverage by the treaty partner. With respect to exchange of information, we believe that since a treaty relationship is to be established, the broadest possible provisions for information exchange are desirable; but even if this notion is unacceptable to the treaty partner, at a minimum we wish to obtain sufficient information to permit the treaty to operate, even if the information was obtained by the treaty partner under a national level tax not generally covered by the treaty.

Trusts and partnerships. Unlike the OECD model, the U.S. model contains rules ascribing a state of residence to trusts and partnerships.¹⁹⁶ These rules are intended to permit the treaty to operate in circumstances that are relatively common in United States practice.

Remittance basis. Reductions in source basis taxation are generally not justified in the face of rules in the residence state preventing taxation of the benefited income. Many countries — particularly countries previously forming part of the Commonwealth of the United Kingdom — provide by law that residents will not be taxed on income which is not remitted to the country.

192. *Id.* art. 2(2). See I.R.C. §§ 531-537, 541-547.

193. U.S. Model, *supra* note 173, art. 2(2).

194. *Id.* art. 24(6).

195. *Id.* art. 26(6).

196. *Id.* art. 4(1).

The U.S. model denies reductions in source basis taxation in such circumstances.¹⁹⁷

Construction projects. The model provides that a construction project will not be considered a permanent establishment, and thus subject to taxation at source, until it lasts for more than 24 months in the source state.¹⁹⁸ This provision reflects the U.S. position as a net exporter of construction services. The comparable OECD provision is 12 months;¹⁹⁹ the UN model prescribes a period of 6 months.²⁰⁰

Net basis election for real property. The U.S. model, reflecting statutory law,²⁰¹ permits a taxpayer to elect to be taxed on real property income on a net basis.²⁰² This rule is included in the model to ensure that the other state will allow similar net basis taxation. We are prepared to delete this rule when we are satisfied, through negotiations, that the statutory law of the other state permits such taxation.

Allocation of expenses to permanent establishment. The U.S. model contains more detailed rules than the OECD model governing the allowance of deductions in the source state for expenses borne by a home office on behalf of the entire enterprise.²⁰³ This provision is designed to reflect United States rules governing allocations of expenses to foreign source, as opposed to domestic source, income.²⁰⁴

Definition of business profits. The U.S. model contains a rule defining business profits, and making clear that rentals of tangible personal property and income from the licensing of films and broadcasting rights come within the definition.²⁰⁵ We seek a definition of business profits because the OECD model is ambiguous in regard to certain kinds of income. We prefer to classify film and broadcast income, and income from the leasing of tangible property, as business income, because this classification ensures taxation at source, if there is to be such taxation, on a net basis. The

197. See *id.* art. 4(6).

198. *Id.* art. 5(3).

199. OECD Model, *supra* note 39, art. 5(3).

200. United Nations Model Double Taxation Convention Between Developed and Developing Nations, U.N. Doc. ST/ESA/102, art. 5(3) (1980) [hereinafter cited as U.N. Model].

201. See note 137 and accompanying text *supra*.

202. U.S. Model, *supra* note 173, art. 6(5).

203. *Id.* art. 7(3).

204. Treas. Reg. § 1.861-8 (1978). See Benvignati, *Treasury Regulation § 1.861-8 and Research and Development Expenses: An Economic Evaluation*, 19 COLUM. J. TRANSNAT'L L. 493 (1981).

205. U.S. Model, *supra* note 173, art. 7(7).

expenses associated with these kinds of income can be high. In contrast, the OECD model classifies these types of income as royalties, but provides for exemption at source.²⁰⁶

Expanded definition of shipping and air transport income. The U.S. model expands the concept of income from international shipping and air transport to cover the rental of ships, aircraft, and containers used in international transport.²⁰⁷ We believe that the income from such activities is essentially similar to income from international shipping and air transport, and that the policies dictating a separate provision for the latter types of income apply equally to the former.

Direct investment dividends. The U.S. model provides for a maximum rate of 5 percent for source basis taxation of dividend income derived by a corporation owning 10 percent or more of the voting stock of the company paying the dividends.²⁰⁸ The comparable rule in the OECD model provides for a maximum 5 percent rate when the payee corporation owns 25 percent or more of the capital of the company making such payments.²⁰⁹ The U.S. preference for a 10 percent ownership test is designed to mesh with U.S. statutory law governing the deemed paid foreign tax credit.²¹⁰

Second withholding taxes. The U.S. model permits the United States to impose its "second withholding taxes" on dividends and interest paid by a foreign corporation deriving income from the United States.²¹¹ These rules are particularly important in negotiations with a country having a "branch profits" tax.

Royalties. The U.S. model provides that royalties include gains contingent on the productivity, use, or disposition of rights or property.²¹² This rule corresponds roughly with U.S. statutory law.²¹³

Capital gains on the disposition of shares in a real property holding organization. This is one respect in which our current negotiating practice deviates from the model. Under both our model²¹⁴ and the OECD model,²¹⁵ a source country may tax capital

206. See note 68 *supra*.

207. U.S. Model, *supra* note 173, art. 8(2).

208. *Id.* art. 10(2).

209. See note 66 and accompanying text *supra*.

210. I.R.C. §§ 902, 960.

211. See U.S. Model, *supra* note 173, arts. 10(2), 10(5), 11(6).

212. *Id.* art. 12(2).

