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TREATY-BASED NONDISCRIMINATION: Now You See It Now You Don't

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I. INTRODUCTION

A broad nondiscrimination provision appears in every income tax treaty that the United States has entered into in the last quarter century. The nondiscrimination article of these treaties purports to prohibit discriminatory taxes levied against foreign nationals or their businesses. However, some distinctions have always been permitted, based on the fact that domestic and foreign taxpayers are not similarly situated because different taxing jurisdictions are concerned. The problem is that it is difficult to articulate a consistent and rational standard to apply to determine when proscribed discrimination is present.

The language used in a typical U.S. nondiscrimination provision, such as Article 24 of the 1981 U.S. Model Income Tax Treaty (the "1981 U.S. Model"), can be traced to the 1963 draft model convention published by the Organization for Economic Cooperation and Development Committee on Fiscal Affairs, Draft Double Taxation Convention on Income and on Capital (the "1963 OECD Model").¹ The 1977 draft of the Organization for

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1. Although all of the recent U.S. income tax treaties contain a nondiscrimination provision, this provision has not always been present. For example, the following income tax treaties contain no such provision: Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, May 14, 1953, U.S.-Austl., 4 U.S.T. 2274; Convention on Rates of Income Tax on Nonresident Individuals and Corporations, Dec. 30, 1936, U.S.-Can., 50 Stat. 1399; Convention on Double Taxation, Apr. 27, 1932, U.S.-Fr., 49 Stat. 3145; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Mar. 30, 1955, U.S.-Italy, 7 U.S.T. 2999; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Apr. 16, 1954, U.S.-Japan, 6 U.S.T. 149; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, June 13, 1949, U.S.-Nor., 2 U.S.T. 2323; Convention for the

Economic Cooperation and Development Model Double Taxation Convention on Income and on Capital (the "1977 OECD Model") includes a similar provision as its Article 24. Both the 1963 OECD Model and the 1977 OECD Model have been instrumental in guiding development of the language of bilateral income tax treaties. Copies of Article 24 of the 1981 U.S. Model and of Article 24 of the 1977 OECD Model are attached as Appendix A and Appendix B.

Although treating similarly situated taxpayers the same is a laudable goal, there appears to be a great distance between acceptability of the non-discrimination concept in general and the ease or exactness of its application. A former international tax counsel and Director of the Office of International Tax Affairs at the U.S. Treasury Department, who was involved in negotiating several U.S. income tax treaties, has observed that, "as admirable as the 'nondiscrimination' concept sounds, the ramifications of ... [the nondiscrimination article] are probably more uncertain than those of any other article."² Similarly, interpretation of the nondiscrimination article of U.S. income tax treaties has been described as "a most confusing area of the tax law."³

Based in part on particular policy concerns and in part on interpretative difficulties discussed below, some countries either refuse to include nondiscrimination provisions in their treaties, or significantly limit the application of such provisions. Thus, in addition to being difficult to interpret, the typical model nondiscrimination article is not necessarily acceptable to other nations.

More disturbing is the increasing tendency of Congress to articulate a standard, apply it to proposed legislation, and state that, while Congress does not consider the legislation discriminatory under that standard, if a court disagrees then the nondiscrimination provision is intended to be overridden anyway. Such behavior is one of the reasons for the title of this article. Another reason is the evanescent character of discrimination as seen through the eye of the beholder.

This article analyzes the nondiscrimination concept, evaluates its general acceptance worldwide, explores its rather inconsistent application in the United States, and considers whether it makes sense to continue including a nondiscrimination article in future U.S. income tax treaties.

Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Dec. 22, 1966, U.S.-Trin. & Tobago, 18 U.S.T. 3091.

2. Robert J. Patrick, Jr., A Comparison of the United States and OECD Model Income Tax Conventions, 10 Law & Pol'y Int'l Bus. 613, 705 (1978); see discussion of Australian position on nondiscrimination *infra* pp. 55-57.

3. James G. O'Brien, The Nondiscrimination Article in Tax Treaties, 10 Law & Pol'y Int'l Bus. 545, 612 (1978).

A. Concept of Nondiscrimination

The principle of nondiscrimination against foreign nationals and their enterprises has been applied in international fiscal relations since well before the appearance, at the end of the nineteenth century, of the classic bilateral double taxation convention.⁴ The nondiscrimination principle was often incorporated in consular or establishment conventions and in treaties of friendship, commerce, and navigation; the parties to those agreements often attempted to obtain “most favored nation” protection for the businesses conducted abroad by their nationals.

The existence of nondiscrimination provisions in treaties has been justified as being consistent with the concept that taxes should not be an impediment to the free-flow of international trade, investment, or the movement of individuals.⁵ According to the American Law Institute (the “ALI”), it is accepted practice to include generalized assurances that a country will not employ excessive or burdensome taxation as a protectionist or exclusionary device, “which means that nationals (or residents) of both treaty countries will be on a level [tax] playing field.”⁶ Rather than leveling the playing field by extending domestic investment incentives to *foreign* investments made by their own nationals, the level playing field concept has been implemented by having source countries agree to *avoid placing extra burdens upon foreign persons and their businesses conducted in the source countries*. Thus, in practice, a treaty nondiscrimination provision represents a commitment that a source-country will not tax nationals⁷ or residents of its treaty partner more heavily than it taxes its own nationals or residents.

In addition to committing to tax foreign nationals no more heavily than source-country nationals, some source countries, including the United States, implement the level playing field concept by retaliating against foreign nationals of a country that imposes discriminatory taxes against source-country nationals. For example, sections 891 and 896 of the Internal Revenue

4. See Committee on Fiscal Affairs, Organization for Economic Co-Operation and Development Model Double Taxation Convention on Income and on Capital, art. 24 (1977) [hereinafter “1977 OECD Model”] (Appendix B hereto); 1963 and 1977 OECD Model Income Tax Treaties and Commentaries art. 24, para. 1(2) (Kluwer 1987) [hereinafter “1977 OECD Commentaries”]. The concept also appears in the League of Nations Mexico Model Convention (1943) and the London Model Convention (1946).

5. See American Law Institute, Federal Income Tax Project, International Aspects of United States Income Taxation II, Proposals on United States Income Tax Treaties [hereinafter “A.L.I. Treaty Project”], 253 (1992).

6. *Id.*

7. The term “nationals” is used in the 1977 OECD Model and in the 1981 U.S. Model Income Tax Treaty. 1977 OECD Model, *supra* note 4, art. 24, para. 1-2; U.S. Model Income Tax Treaty, art. 24, para. 1-2 (1981) [hereinafter “1981 U.S. Model”] (appendix A hereto). See *infra* at text accompanying notes 142-64.

Code (the "Code") allow the United States to increase taxes applicable to nationals, residents and corporations of another nation that subjects U.S. citizens or domestic corporations to discriminatory or extra-territorial taxes.⁸

B. *Typical Nondiscrimination Provisions*

In order to evaluate the concept of nondiscrimination in the context of the actual nondiscrimination provisions found in a typical U.S. treaty, reference must be made to the specific restrictions that the treaty incorporates.

Article 24 of the 1981 U.S. Model, which is discussed in detail throughout the balance of this article, includes four basic rules.

1. Nationals of one country may not be subjected in the second country to any taxation or requirement connected therewith that is "other or more burdensome" than is applicable to nationals of the second country who are "in the same circumstances."⁹

2. Taxes may not be "less favorably levied" by a country on foreign owned permanent establishments located in the country than are levied by the country on enterprises of the country carrying on "the same activities."¹⁰

3. Enterprises of one country, the capital of which is owned or controlled wholly or partly, directly or indirectly, by one or more residents of the second country, may not be subjected in the first country to any taxation or requirement connected therewith that is "other or more burdensome" than that applicable to "similar enterprises" of the first country.¹¹

4. Interest, royalties, and other disbursements paid by a resident of one country to a resident of the second country, shall, for purposes of determining taxable profits of the resident of the first country, be deductible under the same conditions as if they had been paid to a resident of the first country.¹²

8. Although critical to their implementation, neither section 891 nor section 896 of the Code defines discrimination.

9. 1981 U.S. Model, *supra* note 7, art. 24, para. 1.

10. 1981 U.S. Model, *supra* note 7, art. 24, para. 3.

11. 1981 U.S. Model, *supra* note 7, art. 24, para. 5.

12. 1981 U.S. Model, *supra* note 7, art. 24, para. 4.

C. Covered Taxes

While U.S. income tax treaties are normally limited to federal income taxes,¹³ their nondiscrimination articles may be much broader. For example, in the 1981 U.S. Model, the nondiscrimination rules apply to “taxes of every kind and description” imposed by one of the treaty countries or by any political subdivision or local authority of such countries.¹⁴ Thus, the provision would apply to federal estate, gift, and generation-skipping taxes, as well as to all state and local taxes.¹⁵

D. Concerns of Other Nations

The approaches of other nations indicate that the 1981 U.S. Model nondiscrimination article is not universally accepted. These approaches also help raise the question of whether the United States should continue to seek nondiscriminatory treatment for its nationals and grant such treatment to nationals of its treaty partners. By way of illustration, Canada, Australia, and New Zealand generally have not adopted a nondiscrimination provision similar to that of the 1981 U.S. Model.¹⁶ Also, Japan reserves the right not to extend domestic benefits to the permanent establishments of nonresidents.¹⁷

Article 23 of the U.S.-Australia income tax treaty of 1982¹⁸ adds the following three limiting paragraphs to the 1981 U.S. Model:

- (2) Nothing in this Article relates to any provision of the taxation laws of a Contracting State:
 - (a) in force on the date of signature of this Convention;
 - (b) adopted after the date of signature of this Convention but which is substantially similar in general purpose or intent to a provision covered by subparagraph (a); or
 - (c) reasonably designed to prevent the avoidance or evasion of taxes;provided that, with respect to provisions covered by

13. 1981 U.S. Model, *supra* note 7, art. 2, para. 1.

14. 1981 U.S. Model, *supra* note 7, art. 24, para. 1.

15. See Convention with Respect to Taxes on Income and on Capital, Sept. 26, 1980, U.S.-Can. art. XXV, para. 10, T.I.A.S. No. 11,087, at 24, [hereinafter “U.S.-Can. Treaty”].

16. 1977 OECD Commentaries, *supra* note 4, art. 24, para. 61.

17. 1977 OECD Commentaries, *supra* note 4, art. 24, para. 65.

18. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, August 6, 1982, U.S.-Austl., art. 23, para. 2-4, T.I.A.S. No. 10,773, at 50-52 [hereinafter “U.S.-Austl. Treaty”].

subparagraphs (b) or (c), such provisions (other than provisions in international agreements) do not discriminate between citizens or residents of the other Contracting State and those of any third State.

- (3) Without limiting by implication the interpretation of this Article, it is hereby declared that, except to the extent expressly so provided, nothing in the Article prevents a Contracting State from distinguishing in its taxation laws between residents and nonresidents solely on the ground of their residence.
- (4) Where one of the Contracting States considers that the taxation measures of the other Contracting State infringe the principles set forth in this Article the Contracting States shall consult together in an endeavor to resolve the matter.

Paragraph 2 of this additional language permits Australia to continue enforcing all of its tax provisions that were in effect in 1982, or that are adopted after 1982 and have a substantially similar purpose or intent as a pre-1983 provision, regardless of whether they discriminate against U.S. taxpayers. As to post 1982 provisions, the treaty does not protect against discrimination against U.S. taxpayers as compared with Australian residents or nationals, but only as compared with *third* country nationals. Paragraph 3 of the additional language allows a Contracting State to distinguish in its tax laws between residents and nonresidents solely on the basis of their residence. A similar provision appears in the U.S.-New Zealand income tax treaty of 1982.¹⁹

Paragraph 4 of the additional language provides for competent authority consultation where one of the parties believes discrimination has occurred. Although the treaty does not state that this is the sole remedy, the competent authority provision may have been intended to preclude individual taxpayer private actions.²⁰ If paragraph 4 is intended to limit enforcement

19. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, July 23, 1982, U.S.-N.Z., art. 23, T.I.A.S. No. 10,772 [hereinafter "U.S.-N.Z. Treaty"]. New Zealand also entered a reservation to the OECD Model nondiscrimination provision. No other New Zealand treaty contains a nondiscrimination article.

20. The U.S. Treasury Department's Technical Explanation of the U.S.-Austl. Treaty speaks only of a taxpayer's right to enlist his government's aid in determining whether discrimination has occurred. Treasury Dept. Technical Explanation of U.S.-Austl. Treaty, Fed. Tax Treaties I (P-H) ¶ 15,062 at ¶ 15,069.

to official competent authority negotiations, it may be ineffectual, since paragraph 4 only requires consultation, not agreement.²¹ Nor is it clear that a U.S. taxpayer can compel the Internal Revenue Service to participate in negotiations under the competent authority procedure.²²

It seems that Australia's reason for negotiating double taxation agreements is simply to agree upon a division of taxing rights between itself and other countries in a way that relieves double taxation and prevents fiscal evasion. Under this view, a nondiscrimination article, like Article 24 of the 1981 U.S. Model, is not necessary. Australia is apparently of the view that certain serious disadvantages may arise from including a broad nondiscrimination provision in its treaties. Such a provision would conflict with what Australia considers a proper division of taxing rights between the parties to the tax treaties. For example, it would restrict Australia's right to impose a branch profits tax, could limit Australia's ability to reallocate profits under an arm's-length pricing provision,²³ and could prevent Australia from applying "thin capitalization" rules to foreign-owned companies.

Australia is also concerned that such an article would preclude it from adopting some tax measures intended principally for economic regulation, rather than revenue raising. Apparently Australia is concerned that particular economic problems may arise only in relation to foreign-owned companies, and believes that its ability to deal with such problems through measures affecting only those companies should not be impaired. Apart from policy considerations, Australia also apparently considers the language of Article 24 of the 1981 U.S. Model too imprecise.