213. I.R.C. § 1235(a).

214. U.S. Model, *supra* note 173, art. 13(1).

215. See note 70 *supra*.

gains on real property. But an investor may avoid source state taxation by incorporating a holding company to own the property.²¹⁶ This device will not insulate operating income from current taxation, but it may be effective for avoiding source taxation of capital gain on sale of the shares, which may well reflect appreciation in the value of the underlying property.

United States statutory law does not generally tax foreign investors on gains from the disposition of shares in corporations formed to hold real property. In connection with the Revenue Act of 1978, however, legislation was proposed which would have taxed gains from the disposition of shares in a company formed to hold U.S. farmland.²¹⁷ In the 96th Congress, more far-reaching legislation has been introduced which would tax foreign investors on their gains from the disposition of shares in real property holding organizations — entities formed to hold any U.S. real property.²¹⁸ The legislation has had broad congressional support; and the Treasury has supported the general idea behind it.

In the face of these developments, we have modified our treaty policy and now seek a provision granting reciprocal rights to source state taxation of capital gains on the sale of shares in corporations formed for the sake of holding real property situated in that state.

Independent personal services. The U.S. model allows source basis taxation when a person is present in the source state for more than half of a taxable year.²¹⁹ This provision, which derives from U.S. statutory concepts,²²⁰ is similar to the dependent personal services provisions in both the OECD²²¹ and the U.S. models.²²² It is intended to supplement the "fixed base" rule which the OECD model uses exclusively for independent services²²³ and which is sometimes difficult to administer.

Directors' fees. The U.S. model contains no separate article on this subject, reflecting the view that directors' fees should be taxed as independent personal services or dependent personal services, as

216. See U.S. Model, *supra* note 173, art. 13(4).

217. The proposal led to the adoption of section 553 of the Revenue Act of 1978, P.L. 95-600, 92 Stat. 2763, under which the Treasury Department was required to submit a report to Congress concerning the proper manner of taxing gains realized by foreign persons from foreign investments in United States property.

218. This legislation has since been passed. Omnibus Reconciliation Act of 1980, P.L. 96-499, Foreign Investment in United States Real Property, 94 Stat. 2682.

219. U.S. Model, *supra* note 173, art. 14.

220. See I.R.C. § 871(a)(2).

221. See note 73 and accompanying text *supra*.

222. U.S. Model, *supra* note 173, art. 15(2).

223. See note 74 and accompanying text *supra*.

the case may be. Many other countries have special statutory rules for directors' fees, because such fees are not deductible by the paying corporation. They are, in effect, considered a distribution of corporate profits.

Artists and athletes. The OECD model provides that the state where services of an artist or athlete are rendered may tax the income from such services without limit.²²⁴ It also provides that where income from such services is diverted to another person, the source state may tax without regard to the existence of a permanent establishment or fixed base.²²⁵ The U.S. model, in contrast, contains a "threshold" limiting source state taxation when an artist or athlete has not received remuneration in excess of \$15,000 in the taxable year.²²⁶ It also limits the special rule on source state taxation of diverted income to cases where the performer has an interest in the recipient entity.²²⁷

Social Security payments. The OECD model reserves to the residence state the right to tax pensions, including benefits paid from a public social security fund.²²⁸ The U.S. model provides for exclusive taxation of social security and other public pensions at source.²²⁹ Since the United States does not tax Social Security benefits,²³⁰ and has geared benefit levels accordingly, we seek to ensure that our benefit structure will not be impaired by taxes imposed by the other state.

Annuities, alimony, and child support. The U.S. model contains specific provisions, missing from the OECD model, to deal with these items of income.²³¹ With respect to annuities and alimony, the U.S. model provides for exemption in the source state.²³² With respect to child support, the model — reflecting U.S. statutory law, which does not provide for taxation of such payments²³³ — provides for exemption in both states.²³⁴

Government service. The U.S. model follows the OECD model in this article,²³⁵ except that it contains a rule treating the spouse

224. OECD Model, *supra* note 39, art. 17(1).

225. *Id.* art. 17(2).

226. U.S. Model, *supra* note 173, art. 17(1).

227. *Id.* art. 17(2).

228. *See* note 78 *supra*.

229. U.S. Model, *supra* note 173, art. 18(1).

230. I.R.C. § 61; Treas. Reg. § 1.61-11 (1965).

231. U.S. Model, *supra* note 173, art. 18(2), 18(4).

232. *Id.* art. 18(2), 18(3).

233. I.R.C. § 71(b); Treas. Reg. § 1.71-1(e) (1960).

234. U.S. Model, *supra* note 173, art. 18(4).

235. *Id.* art. 18. Compare OECD Model, *supra* note 39, art. 19.

or dependent child who begins to render government service after moving abroad like the spouse who moved abroad for the purpose of rendering such service.²³⁶ In addition, the U.S. model provides that a citizen rendering government service will generally be treated as a resident of the sending state for all purposes under the treaty.²³⁷

Students. The U.S. model provides an election for a student to be treated for tax purposes as a resident of the state in which he is studying.²³⁸ This provision is intended to permit the student to take advantage of statutory allowances and exemptions available only to residents. A person who makes such an election is required to pay tax on his worldwide income to the United States.²³⁹

Non-discrimination. The U.S. model covers discrimination against nonresidents but provides that, in effect, nonresident aliens will not be entitled to net basis taxation in the United States.²⁴⁰ In addition, the model provides a relatively detailed rule governing the allowance of indirect expenses as deductions in the source state.²⁴¹ In these respects the U.S. model extends principles found in the OECD model. On the other hand, the U.S. model²⁴² — unlike the OECD model — provides no protection against discrimination by the source state for corporations not having a permanent establishment in that state.