Some countries may also find a nondiscrimination provision unnecessary to resolve some problems. The ALI's suggested manner of dealing with a situation in which a nondiscrimination claim conflicts with a specific substantive rule of a treaty is to apply the specific substantive rule *despite* the nondiscrimination provision, because the treaty implicitly reflects its own resolution of the conflict.²⁴ In other words, since the nondiscrimination language is more general, the ALI suggests that the more specific provision should govern. Similarly, the ALI suggests that if treaty negotiators can

21. A similar problem exists with the competent authority or mutual agreement provision. See Sanford H. Goldberg, *How and Does the Competent Authority Work? — A Multinational Analysis*, 39 *The Tax Executive* 5 (1986); Sanford H. Goldberg, *USA: Competent Authority*, 40 *Bull. for Int'l Fiscal Documentation* 431 (1986).

22. See *Yamaha Motor Corp. v. United States*, 779 F.Supp. 610 (D.D.C. 1992); see generally Sanford H. Goldberg and Seth B. Goldstein, "U.S. District Court Lacks Jurisdiction to Compel IRS to Consider Request for Competent Authority Assistance," 40 *Can. Tax J.* (forthcoming 1992) (manuscript on file with author).

23. However, the U.S.-Can. Treaty, *supra* note 15, includes a typical "associated enterprise" article.

24. See generally A.L.I. Treaty Project, *supra* note 5.

reasonably be said to have accepted an existing domestic law or treatment in effect at the time the treaty was negotiated, such law or treatment should not be attacked on nondiscrimination grounds. Such interpretative refinements might be considered by other nations as a means of reconciling some of their disagreements with the United States without resort to a nondiscrimination provision.

Canada also has reservations about the 1981 U.S. Model nondiscrimination article, perhaps because Canada recognizes that it discriminates against foreign taxpayers in a number of ways and wants to be able to continue to do so.²⁵ Like Australia, Canada has agreed to treat all foreign taxpayers similarly, but not necessarily the same as it treats its own residents. Thus, Article XXV(2) of the U.S.-Canada treaty²⁶ compares nationals of the other treaty country to “citizens of any third State in the same circumstances (including State of residence)...” Similarly, Article XXV(5) of the U.S.-Canada treaty, dealing with foreign-owned domestic corporations, compares U.S.-owned companies to companies “owned or controlled, directly or indirectly, by one or more residents of a third State,” rather than to companies owned by Canadian residents.²⁷ Finally, like the Australia²⁸ and New Zealand²⁹ treaties, Article XXV(8) of the U.S.-Canada treaty provides:

The provisions of paragraph 7 shall not affect the operation of any provision of the taxation laws of a Contracting State:

- (a) Relating to the deductibility of interest and which is in force on the date of signature of this Convention (including any subsequent modification of such provisions that does not change the general nature thereof); or
- (b) Adopted after such date ... and which is designed to ensure that a person who is not a resident of that State does not enjoy, under the laws of that State, a tax treatment that is more favorable than that enjoyed by residents of that State.³⁰

25. Under questioning in the Canadian House of Commons concerning the disallowance of deductions for advertising placed in foreign magazines, International Trade Minister John Crosbie acknowledged that the provision was discriminatory. “I expect the Americans to accept with resignation and disfavor and disappointment and frustration and irritation and anger our position with regard to cultural industries. I don’t blame them. If I was them, I’d take the same position.” BNA Daily Tax Report (Mar. 20, 1991) at G-6.

26. U.S.-Can. Treaty, *supra* note 15, at art. XXV, para. 2, T.I.A.S. No. 11,087, at 23.

27. U.S.-Can. Treaty, *supra* note 15, art. XXV, para. 5.

28. See *supra* note 18.

29. See *supra* note 19.

30. U.S.-Can. Treaty, *supra* note 15, art. XXV(8).

Differences in the views of other nations as to the appropriate scope of a nondiscrimination provision raises the fundamental question: What conduct by a state constitutes discrimination?

E. *Recent Withdrawal of U.S. Model Treaties*

In its notice withdrawing both the 1977 and 1981 U.S. Models, the U.S. Treasury Department recently noted that the model treaties, which have served as a starting point for U.S. treaty negotiations with other nations, are "significantly" outdated.³¹ The notice invited comments from the private sector on the nondiscrimination article and nine other parts of the model treaties. Thus, it is now appropriate to reconsider what function, if any, the nondiscrimination article of a U.S. income tax treaty should serve.

II. WHAT IS DISCRIMINATION?

Just as the courts have difficulty in evaluating claims under the due process and equal protection provisions of the U.S. Constitution (the "Constitution"), so it appears that claims of discriminatory taxes prove difficult to evaluate. One problem is determining what sort of unequal treatment rises to the level of prohibited discrimination. Another problem is determining who is to be compared to whom in deciding whether unequal treatment exists. Finally, although perhaps a problem of different magnitude, if discrimination is found, what is the appropriate remedy.

A. *Equal Protection Clause*

Few U.S. courts have considered issues arising under nondiscrimination provisions of treaties. Yet, there is a rather large body of law interpreting the Equal Protection Clause in the Fourteenth Amendment of the Constitution that one might think would provide some guidance. The Equal Protection Clause provides that: "[n]o State shall ... deny to any person within its jurisdiction the equal protection of the laws."³² Since this clause assures that persons similarly situated will be treated alike under the laws of a state, it seems to share the general goal of nondiscrimination articles of income tax treaties.

Courts that have interpreted the Equal Protection Clause have not

31. T.D. News Rel. N.B.-1900 (July 17, 1992), 92-13 CCH ¶ 46,416. The OECD has recently released its latest, 1992 model treaty; this article does not comment on the 1992 model.

32. U.S. Const. amend. XIV, § 1. A similar provision is "read into" U.S. Const. amend. V.

required *identical* treatment. In the absence of a “suspect” classification, in fact, the courts seem to accept virtually any non-arbitrary distinction among different persons.³³ The applicable standard, referred to as the “rational basis test,” is often phrased in three parts: (1) the classification must rest on real rather than superficial differences, (2) the distinction must have some relevance to the purpose for which the classification is made, and (3) the different treatment must not be *so* disparate relative to the difference in classification as to be “wholly arbitrary.”³⁴

Despite the apparent similarity between constitutional equal protection and treaty nondiscrimination, different standards may be acceptable in interpreting them given the differences in their origins and purposes. The Equal Protection Clause was designed to prevent the various states within the United States from drawing invidious and arbitrary distinctions among those persons within their borders, while preserving to the extent possible the rights of states to govern themselves.³⁵ This restriction on the states was thus intended to permit great latitude to state legislatures. However, the same deference need not be given in the international arena. As the Supreme Court recently stated in *Davis v. Michigan Dept. of the Treasury*, “‘our decisions in [the equal protection] field are not necessarily controlling where problems of intergovernmental tax immunity are involved,’ because ‘the Government’s interests must be weighed in the balance.’”³⁶ “Instead, the relevant inquiry is whether the inconsistent tax treatment is directly related to, and justified by, ‘significant differences between the two classes.’”³⁷ The *Davis* Court stated that “[t]he State’s interest in adopting the discriminatory tax, no matter how substantial, is simply irrelevant....”³⁸ Thus, discrimination for treaty purposes may be present even though, applying equal protection standards, discrimination would not be found.

B. *Permitted Distinctions*

In interpreting “taxation or any requirement connected therewith which is other or more burdensome,” the Commentaries to the 1977 OECD Model state that when a tax is imposed on nationals and foreigners in the same circumstances, (1) it must be in the same form as regards both the basis

33. See *Railway Express Agency, Inc. v. New York*, 336 U.S. 106 (1949) (setting forth the rational basis test).

34. See *Dandridge v. Williams*, 397 U.S. 471 (1970).

35. See generally Ronald D. Rotunda & John E. Nowak, *Constitutional Law* ch. 14 (4th ed. 1991).

36. *Davis v. Michigan Dept. of the Treasury*, 489 U.S. 803, 816 (1989); see also *Kraft Gen. Foods, Inc. v. Iowa Dept. of Revenue*, 112 S.Ct. 2365 (1992).

37. *Davis*, 489 U.S. at 816.

38. *Id.*

of the charge and the method of assessment, (2) its rate must be the same, and (3) the "formalities" connected with the taxation (returns, payment, prescribed times, etc.) must not be more onerous for foreigners than for nationals.³⁹ In practice, however, differences in collection mechanisms and return requirements have been accepted because of the different circumstances in which treaty country residents not resident in the United States find themselves compared to U.S. residents.⁴⁰

The OECD Commentaries to the 1977 OECD Model acknowledge another permitted distinction. The nondiscrimination provision is not to be construed as obliging a state that accords special taxation privileges to its own public bodies or services to extend the same privileges to public bodies or services of another state.⁴¹ This is considered justified "because such bodies and services are integral parts of the State and at no time can their circumstances be comparable to those of the public bodies and services of the other State."⁴²

Similarly, the OECD Commentaries state that the nondiscrimination provision is not to be construed as obliging a state which accords special taxation privileges to not-for-profit private institutions whose activities are performed for purposes of public benefit, which are specific to that state, to extend the same privileges to similar institutions whose activities are not for that state's benefit. It is perhaps for this reason that the ALI considers it inappropriate to compare foreign nationals to domestic tax exempt entities.⁴³

Such limitations on the scope of nondiscrimination with respect to private not-for-profit institutions permit the United States to limit the exemption under section 501 of the Code in some instances to domestically organized entities, although the major exemptions under section 501(c) do not require domestic organization. For U.S. income tax purposes, a charitable deduction is allowed only for contributions made to domestically organized or created entities.⁴⁴ Moreover, a charitable contribution by a corporation is deductible only if it is to be used within the United States.⁴⁵ Since the

39. 1977 OECD Commentaries, *supra* note 4, art. 24, para. 4.

40. In the 1977 OECD Model, *supra* note 4, art. 24, para. 1 & 3 and in OECD Committee on Fiscal Affairs, Draft Double Taxation Convention on Income and Capital 151, para. 1(2) (1963), "in the same circumstances" may mean "in substantially similar circumstances both in law and fact." See also discussion *infra* pt. IV.D.

41. 1977 OECD Commentaries, *supra* note 4, art. 24.

42. 1977 OECD Commentaries, *supra* note 4, art. 24, para. 1 at 7. The OECD Commentary states, however, that this reservation is not intended to apply to state corporations carrying on gainful undertakings.

43. A.L.I. Treaty Project, *supra* note 5, at 258-59.

44. IRC § 170(c). The 1977 OECD Commentaries do not expressly discuss the deductibility of contributions made to such domestic exempt organizations.

45. *Id.*

income tax deduction provision applies to both foreign and domestic taxpayers, it does not appear to be discriminatory. However, the U.S. gift and estate tax charitable deduction provisions are different for resident and nonresident taxpayers. Resident taxpayers and U.S. citizens are permitted charitable deductions for gift and estate tax purposes for transfers to both domestic and foreign charities, whereas nonresident taxpayers who are not U.S. citizens are permitted charitable deductions for gift and estate tax purposes only for transfers to domestic charities.⁴⁶ Since foreign charities are generally not subject to U.S. income tax,⁴⁷ it would be difficult for them to claim that their inability to receive deductible contributions is a more burdensome tax or requirement. In addition, under the OECD Commentaries, this distinction is permissible if the ability to receive deductible contributions is a “special taxation privilege.”⁴⁸

Consistent with this view, the Internal Revenue Service has refused to extend Article 24 to foreign pension trusts. In a Technical Advice Memorandum, the Service denied income tax exemption to a Dutch pension fund that satisfied the requirements of section 401(a) of the Code and related provisions except for the fact that it was created in the Netherlands.⁴⁹ In reaching that result, the Service had to determine whether, in spite of the nondiscrimination provision in the treaty, exemption could be denied on the grounds of U.S. national social purpose.⁵⁰ The Technical Advice Memorandum states that the purpose behind the section 501(a) exemption granted to U.S. pension funds is to encourage the development and use of private pension funds by U.S. employers so that their U.S. employees will not have to rely on public welfare after retirement for their support.⁵¹ In the case under consideration, in contrast, the pension fund’s beneficiaries were primarily employees other than U.S. nationals or residents. Because the social purposes served by domestic pension plans—to benefit U.S. workers—did not apply to a foreign pension fund benefiting primarily non-U.S. workers, the

46. Compare IRC § 2522(a) with IRC § 2522(b) (relating to charitable gifts) and IRC § 2055 with IRC § 2106(a)(2) (relating to charitable bequests).

47. IRC § 501(c)(3). A foreign charity may be subject to U.S. tax, however, on any unrelated business taxable income of the organization. See IRC §§ 511(a), 512(a)(2).

48. 1977 OECD Commentaries, *supra* note 4, art. 24. The coverage of cross-border charitable contributions in the U.S.-Can. Treaty may also indicate that the U.S. and its treaty partners acknowledge that the limitation on charitable donees is not violative of Article 24. See U.S.-Can. Treaty, *supra* note 15, art. XXI(5).

49. I.R.S. T.A.M. 8030005 (Mar. 28, 1980).

50. *Id.* Another issue was whether the permanent establishment nondiscrimination provision of Article 24(3), which uses the term “same activities” could be broadened to include the “same circumstances” as in Article 24(1). The Service concluded, without analysis, that “same activities” means the same thing as “same circumstances.” *Id.*

51. *Id.*

Dutch pension fund was held taxable.⁵²

The ALI has suggested that a taxing country should not be considered to be engaged in prohibited discrimination if its treatment of foreign treaty beneficiaries, or entities owned by them, is "reasonably comparable" to the treatment extended to resident taxpayers or entities owned by them.⁵³ Similarly, the ALI states that the fact that foreign taxpayers are subject to limited tax jurisdiction in the source country, and frequently have few (if any) assets located there, may justify differences in enforcement and collection mechanisms without introducing prohibited discrimination.⁵⁴ Nevertheless, the ALI suggests that no remedy should inhere under a nondiscrimination article unless the effect of the violation puts the person or entity at a substantively significant disadvantage in relation to domestic or domestically owned taxpayers.⁵⁵ Such differences are sometimes rationalized and referred to as "procedural" rather than "substantive" differences.⁵⁶ But the use of a label, while convenient, does not necessarily provide insight into which distinctions in treatment are or should be permitted.