Mutual agreement. The U.S. model provides for no time limit on the period in which a case can be presented to the competent authority, and spells out in detail some of the actions which are permissible for the competent authority to take.²⁴³ We think it helpful to provide as much guidance to the competent authority as possible. Many countries, which have more flexible competent authority mechanisms than the United States, do not perceive the need for such rules, which are not found in the OECD model.

Exchange of information and administrative assistance. The U.S. model provision on exchange of information is broader than that of the OECD. It expressly requires a state of which information is requested to take depositions, and engage in other specified information-gathering activities, on behalf of the requesting

236. U.S. Model, *supra* note 173, art. 19(1).

237. *Id.* art. 4(5).

238. *Id.* art. 20(2).

239. *Id.*

240. *Id.* art. 24(1).

241. *Id.* art. 24(4).

242. *See* note 91 *supra*.

243. U.S. Model, *supra* note 173, art. 25(2), 25(3).

state.²⁴⁴ The U.S. model is intended to produce information in a form that will be useable in U.S. courts. It also contains a provision requiring the residence state to collect taxes on behalf of the source state for the purpose of ensuring that relief granted by the source state does not inure to the benefit of persons not entitled to such relief.²⁴⁵ This feature is aimed at combatting the use of nominees to secure unintended advantages under a treaty.

Territorial extension. The U.S. model contains no provision like that of the OECD model²⁴⁶ governing territorial extensions. Since territorial extensions must be independently ratified in the United States, a territorial extension provision is of no effect and, indeed, can be misleading.

C. Other Issues

The U.S. and OECD models are, of course, blueprints for only the issues commonly faced in treaty negotiations. There are many treaty issues which do not fit within the confines of the models. These issues arise either from special features in the other country's law or in our own, or from the status of the treaty partner — as a developing country, for example. As might be expected, these are some of the most serious and controversial issues we confront.

Imputation systems. In recent years a number of developed countries have modified their pattern of taxing corporate earnings in order to mitigate "double taxation" at the corporate and shareholder levels. This "integration" of corporate and shareholder taxation has taken a variety of forms. In some countries, distributed profits are taxed at a lower rate than undistributed profits.²⁴⁷ In others an "imputation" system is used.²⁴⁸ Imputation means that part or all of the tax charged to the corporation is allowed as a credit to the shareholder when profits are distributed as a dividend; the shareholder includes in income both the dividend and the amount of creditable tax, and claims a credit against his individual liability for the tax paid by the corporation.

Imputation itself has various manifestations. Some countries have adopted "compensating" taxes at the time of a distribution, or at the time of a distribution of previously untaxed profits, to ensure that the shareholder credit is funded by taxes paid by the

244. *Id.* art. 26(3).

245. *Id.* art. 26(4).

246. OECD Model, *supra* note 39, art. 28.

247. *See id.* art. 10, Commentary, paras. 39-42.

248. *See id.* paras. 43-54.

corporation.²⁴⁹ Some countries allow shareholder refunds when the credit at the individual level exceeds the shareholder's tax liability.²⁵⁰ Some countries have combined split rate systems with an imputation feature.²⁵¹ Some countries impute only a relatively small portion of corporate level taxes to the shareholder.²⁵² Some countries maintain substantial residual taxes at the shareholder level.²⁵³ The variations on this theme are many and complex.

In most cases, however, imputation countries, by their domestic law, do not accord the shareholder tax credit to nonresidents. Nonresident shareholders are ordinarily taxed at a flat percentage of the dividend. Imputation systems thus place our investors at a disadvantage, in terms of access to capital, by comparison with investors who are residents of the imputation country. We have sought in treaty negotiations to secure benefits for U.S. investors commensurate with the imputation benefits granted to source state investors. This may involve "imputation credits", or some substitute for them, for our residents who make equity investments in such countries. The issue gives rise to controversy and complexity in current negotiations.

Tax sparing. A major issue, in negotiating with developing countries, concerns "tax sparing", the grant by the state of residence of a tax credit for taxes that would have been charged in the source state but are not because of special tax relief or "tax holiday" provisions. The position of developing countries is now as it was two decades ago: that tax holidays are in their national interest and that without tax sparing a credit country such as the United States — which allows the credit only for foreign taxes actually paid — counteracts the tax holiday legislation and itself collects the tax "spared".

We think it inappropriate to use tax treaties to favor foreign investment over domestic investment. Moreover, given the history of this issue, we believe that a treaty reflecting a different view would be unlikely to achieve ratification.

Source basis taxation in developing countries. The OECD and U.S. models are, as indicated, designed primarily for treaties

249. The systems adopted by Germany, the United Kingdom, and France exhibit this feature.

250. See OECD Model, *supra* note 39, art. 10, Commentary, paras. 45-46 (French, British, and Turkish systems).

251. See *id.* para. 54.

252. The system adopted by Denmark exhibits this feature.

253. The system adopted by Denmark exhibits this feature as well.

between countries where the flows of income and capital are roughly reciprocal. The limitations of source state taxation in those models produces a revenue cost for that state. However, when investment flows are more or less reciprocal, the revenue sacrifices more or less offset each other. In a treaty between a developed and a developing country the flows are largely in one direction: income flows from the developing country to the developed country. Thus, a model which is in form reciprocal in fact can impose a substantial revenue burden on a developing country.