C. Which Country Comparison

The Internal Revenue Service has not always taken a consistent approach in determining what comparison is required under the nondiscrimination provision. Article 24(1) of the 1981 U.S. Model, for example, is susceptible of two interpretations. First, it can be interpreted as prohibiting the United States from imposing taxes on foreign citizens who reside in the United States which taxes are more burdensome than those imposed by the foreign country on U.S. citizens who reside in the foreign country. Such a comparison might be referred to as a "foreign-tax jurisdiction" or "reciprocal" comparison. Second, the 1981 U.S. Model can be interpreted as prohibiting the United States from imposing more burdensome taxes on foreign citizens who reside in the United States than are imposed on resident U.S. citizens. Such a comparison might be referred to as a "source-jurisdiction" comparison.

In a ruling under the former (1941) U.S.-Canada treaty, the Internal Revenue Service determined that the source-jurisdiction comparison is the correct one and denied Canadian citizens who were part-year United States residents the benefit of electing head-of-household or joint-filing tax

52. *Id.*

53. See A.L.I. Treaty Project, *supra* note 5, at 255.

54. A.L.I. Treaty Project, *supra* note 5, at 256.

55. A.L.I. Treaty Project, *supra* note 5, at 256.

56. See e.g., A.L.I. Treaty Project, *supra* note 5, at 256 ("[d]espite the fact that substantive tax discrimination is to be determined by comparing [non-resident taxpayers with resident taxpayers], it is unavoidable that procedural differences ... will be encountered.").

treatment.⁵⁷ In the General Counsel's Memorandum associated with that ruling,⁵⁸ the Service relied on the Technical Memorandum of the Treasury Department on the U.S.-U.K. treaty (effective July 25, 1946) and the literal language of the Canadian treaty.⁵⁹ The General Counsel Memorandum stated that this interpretation is "consistent with the interpretation attributed to the nondiscrimination clauses incorporated into the 1943 Mexican draft, the 1945 London draft, the O.E.E.C. drafts, and the [1963] O.E.C.D. draft of the Model Tax Convention,"⁶⁰ and noted that the United States "participated in the drafting of all of the above documents either on an official or unofficial basis."⁶¹

Also consistent with this view is Article 24(1) of the 1981 U.S. Model, which provides that a U.S. national who is not a resident of the United States is not in the same circumstances as a foreign national who is not a resident of the United States. Similarly, the Assistant Treasury Secretary for Tax Policy assumed that a source-jurisdiction comparison was relevant in responding to a recent protest by the Confederation of British Industry.⁶² Apparently, the protest claimed discrimination in the application of the look-through rules of section 904(d)(3) of the Code, dealing with the foreign tax credit (the "FTC"). Those rules permit look-through treatment for FTC purposes of certain amounts received (or deemed received) by a U.S. shareholder from a controlled foreign corporation. The Code does not expressly permit such a look-through for payments received by a domestic subsidiary from its foreign parent corporation. The Assistant Secretary concluded that there was no discrimination against U.K.-owned U.S. corporations, since the concerns leading Congress to adopt the look-through rules do not exist in the case of a foreign parent payor. According to the staff of the Joint Committee on Taxation, as reflected in the General Explanation to the Tax Reform Act of 1986, there were four such concerns: (1) the availability of information from the payor necessary to enforce the rule; (2) the economic equivalence of the payor to a branch of the payee; (3) the economic equivalence of the payment to a dividend; and (4) the incentive to "strip earnings" out of the payor's jurisdiction by converting dividends to deductible payments.⁶³

However, the Internal Revenue Service has not always taken the view that the source-jurisdiction comparison applies. In General Counsel's

57. Rev. Rul. 74-239, 1974-1 C.B. 372.

58. WESTLAW, FTX-GCM database, elec. cit. G.C.M. 35518 (Oct. 11, 1973).

59. *Id.* at 2.

60. *Id.* at 3.

61. *Id.*

62. Letter from Fred T. Goldberg, Jr. to G.D. Swaine (May 20, 1992), in 92 Tax Notes, Highlights & Documents 116-52 (June 4, 1992).

63. See Staff of the Joint Comm. Tax'n, General Explanation of the Tax Reform Act of 1986, 866-67, 888-91 (1987).

Memorandum 35444,⁶⁴ interpreting the nondiscrimination provision of the U.S.-Japan treaty on Friendship, Commerce and Navigation, the issue was the application of section 367 of the Code to the merger of two public Japanese companies with branches operating in the United States. The taxpayer argued that the correct comparison was a merger of two U.S. corporations with Japanese branches and the consequences of such a merger under U.S. income tax law—one sort of source-jurisdiction comparison. The Service did not agree.⁶⁵ It relied instead on a foreign tax-jurisdiction comparison, noting that there was no discrimination because if two U.S. corporations, each with a branch operating in Japan, were to consummate a corporate merger, the transaction might well give rise to the imposition of a *Japanese* tax.⁶⁶ Thus, instead of comparing the treatment of U.S. and Japanese entities under U.S. tax law, the Service compared Japanese taxpayers engaging in trade or business in the United States under U.S. law and U.S. taxpayers engaging in trade or business in Japan under Japanese law.⁶⁷

So far, the federal courts have also adopted a source-country comparison. For example, the Tax Court recently rejected a claim of discrimination by a non-resident alien, resident of Switzerland, who was married to a non-resident alien and who was required to pay U.S. income tax based upon his status as a married individual filing separately.⁶⁸ Section 6013(a)(1) of the Code denies joint returns to any individual whose spouse is a nonresident alien. The court reasoned that the Swiss individual was not discriminated against because (1) he was treated the same as any other nonresident alien individual, and (2) even if he were a U.S. *citizen* he would be subject to the same filing status restriction if he were married to a nonresident alien.⁶⁹

D. *Generic vs. Individual Comparison*

Another question is whether a required comparison is generic or specific? A generic comparison ignores the specific facts involved and looks instead to a hypothetical taxpayer and his or her *potentially* applicable facts and circumstances. Although it is not clear, it seems that the Internal Revenue Service applies the nondiscrimination provision on a generic basis. In

64. G.C.M. 35444 (Aug. 17, 1973).

65. *Id.*

66. *Id.*

67. See *id.* In addition, the Service argued that section 367 did not give rise to discriminatory tax treatment against Japanese corporations because section 367 does not single out Japanese corporations for more burdensome tax treatment than that applicable to taxpayers of any other (third) nation.

68. Hofstetter v. Comm'r, 98 T.C. No. 48 at 4981 (CCH) (June 29, 1992). See IRC § 6013(a)(1).

69. *Id.* at 4984-85.