The UN guidelines,²⁵⁴ which contain a more expanded source basis of taxation,²⁵⁵ recognize the need of developing countries to conserve revenues. The shift is, however, tempered by the often conflicting need of developing countries to attract capital, an objective which is best served by limited source basis taxation.

Permanent Establishment Definition and Business Profits. The UN guidelines include an expanded definition of the permanent establishment concept.²⁵⁶ It permits taxation by the source state if an enterprise maintains a stock of goods for delivery in that state,²⁵⁷ or if it has an agent there who regularly makes deliveries on behalf of the enterprise.²⁵⁸ It permits a limited "force of attraction" of nonattributable income at source.²⁵⁹ And it contemplates source taxation of a foreign enterprise engaged only in purchasing in the source state.²⁶⁰

Shipping. The UN guidelines contain an optional provision allowing source state taxation of shipping activity which is more than casual, even if that activity is conducted by an enterprise managed outside that state's borders.²⁶¹

Investment Income. With respect to dividends, interest, and royalties the UN guidelines provide for a positive rate of taxation at source, but do not fix the maximum rate;²⁶² the participating developing countries believed the OECD rates — 5 percent on direct investment dividends, 15 percent on portfolio dividends, 10 percent on interest, and zero on royalties²⁶³ — were too low. With

254. U.N. Guidelines, *supra* note 52.

255. *Id.* at 7-12.

256. *Id.* at 14-24.

257. *Id.* at 19-20.

258. *Id.* at 20-21.

259. *Id.* at 25.

260. *Id.* at 29-30.

261. *Id.* at 31-36.

262. *Id.* at 37-57.

263. *Id.* at 38, 43, 50-51.

respect to capital gains, the UN guidelines reserve the right of the source state to tax shares representing a substantial participation in a company engaged in business within that state.²⁶⁴

Personal Service Income. The UN guidelines treat managerial salaries as taxable in the state of a company's residence, regardless of where the managerial services are performed.²⁶⁵ They contain an option to allow source state taxation of pensions.²⁶⁶

Other Income. The UN guidelines limit residual residence state taxation to income from sources in the state of residence or from third countries; the source state is permitted to tax residual income arising, under its own laws, in that state.²⁶⁷

The United States has long recognized that items that would likely be exempt at source in a developed country treaty may be taxable at source in a treaty with a developing country. In negotiating with developing countries we have sought primarily to shift items that such countries might prefer to tax on a gross basis into net basis taxation, since we believe net basis taxation to be both fairer and more reasonable than gross basis taxation. These points, of course, imply a broadened definition of "permanent establishment" in treaties with developing countries, and this coincides with a basic thrust of the UN guidelines.

The United States has also been prepared to accept relatively low thresholds for taxation of services income at source. And we have accepted relatively high source taxation of passive income in developing country treaties, focusing more on the practical need to avoid excess foreign tax credits than on the theoretical preference for residence basis taxation of such income.

As a very general matter, therefore, many of the UN guidelines appear acceptable as they stand, or with relatively minor revisions. We intend to draw heavily upon them in producing internal guidelines for use in negotiations with developing countries.

Foreign tax credit. In June 1979 the Internal Revenue Service issued proposed regulations setting forth standards for determining when a payment to a foreign government constitutes an "income tax", or a tax in lieu of an income tax, creditable against U.S. tax liability under the Internal Revenue Code.²⁶⁸ These standards

264. *Id.* at 25.

265. *Id.* at 61.

266. Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries, U.N. Doc. ST/ESA/94, at 85, Guideline 18B(2) (1979).

267. *Id.* at 89, Guideline 21(3).

268. These Regulations have been redesignated as "temporary" since the delivery of

would preclude credits in the case of certain taxes which are viewed, or at least labeled, as "income taxes" by the governments imposing them.²⁶⁹ The regulations have doubtless highlighted questions regarding the extent to which tax treaties should, and do, guarantee foreign tax credits for the taxes they cover. These questions are especially acute with respect to payments to foreign governments in connection with the exploitation of natural resources. It is our present policy to accord a treaty credit for covered taxes, and in some cases this implies a credit in cases where there may be doubt regarding the application of the statute. In such cases of doubt we believe the treaty credit should be limited so that it will have no effect for source state credits exceeding the tentative U.S. liability with respect to income arising in that state.

State taxation using the unitary apportionment method. The "arm's length" method of apportioning profits among components of an integrated international enterprise has been the international standard since the 1930's. Within the United States, among states, a "unitary apportionment" method is still widely used. Many foreign countries have strongly objected to this method of state taxation when it is applied to foreign controlled corporate groups. They have argued that the method results in taxing more profits than are attributable to activities conducted within a state, and that it requires a burdensome amount of information about an enterprise's worldwide operations.

Third country use. Most United States treaties allow benefits in the nature of reductions in source basis taxation to corporations organized in the treaty partner, regardless of whether the owners of the corporation are residents of, or are in any other way connected with, that country.²⁷⁰ Any treaty conceivably can, therefore, be used to effect an overall change in the incidence of United States taxation of U.S. source income, by the simple formation of a "holding company" qualifying for treaty benefits. If a person, for instance, holds equity securities subject to our 30 percent withholding tax on dividends, he can normally reduce that tax by organizing a corporation in a country with which we have a treaty

these remarks. Temp. Treas. Reg. §§ 4.901-2, 4.903-1 (1980).

269. Temp. Treas. Reg. § 4.901-2 (1980).

270. See, e.g., Agreement for Relief From Double Taxation on Earnings From Operation of Ships and Aircraft, Aug. 7, 1964, United States - Mexico, 15 U.S.T. 1528, T.I.A.S. No. 5635; Understanding Relating to Exemption of Shipping and Aircraft Profits, Nov. 30, 1971, United States - Japan, 22 U.S.T. 1775, T.I.A.S. No. 7216; Convention for the Avoidance of Double Taxation with Respect to Income, July 22, 1954, United States-Germany, 6 U.S.T. 1065, T.I.A.S. No. 3245.

reducing the rate to 15 percent.

In practice, however, this kind of "third country use" of tax treaties does not routinely arise, because it is ordinarily not cost-free to make investments through a holding company specially organized in a treaty partner. Most treaty partners of the United States will tax income received by the corporation, which ordinarily will eliminate any advantage from the reduction of the U.S. rate at source. To the extent the investor will be subject to withholding tax on payments from the corporation, or to the extent he is not able to claim complete relief in his home country for a dividend from a foreign corporation, the additional tax burden will often exceed the benefits achieved under the treaty with the United States.

This protection of the treaty process depends, however, on the existence of normal taxing provisions in the law of the treaty partner. Some of our treaty partners have special provisions granting privileges to holding companies, which result in reduced taxation of the holding company or reduced taxation on the payment of income from the treaty country to a third country.²⁷¹ Sometimes this occurs for reasons of domestic policy, but sometimes the treaty partner has deliberately enacted provisions with the aim of attracting "offshore" business, with an eye to the revenues that can be collected from licensing fees or those taxes which are imposed; and to the service industry that can be built up around an "offshore" financing business.

In addition, treaties can be used to channel benefits to "third country" beneficiaries through the use of "conduit" companies. This practice depends upon an exemption from source basis taxation of payments from that country, and an hospitable attitude toward "offshore" business. The conduit company earns income in the United States which is subject, under the treaty, to reduced U.S. tax; the income is then siphoned off as payments deductible from the base subject to tax in the treaty partner, to the person who is the real investor.

These "treaty shopping" practices are objectionable for a number of reasons. The practices cause unintended revenue loss, not contemplated by the treaty "bargain". They may undermine the willingness of third countries to enter into treaty negotiations with us. And, perhaps most seriously, such practices are contrary to the spirit of international double tax treaties, and enhance op-

271. *E.g.*, Netherlands Antilles Profits Tax Ordinance of 1940, arts. 14-14A.

portunities for international tax evasion. Double tax treaties are founded on the principle of allocating taxing rights based on "economic allegiance";²⁷² treaty shopping accords a revenue power to a third country, the "base country", which has little or no claim to such allegiance. In addition, since most "base countries" have local law provisions which ensure confidentiality of the identity of the ultimate investor, the conclusion is inescapable that the practices are employed to a large extent by persons evading taxes in their home country.

Within the last two years we have initiated negotiations aimed at modifying three treaties which we believe present treaty shopping problems — with Switzerland, the Netherlands Antilles, and the British Virgin Islands.²⁷³ Our objective in these negotiations, generally, is to secure new provisions that will eliminate or materially reduce the potential for abuse.

There are potential statutory solutions to the "treaty shopping" problem. Congress could enact a law denying benefits under income tax treaties to corporations disproportionately owned by third-country interests, or to income used to a disproportionate extent to satisfy third-country claims. Switzerland has a law like that,²⁷⁴ but it is aimed at persons using Switzerland as a base country to derive income from countries with which Switzerland has tax treaties, not at persons earning income in Switzerland.²⁷⁵ Such legislation by the United States would require careful assessment. Statutory override of treaty bargains has a disruptive effect on our entire treaty program, if not on our foreign relations generally. Moreover, a blanket denial of benefits to corporations controlled by third country residents would undoubtedly cut too broadly since our principal difficulties stem only from a few treaties with countries which have chosen to foster an "offshore" business as a deliberate policy. Such legislation might deny benefits to arrangements having legitimate business purposes.

272. See text accompany note 6 *supra*.

273. Convention for the Avoidance of Double Taxation with Respect to Taxes on Income, May 24, 1951, United States - Switzerland, 2 U.S.T. 1751, T.I.A.S. No. 2316; Protocol to the Convention with Respect to Taxes on Income and Certain Other Taxes for the Purpose of Facilitating Extension to the Netherlands Antilles, June 15, 1955, United States - Netherlands, 6 U.S.T. 3696, T.I.A.S. No. 3366; Agreement Relating to the Application of the Income Tax Convention to Specified British Territories, Aug. 19, 1957, United States - United Kingdom, 9 U.S.T. 1459, T.I.A.S. No. 4141.

274. See generally Boczek, *WORLD TAX SERIES-TAXATION IN SWITZERLAND* 785-94 (1976).

275. See *id.*

Coverage of possessions. A number of our negotiations have raised the question of treaty coverage of U.S. possessions. At present, none of our treaties in force applies to any of the possessions. The possessions have income tax systems which are separate from the U.S. system, although the law in force in many of them is the Internal Revenue Code as "mirrored"; and in others, the law is closely patterned on our internal tax law. We generally believe that covering the possessions is a salutary idea, because it secures the protections of a treaty for possessions residents who wish to invest or otherwise earn income abroad, and it may contribute to increased investment in the possessions. However, under present law, coverage of the possessions would, as a practical matter, require the negotiation of "mini-treaties", and the possessions to date have not clearly expressed interest in undertaking such an effort.