Revenue Ruling 74-239,⁷⁰ the question was whether the nondiscrimination clause of a protocol to the 1941 U.S.-Canada treaty prevented the United States from denying a Canadian citizen, who was a dual-status taxpayer, the benefits of using the head of household tax rate tables, optional tax tables, standard deduction or joint return for federal income tax purposes. None of these provisions is applicable to a person who is a nonresident alien at any time during the year. The ruling concluded that a dual-status Canadian citizen is not in similar circumstances to a U.S. citizen because "not all of his worldwide income is necessarily subjected to federal income tax."⁷¹ There was no discussion of whether the dual status taxpayer *actually* had income that was not subject to U.S. tax and the comparison was therefore generic. Moreover, while any existing discrimination could have been solved by allowing the taxpayer to elect to include his worldwide income and be taxed as a resident, there was no discussion of that possibility.⁷²

In *Watson v. Hoey*,⁷³ the issue was whether, under a nondiscrimination treaty with Ireland, the estate of a nonresident alien decedent was entitled to the same exemption granted both resident and nonresident citizens under the U.S. estate tax law. The exemption, if allowed, would have been sufficient to eliminate any U.S. estate tax liability. The court ruled against the estate, saying:

In the present case, because of its size and the proportionate location of its assets here and abroad, the estate of the nonresident not a citizen pays a small tax, although a similar estate of a nonresident citizen would pay none. But taking it *by and large*, the 1934 Revenue Act did not unfairly discriminate against the nonresident not a citizen.⁷⁴

Thus, the comparison was generic and not specific.

It would have been more in keeping with the intent of the treaty countries to have permitted an allocation of the exemption in accordance with the proportionate amount of assets situated in the United States as compared to the worldwide assets. This is the way that the unified credit, administrative expenses and deductions are now treated.⁷⁵

70. Rev. Rul. 74-239, 1974-1 C.B. 372.

71. *Id.*

72. The discrimination is now partially eliminated by Article XXV of the current U.S.-Can. Treaty and is ameliorated by changes in the Code. See U.S.-Can. Treaty, *supra* note 15, art. XXV; IRC § 6013(g), (h).

73. 59 F. Supp. 197 (S.D.N.Y. 1943).

74. *Id.* at 200 (emphasis added).

75. IRC §§ 2102(c)(3)(A), 2106(a)(1); cf. U.S.-Can. Treaty, *supra* note 15, art. 24, para. 4.

Although these authorities generally take the generic approach, the wording of the nondiscrimination provision of Article 24(1) of the 1981 U.S. Model seems more appropriately to invoke an individual or specific analysis. Moreover, requiring a taxpayer to prove the consequences to a class might impose much more substantial evidentiary and practical burdens on foreign taxpayers. Such a burden may be insurmountable if the courts also adopt a standard of proof requiring the taxpayer to show that there is no *possible* set of facts under which the alleged discrimination would not reach "substantive" proportion.

E. Which Nation's Taxes?

Recently the Code was amended to limit the interest deduction for "earnings-stripping" payments to related tax-exempt parties.⁷⁶ The Code provides that certain interest paid or accrued by a corporation to a related tax-exempt party is not deductible.⁷⁷ The deduction is denied to the extent that the excess, if any, of the payor corporation's total interest expense over total interest income is greater than fifty percent of the corporation's adjusted taxable income.⁷⁸ The interest is only disallowed where the payor corporation has a ratio of debt to equity as of the close of the taxable year exceeding one and one-half to one.⁷⁹ A taxpayer is treated as tax exempt with respect to interest received if no tax is imposed by the United States with respect to such interest.⁸⁰ If a treaty between the United States and any foreign country reduces the U.S. tax rate imposed on interest that the taxpayer pays to a related person, the related person is treated as tax exempt, and the interest is treated as nondeductible, to the extent of the same proportion of such interest paid or accrued as the treaty's rate reduction from the thirty percent normal statutory rate bears to the thirty percent rate.⁸¹

Subsequent to the introduction of the proposal in the House, a number of taxpayers' representatives contended that the provision violated the nondiscrimination provision of U.S. treaties.⁸² The Conference Report answered that contention by stating:

Finally, some have argued that ... the House bill provision would violate treaties. The conferees believe that the conference agreement

76. IRC § 163(j).

77. IRC § 163(j)(1)(A).

78. IRC § 163(j)(2)(B)(i).

79. IRC § 163(j)(2)(A)(ii).

80. IRC § 163(j)(3)(A).

81. IRC § 163(j)(5)(B).

82. See H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. 568 (1989).

does not violate treaties. This belief is based on several factors. First, the conferees believe that because the provision treats similarly situated persons similarly, there is no discrimination under treaties. For this purpose the conferees believe that the determination of which persons are similarly situated is properly made by reference to the U.S. tax those persons do or do not bear on interest income from U.S. corporations.⁸³ This is consistent with the view that payments leaving U.S. taxing jurisdictions may in appropriate circumstances, consistent with treaties, be subjected by the United States to tax that would not be imposed on a payment to a U.S. person.⁸⁴

The conferees' analysis is clearly correct in ignoring foreign taxes. Under Article 24 of the 1981 U.S. Model, in determining whether an alien has been subject to more burdensome taxation by the United States, only U.S. taxes are considered. Paragraph 1 of Article 24 provides that a national of one state shall not be subjected to other or more burdensome taxation or connected requirements in the "other Contracting State." Paragraph 3 provides that the taxation on a permanent establishment of an enterprise of one state shall not be less favorably levied in that "other Contracting State." Paragraph 5 applies to foreign-controlled enterprises which shall not be subjected to discriminatory taxation in the state in which the enterprise is located.

On the other hand, the interest restrictions in the earnings-stripping provision still seem to violate basic nondiscrimination principles, including the views expressed in the OECD Commentaries and in the ALI's recommendations that foreign taxpayers appropriately not be compared to domestic tax-exempts.⁸⁵

F. *Interpretative Guidance*

The 1981 U.S. Model is not accompanied by commentaries. However there were commentaries for the 1977 OECD Model on which the 1981 U.S. Model is based. Therefore, in the absence of any helpful language in the "legislative history" of the treaty under consideration, reference is commonly made to the OECD Commentaries in interpreting language in U.S. treaties. However, as an initial matter, it is not clear whether it is appropriate to apply the OECD Commentaries to U.S. treaties. While generally beyond the scope

83. Reference to such views appears in the Conference Report. H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. 568 (1989).

84. *Id.* The Conference Report further stated in a footnote as follows: "Thus the provision makes no distinction between foreign lenders on the basis of whether or not their interest income is subject to tax in their residence country." *Id.* at 568 n.4.

85. See *supra* text accompanying notes 41-48.

of this article, many intriguing issues are raised by the question of the relevance of the OECD Commentaries.

Assuming that the Commentaries are relevant, one issue is whether there are limitations on the circumstances under which reference can be made to them—for example, must the treaty language be ambiguous? A second issue is whether it matters that the Commentaries were written before, rather than after, the treaties being interpreted were agreed upon.⁸⁶ In *United States v. A. L. Burbank & Co.*,⁸⁷ a rare U.S. case in which reference was made to the OECD Commentaries, the Second Circuit relied on the Commentaries from a *later* model convention to reinforce its decision on the exchange of information article of the earlier U.S.-Canada treaty. A third issue is the weight to be given to the Commentaries.

Perhaps the most useful reference in this difficult interpretative area is the Vienna Convention on the Law of Treaties,⁸⁸ which came into force on January 27, 1980, and which by its terms is applicable only to treaties concluded after that date. Many countries, including the United States, have not adopted the Vienna Convention. Nevertheless, its provisions dealing with the interpretation of treaties have been generally accepted by tax administrations, including that of the United States, and various courts, as a codification of customary international law. Interpretation is dealt with in Article 31 of the Vienna Convention, which sets forth the general rule, and Article 32, which deals with supplementary means of interpretation.⁸⁹

Article 31 provides as follows.