III. MANAGEMENT OF THE TREATY PROGRAM

The questions of what U.S. tax treaty policy "is" and how it is formulated ultimately depend, of course, not only upon what the models or the treaties in force provide, or what view we take in the abstract about particular issues, but also upon our methods of conducting bilateral negotiations. This raises a host of questions about the "management" of the treaty program: how we formulate or revise provisions of the U.S. model; how we determine which countries we will negotiate with; how negotiations are actually conducted; and finally, how treaties in force are administered.

Design of the U.S. model treaty. The most important decision that has been made in designing the U.S. model was to adhere as closely as possible to the OECD model. The discussion to this point indicates the basic justification for this approach: the OECD model represents an appropriate, if not perfect, theoretical basis for tax treaty negotiations; it evolved in a pragmatic way; and it offers the best chance of achieving the maximum degree of international tax harmonization, the reduction of tax-based barriers to the free movement of goods, persons, and capital across borders, with appropriate protections against international tax evasion. In light of the widespread international acceptance of the OECD model, any other choice would, in many cases, make the achievement of treaties impossible. These considerations have prevailed in the design of the U.S. model, despite the fact that much of the language used in that model is not found in the Internal Revenue Code; that some of the concepts of the OECD model are relatively unfamiliar as well; and that, in certain respects, we believe that substantive

rules in the OECD model stand in need of improvement.

Those departures we have made from the OECD model are not generally motivated by differences in economic theory or differences in our view of the practical requirements of international tax cooperation. The only major exceptions to this statement are the reciprocal interest exemption²⁷⁶ and the investment and holding company provisions.²⁷⁷ The interest exemption does reflect a consistent U.S. preference for a stricter "residence" basis approach to taxing liquid international capital which moves freely from country to country; but the approach we pursue is at least implicitly conceded by the commentary to the OECD model. The investment and holding company provisions are, we believe, essential attributes of a modern bilateral treaty; but here again, the commentary acknowledges the validity of our position, and we are currently pursuing discussions at the OECD aimed at devising a common international view of treaty abuse. In general, if we believe a deviation from the OECD model is warranted based not on some peculiar circumstance of our position but because of deficiencies in the OECD approach, it is advisable to raise the question at the OECD, in an attempt to secure modification of the international model.

In general, most of the deviations we have made from the OECD model are an outgrowth of peculiar features of U.S. law. It is not necessarily true that our statutory practices in these regards are optimal, but treaties are intended to function against a backdrop of domestic law.

Finally, we are prepared to deviate from the OECD model in some instances in anticipation of changes in U.S. statutory law. Ordinarily, we would not deem it wise to change treaty policy in anticipation of statutory changes, because the changes might never occur. But we are conscious of the fact that treaties remain in effect for substantial periods of time, and are not subject to easy revision once they enter into force. Thus, when we perceive a likelihood that legislation will be enacted, and a difficulty with existing treaty policy if it is enacted, and when we view the potential legislation and the treaty policy changes as essentially sound, we are probably wisest to anticipate the legislation and modify our negotiating policy as appropriate.

Selecting Treaty Partners. In cases where another country re-

276. U.S. Model, *supra* note 173, art. 11.

277. *Id.* art. 16.

quests treaty negotiations with the United States, we are usually disposed — subject to scheduling constraints — to comply. Normally, we try to establish at the outset some of the ground rules under which we want negotiations to take place. For example, we forward a copy of the U.S. model in advance, sometimes accompanied by an explanation of its particular features; and we endeavor to make clear the United States position in regard to tax sparing and other incentives for foreign investment. Generally we indicate, in regard to treaties in existence, that we prefer not to negotiate exclusively for the purpose of changing a single provision. Existing treaties almost invariably stand in need of general updating, and if we are to meet we generally prefer a full review.

Insofar as United States initiated negotiations are concerned, it is best to distinguish between countries with which we already have a treaty and countries with which we seek a treaty for the first time. With respect to the former category, the most important instance where we might request negotiations would be where the treaty arrangement is producing unintended consequences. A leading example would be those treaties which give rise to extensive treaty shopping. Another case for U.S. initiated negotiations would be where significant changes in a treaty partner's law have undermined the functioning of the treaty or have altered the bargain represented by the treaty. An example would be our treaty arrangement with Italy, which has completely altered the tax system covered by the treaty in force.

A third case would be where a change in our own law has affected the operation of the treaty. Of necessity, we are slower in initiating renegotiation of treaties in this case, since changes in our law typically leave us with a host of treaties requiring revision. For example, the United States has not concertedly sought renegotiation of treaties to reflect changes brought about by the Foreign Investors Tax Act of 1966;²⁷⁸ over time, however, we have entered into negotiations, because of other circumstances to revise at least half of those treaties; in these negotiations we have undertaken the necessary process of modernization. A systematic program to revise outdated treaties is on our agenda, but it does raise serious problems with the allocation of our staff resources.

A fourth case of U.S. initiated negotiations would be where Congress by statute overrode provisions of our treaties. This has

278. Foreign Investors Tax Act of 1966, Pub. L. No. 89-809, 80 Stat. 1539 (codified in scattered sections of 26 U.S.C.).

occurred only rarely; the best known example was a provision of the Foreign Investors Tax Act of 1966²⁷⁹ which overrode our estate tax treaty with Greece,²⁸⁰ which was then renegotiated.²⁸¹ Congress has now enacted legislation to tax foreign investors on their capital gains from sales of United States real estate,²⁸² and the legislation by its terms would override inconsistent treaty provisions after a five year delay.²⁸³ Our hope is that, in that five year period, we could negotiate protocols with the various countries with which we have treaties that would be subject to the override.

With respect to countries with which we have no treaties, we make it clear that we stand ready to negotiate but ordinarily do not urge any particular country to commence negotiations. We generally make the point that a tax treaty has substantial value, because it establishes fiscal relations between the two countries and because it represents an indication to private investors of the existence of a stable climate for investment. We normally do not press particular countries to negotiate, because it has been our experience that negotiations have the best chance for success where the other country comes on its own to recognize the desirability of a treaty relationship.

The treaty bargaining process. In the process of bilateral bargaining, there are issues on which the U.S. and OECD models differ, where we are asked to make concessions in the direction of the OECD model; there are issues where we are asked to agree to a provision contrary to both models; and there are novel questions on which the models are silent.

With respect to movement in the direction of the OECD model, and movements away from both the U.S. and OECD models, there are some issues we never concede, and some where we must make a judgment based upon the overall balance of the treaty bargain. We do not concede, for example, on citizenship ba-

279. *Id.*

280. Convention and Protocol for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on the Estates of Deceased Persons, Feb. 20, 1950 (Protocol, July 18, 1950), United States - Greece, 5 U.S.T. 12, T.I.A.S. No. 2901; Protocol Modifying and Supplementing the Convention of February 20, 1950, for the Avoidance of Taxation, Feb. 12, 1964, United States - Greece, 18 U.S.T. 2853, T.I.A.S. No. 6375.

281. Protocol Modifying and Supplementing the Convention of February 20, 1950, for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on the Estates of Deceased Persons, Feb. 12, 1964, 18 U.S.T. 2853, T.I.A.S. No. 6375, reprinted in 1 TAX TREATIES (CCH) ¶ 3168.

282. Omnibus Reconciliation Act of 1980, Pub. L. 96-499, Foreign Investment in United States Real Property, 94 Stat. 2682.

283. *Id.* § 1125(c).

sis taxation; protecting provisions of U.S. law intended as penalties; noncoverage generally of state and local taxes; protection against at least some forms of discrimination; and the U.S. statutory rule regarding corporate residence.²⁸⁴ These are issues where we perceive a strong national interest reflected in the U.S. model. While we might make a concession on at least some of these issues in certain circumstances without serious impairment of our interests, we prefer not to establish precedents clearly contrary to the model on these questions. We believe each treaty represents a separate bargain, and do not grant concessions simply because they have been granted in other negotiations. Nevertheless, in practice it is sometimes difficult to convince another country that we have good reason for not accepting a provision that we have accepted elsewhere.

On the other hand, there are provisions in the U.S. model which are different from those of the OECD model but to which we do not ascribe great significance. For example, the rules for resolving cases of dual residence of individuals are different in our model from those proposed by the OECD. We believe our rules are better than those of the OECD, but the differences are of little practical importance and we have been prepared to adopt the OECD rules.

Between these extremes lie a wide range of issues which must be considered on a treaty-by-treaty basis. The factors we normally take into account in making the necessary judgments are the practical importance of a concession to the United States and U.S. taxpayers; the provisions of foreign law that will be operative if the concession is made; the degree to which a particular concession might be regarded as a precedent for other negotiations; and the difficulties that a particular concession might create for the ratification process.

With respect to issues not covered by existing models, our objective in seeking agreement is frequently not conformity to principle but the establishment of a principle itself. Issues regarding the imputation credit²⁸⁵ are of particular difficulty precisely because what is involved for both countries is the establishment of a new principle. Eventually, of course, whatever principle is embodied in the treaties will, in some form, find its way into the work of international organizations, since that work has always been not so

284. See I.R.C. §§ 1, 531-537, 541-547, 891, 896, 7701(a)(4), 7701(a)(5). See also U.S. Model, *supra* note 173, art. 2 (omitting personal holding company, accumulated earnings, and state and local taxes from coverage), 24 (non-discrimination).

285. See text accompanying notes 248-54 *supra*.

much a process of formulating abstract rules as of elaborating rules established, more or less, by usage. Because of the size and economic importance of the United States, we have special responsibilities in this regard; often when a new and serious international problem arises, like that created by the imputation systems, other countries will await the outcome of our negotiations before pursuing their own. These considerations can make bilateral negotiations over new issues very difficult.

Particular negotiations may raise special issues not covered, or not covered in sufficient detail, by the models. For example, discussions of information exchange with bank secrecy countries, and discussions of treaty shopping with tax havens, have made these negotiations unique. In these discussions we are not aiming at establishing or clarifying fiscal relations between two countries, but at solving a serious problem for the tax system. Just as we have fundamental concerns involved, the other country has concerns which it views as equally fundamental. In the best of circumstances the "trade" made in such negotiations involves a compromise which improves the situation for both sides, without requiring ultimate concessions by either.