General rule of interpretation

1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose.
2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:
 - (a) any agreement relating to the treaty which was made between all the parties in connection with the con-

86. See Sidney I. Roberts & Peter A. Glicklich, U.S. Interprets Netherlands-U.S. Treaty by Reference to Later Treaties with Other Nations, 34 Can. Tax J. 228 (1986).

87. 525 F.2d 9 (2d Cir. 1975), cert. denied, 426 U.S. 934 (1976). The IRS has also used the OECD Commentaries in interpreting treaties on several occasions. See e.g., Rev. Rul. 91-32, 1991-1 C.B. 107; Rev. Rul. 86-145, 1986-2 C.B. 297.

88. Vienna Convention on the Law of Treaties, May 23, 1969, 1155 U.N.T.S. 331 (entered into force Jan. 27, 1980).

89. *Id.* at arts. 31, 32.

- clusion of the treaty;
- (b) any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.
3. There shall be taken into account together with the context:
- (a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;
 - (b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;
 - (c) any relevant rules of international law applicable in the relations between the parties.
4. A special meaning shall be given to a term if it is established that the parties so intended.

Article 32 of the Vienna Convention provides:

Supplementary means of interpretation

Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of Article 31, or to determine the meaning when the interpretation according to Article 31:

- (a) leaves the meaning ambiguous or obscure; or
- (b) leads to a result which is manifestly absurd or unreasonable.

As might be expected, paragraph 1 of Article 31 emphasizes that the starting point in interpretation is the text of the treaty. The other items set forth in Article 31 are considered to express the intention of the parties. The application of “supplementary means of interpretation” to determine meaning has a secondary role in the process of interpretation.

A crucial issue, then, in determining the deference that should be given to OECD Commentaries by the tax administrations or the courts in interpreting a bilateral tax treaty is whether the Commentaries fall under Article 31 or 32 of the Vienna Convention.

It has been contended that the OECD Commentaries fall under Article 31(2)(b) of the Vienna Convention on the ground that they constitute an instrument made in connection with the conclusion of the treaty that was the result of joint discussions between member countries who were free to make observations and reservations.⁹⁰ However, this position appears to be contrary to certain statements made in the 1977 OECD Report, that the Commentaries are not designed to be annexed in any manner to the Conventions.⁹¹ These statements appear to deny that the OECD Commentaries should be taken into account on the level of the "agreements" that are referred to in paragraphs 2, 3 and 4 of Article 31 of the Vienna Convention.⁹² Nor is there any indication that the national legislatures delegated to their OECD representatives the power to conclude a treaty that is on the same level as such other agreements.

Moreover, Article 31(2)(b) of the Vienna Convention refers to an instrument made "in connection with the conclusion of the treaty," which appears to refer to a treaty made by the legislatures of the two countries that are parties to the bilateral tax treaty under consideration, not a model treaty. Finally, the elevation of the OECD Commentaries to Article 31 of the Vienna Convention status would make them superior to the bilateral preparatory work in connection with a particular treaty, if any, since the latter is expressly included only under Article 32.

Prior doctrine has generally fit the OECD Commentaries under Article 32;⁹³ such doctrine cites judicial precedents that have relied upon the OECD Commentaries but without clearly expressing a conclusion on the issue of whether they are applied under Article 31 or Article 32 of the Vienna Convention.⁹⁴

The Vienna Convention suggests the following issues in respect of the OECD Commentaries:

- (1) Do the OECD Commentaries fall under Article 31(3)(a) (subsequent practice) or Article 31(4) (special meaning)?

90. Cornelius van Raad, *Interpretation of Tax Conventions: Interpretatie van belastingverdragen*, M.B.B. 1978 No. 2/3, 49 (in translation).

91. OECD Model Double Taxation Convention on Income and on Capital, Report of the OECD Committee on Fiscal Affairs 14 (1977).

92. See also John F. Avery Jones et al., *The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model* (pts. I & II), 1984 *Brit. Tax Rev.* 14-54 and 90-108, at 92-93 (1984).

93. *Id.* at 100.

94. See *Sun Life Assurance Co. of Canada v. Pearson*, 1986 *Simon's Tax Cases* 335 (Ct. App. 1986), stating that "it is common ground that we are entitled to consider the commentary in determining the constitution of the treaty." *Id.* at 347. See *Burbank*, *supra* note 87.

(2) Are they within Article 32 (“preparatory work”) but not Article 31?⁹⁵

(3) Under what circumstances should the OECD Commentaries be considered by a court, i.e., only under the conditions stated in Article 32, or in any case to determine the “object and purpose” of the treaty under Article 31(1)?

(4) If the OECD Commentaries may properly be considered by the courts under Article 32 but not under Article 31, are they entitled to lesser weight than if they were included under Article 31?

The ALI similarly recommends that greater importance be given in interpreting treaties to *bilateral* materials, such as simultaneous or agreed upon technical memoranda, on the grounds that these documents will better reflect the understanding of both parties to the negotiations, while unilateral materials, such as statements by the Treasury Department or the Internal Revenue Service, may reflect only one party’s position.⁹⁶ In addition, the ALI contends that little or no weight should be given to oral or written statements made by individual treaty negotiators,⁹⁷ or to post-ratification unilateral declarations, including interpretative rulings published in connection with pending disputes. Even where prior to ratification one of the countries agrees with material published by the other country interpreting the treaty,⁹⁸ the ALI states that such material should not control where it is contrary to the express language of the treaty.⁹⁹

Since the OECD Commentaries have not been determined to be in the nature of legislative history in the United States, the use of the OECD Commentaries to change the meaning of the otherwise plain language of a treaty is probably improper. However, the Internal Revenue Service and Treasury Department have at least adopted certain views consistent with the OECD Commentaries—the Service believes, for example, that legal rather than factual similarity is required (for example, being taxed under the same regime). That interpretation leaves little room, as a practical matter, for Article 24(1) to apply in the United States except to *resident* aliens.

95. Cf. David A. Ward, Principles To Be Applied In Interpreting Tax Treaties, XXV Can. Tax J. 263, 268 (1977).

96. A.L.I. Treaty Project, *supra* note 5, II.B.

97. But see *O’Connor v. United States*, 761 F.2d 688, 690-91 (Fed. Cir. 1985) (testimony of one negotiator seven years later), *aff’d*, 479 U.S. 27 (1986).

98. Cf. *Treas. Tech. Expl. of Can. Treaty*, art. I, 1987-2 C.B. 298 (example of interpretative material published by the United States).

99. A.L.I. Treaty Project, *supra* note 5, II.B.

The foreign decisions interpreting tax treaties have reached mixed results on this issue. In a case in New Zealand, a jurisdiction where nondiscrimination provisions are not favored, it was held that if the parties being compared are not taxed under the same regime, comparison cannot be made.¹⁰⁰ A Belgian case adopted the same view.¹⁰¹ The French Cour de Cassation, however, adopted an opposite result.¹⁰² The case involved the annual three percent tax on French real estate owned by a corporation whose residence was outside of France. The provision was held to violate Article 24(1) of the France-Switzerland treaty.