Implementing tax treaties: the "competent authority" function. Under all tax treaties, certain powers and duties are delegated to the "competent authorities" of the contracting states. Under the U.S. model, and under our treaties in force, the term "competent authority" is the Secretary of the Treasury or his delegate;²⁸⁶ in practice, the Secretary has delegated this responsibility to the Commissioner of Internal Revenue,²⁸⁷ who in turn has delegated day-to-day responsibilities to the Assistant Commissioner (Compliance) of the Internal Revenue Service.²⁸⁸ On matters involving legal interpretations of treaties, the Assistant Commissioner (Compliance) is enjoined to seek the concurrence of the Assistant Commissioner (Technical).²⁸⁹

The treaties spell out a number of assignments of the competent authority. The typical "mutual agreement" article states that a taxpayer may appeal to the competent authority of the state of which he is a resident or national, if he believes he is being subjected to taxation not in accordance with the treaty.²⁹⁰ The treaties

286. U.S. Model, *supra* note 173, art. 3(1).

287. Treas. Dept. Order No. 150-83, 1973-2 C.B. 508.

288. Delegation Order 114 (Rev. 2), 1980-43 I.R.B. 22.

289. *Id.*

290. See U.S. Model, *supra* note 173, art. 25(1).

authorize the competent authorities to agree to a definition of a term not defined in the treaty if an agreement on a common meaning is necessary or desirable.²⁹¹ In addition, the treaties make the competent authorities responsible for conducting the information exchange permitted or required under the treaties.²⁹² The competent authorities are authorized to communicate directly for the purpose of discharging their responsibilities.²⁹³ This provision is necessary to obviate the need for using diplomatic channels to effect communication between the two contracting states.

One issue with respect to the implementation of our treaties grows out of the manner in which responsibilities for conducting the treaty program and implementing treaties are divided within the Treasury Department. The Internal Revenue Service is not, in general, responsible for the conduct of treaty negotiations; that function is reserved to the Treasury's Office of Tax Policy. Of necessity, however, the Service is assigned the task of handling the "competent authority" process. The most important reason for this is that the Service is in possession of the information which another country would be likely to request pursuant to a treaty, and knows what information the United States might need. In addition, the Service has the prime responsibility for handling individual tax cases.

Public and congressional participation in the treaty negotiating process. One final problem touching on the management of the treaty program concerns the difficulty of engaging Congress and the public in the process of formulating treaty law. Treaty negotiations are conducted on a government-to-government basis, and the provisions of a treaty are not revealed publicly until after a treaty is signed. This means that outside interested parties do not have a full opportunity to comment upon, or to participate in, the development of the provisions that will be included in the treaty; the treaty is presented as a fully negotiated document when it is transmitted by the President to the Senate for advice and consent.

We have taken several steps in recent years to mitigate this problem. In 1976 we published the U.S. model, calling for public comments. The model represents our initial negotiating position; through its publication we intended to apprise the public of our objectives in treaty negotiations, and we have, in fact, received sig-

291. See *id.* art. 25(3).

292. See *id.* art. 26(1).

293. See *id.* art. 25(4).

nificant comments on the model. Second, we have undertaken in recent years to announce publicly at least the outset of treaty negotiations; and, as of 1978, for negotiations showing promise of leading to treaties, we have held public meetings to discuss the major issues and the negotiating positions of the United States. In order to do this, we must obtain the consent of our negotiating partner; and often we are constrained, at the request of other countries, in what we may publicly discuss. Most other countries with which we have negotiated treat the negotiating process as strictly secret. For this reason we have generally declined, in our public meetings, to divulge details regarding positions taken by the other country. Nevertheless, we do manage, through these meetings, to alert the public to most of the major issues in the negotiations, and we have frequently received useful comments and suggestions as a direct result.

Finally, the ratification process ensures full public participation after the signature of a treaty, but before it enters into force. If a provision is found objectionable to the Senate, there is ordinarily opportunity to reopen the negotiations to change the provision, although this process may involve making collateral concessions to the treaty partner.

In general, it is difficult to see a way to avoid restrictions on public participation in the treaty negotiating process. Other countries typically insist upon some degree of confidentiality for the negotiations. Moreover, fully discussing our negotiating positions, the importance that each has for us, our reasons for them, and the like would tend to undermine our own position in the negotiating process. This would have the effect of prolonging negotiations generally, and would inevitably result in less favorable bargains for the United States than we might otherwise be able to obtain.

IV. CONCLUSION

In summary, United States tax treaty policy is founded upon established international principles and practices, accommodated to reflect the special characteristics of our tax system. The essential long-range objectives of the tax treaty program are to eliminate the impediments that double taxation, or the threat of double taxation, might pose to the international flow of goods, capital, and persons, and to establish fiscal relations between the United States and other nations. In pursuing these objectives, we are sometimes forced to agree to compromise provisions that are not ideal, and to accept rules governing transactions with one country which may be

different from those governing similar transactions with another. But if one considers the difficulties of making accommodations with the multitude of varying tax systems in the world today, the value of tax treaties to international economic activity clearly makes them worth these relatively small costs.

For the moment, the major short-term objectives of United States treaty policy are three-fold. First, we must update and modernize our treaties presently in force. This process will eventually eliminate some of the irregularities of the extant pattern of treaty law. Second, we must revise those few treaties which give rise to abuse, for the sake of the integrity of the tax system and to ensure that the treaty program does not result in an unjustified loss of revenue to the United States. Finally, we need to work to expand our treaty network, particularly with developing countries. These objectives are serious and important, and they deserve a high priority. We are devoting to them as much time and effort as we can.