III. ATTITUDE OF THE U.S. TO NONDISCRIMINATION CONCEPT

As indicated above, the reaction of Congress, the courts and the Treasury Department to an alleged violation of the nondiscrimination article of a U.S. treaty has been inconsistent. Indeed, they often determine that allegations of nondiscrimination are unfounded. Even if a claim is well founded, Congress has been increasingly willing to mandate that new legislation apply, notwithstanding the treaty's general proscription of discrimination. Such overrides have become a matter of contention with many of our treaty partners.

Section 7852(d) of the Code was amended by the Technical and Miscellaneous Revenue Act of 1988¹⁰³ (the "1988 Act") to provide that "[f]or purposes of determining the relationship between a provision of a treaty and any law of the United States affecting revenue, neither the treaty nor the law shall have preferential status by reason of its being a treaty or law." The Conference Report accompanying the 1988 Act states that this provision adds no operative rules but rather restates the constitutional principle that the "ordinary rules of interpreting the interactions of statutes and treaties" apply.¹⁰⁴

The statute could be read to continue the generally accepted interpretation that treaties are *not* overridden unless Congress expressly indicates its intention to do so. Thus, if a treaty obligation has not been expressly

100. Commissioner of Inland Revenue v. United Dominions Trust Ltd., 1 N.Z.T.C. 61,028 (1973).

101. Cour de Cassation (June 30, 1988), *Revue Generale de la Fiscalite* 1989 No. 2 p. 42.

102. Cour de Cassation (No. 328P, 392D, 330) (Feb. 28, 1989). The case is discussed in 29 *European Taxation* at 285 (1989). An attempted legislative reversal of the decision was rejected by the court. Cour de Cassation (No. 922P) (Dec. 21, 1990). See 31 *European Taxation* at 315 (1991).

103. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1012(aa)(1)(A), 102 Stat. 3342, 3531.

104. H.R. Conf. Rep. No. 1104, 100th Cong., 2d Sess. 12-13 (1988).

“superseded” for internal U.S. law purposes, under section 7852(d)(1) taxpayers and the Service can continue to look beyond the Code to determine the proper tax treatment of an item.¹⁰⁵ Despite this legislative language, the Tax Court recently suggested, in *dictum*, that section 7852(d)(1) codified a later-in-time rule. The Tax Court’s decision was *dictum* because the issue in dispute, application of the ninety-percent foreign tax credit limitation in the alternative minimum tax, was specifically addressed by Congress in 1988. Congress enacted a “technical” provision stating that the ninety-percent limitation would apply notwithstanding an existing treaty. Therefore, the Tax Court did not specifically address the nondiscrimination argument invoked by a U.S. citizen living and working in Switzerland.¹⁰⁶

A. Testing the Limits of “Procedural” Discrimination

1. *Denial of deductions.*—Consider the Treasury Department’s regulations pursuant to sections 882(c)(2)¹⁰⁷ and 874(a)¹⁰⁸ of the Code. These provisions allow deductions and credits to foreign corporations and nonresident alien individuals *only* if they file U.S. tax returns.¹⁰⁹ The regulations vastly expand this limitation by denying deductions and credits altogether if U.S. returns are not filed “timely.”¹¹⁰ According to the preamble to the regulations, this timely filing requirement is justified by the different administrative and compliance concerns relating solely to foreign corporations and non-resident alien individuals.¹¹¹

However, Article VII(3) of the U.S.-Canada treaty, which is typical of U.S. treaties in this respect, provides that, “[i]n determining the business profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment....” In addition, Article XXV(6) of the U.S.-Canada treaty, like the 1981 U.S. Model, provides that “the taxation on a permanent establishment which a resident of a Contracting State has in the other Contracting State shall not be less favorably levied in the other State than the taxation levied on residents of the other State carrying on the same activities.” Several writers have suggested that the regulations, as applicable to Canadian taxpayers, violate the

105. *Id.*

106. *Lindsey v. Commissioner*, 98 T.C. No. 46 (1992).

107. Treas. Reg. § 1.882-4(a)(2) and (3).

108. Treas. Reg. § 1.874-1(a), (b)(1)-(4).

109. Treas. Reg. § 1.882-4(a)(2); Treas. Reg. § 1.874-1(a).

110. The regulations set forth a novel concept of timely filing, which in no case is the actual deadline for filing returns without penalty for late filing. See T.D. 8322, 1990-2 C.B. 172.

111. *Id.*

U.S.-Canada treaty.¹¹² However, one writer has stated:

The ... claim for treaty relief is under the nondiscrimination provisions of Article XXV(6) of the Canada-U.S. treaty. The longstanding position of the US government (and, I believe, all other governments) is that some differences in the procedural rules applicable to domestic and foreign taxpayers are consistent with the nondiscrimination clause of treaties. Those differences must be justified, however, by the differences in the circumstances of the domestic and foreign taxpayers. The position of the US tax authorities is that assessing and collecting taxes from foreign taxpayers present special problems that justify special procedural rules. I think it highly likely that an American court would hold that those special problems justify the timely filing rule of the regulations under Code sections 874(a) and 882(c)(2). Any other interpretation would call into question the validity of denying deductions to foreigners under any circumstances.¹¹³

That writer also speculated about the motives of the U.S. tax authorities:

[T]he new regulations are a logical complement to the US strategy of forcing foreign taxpayers engaged in economic activities within the United States to either make a formal claim of treaty protection under the new provisions of Code section 6114 or to file a tax return. By filing a tax return, a foreign person provides the IRS with information that should be helpful to it in determining whether an audit is likely to result in a revenue gain for the government. Foreign taxpayers who fail to file become very attractive audit targets—the IRS can be pretty sure that it will be able to recoup the costs of an audit in most cases by denying the foreign person otherwise allowable deductions.¹¹⁴

The regulations under section 882(c) of the Code test the limits of the

112. Comments on Proposed Regulations Under Code Sections 874(a) and 882(c)(2) Regarding the Untimely Filing of Income Tax Returns by Nonresident Alien Individuals and Foreign Corporation, A.B.A. Tax Sec. (May 25, 1990); Linda Ng, U.S. Treasury Denies Canadian Late Filers Their Deductions and Credits, 39 Can. Tax J. 429 (1991).

113. Michael J. McIntyre, Correspondence, 39 Can. Tax J. 1129-30 (1991).

114. *Id.* at 1130.

commonly accepted distinction between procedural (permitted) discrimination and substantive (prohibited) discrimination. By denying foreign filers their deductions and credits when they fail to file timely returns, the regulations effectively prescribe a new and more onerous method of computing their taxable income. Thus, it appears, the regulations discriminate not only “procedurally,” but also substantively. This conclusion is supported by the OECD Commentaries, as well.

Permanent establishments must be accorded the same right as resident enterprises to deduct the trading expenses that are, in general, authorized by the taxation law to be deducted from taxable profits.... Such deductions should be allowed without *any restrictions* other than those also imposed upon resident enterprises.¹¹⁵

What if the United States merely imposed a higher rate of interest on the tax deficiency of all foreign corporations with U.S. permanent establishments? Article 24(3) of the 1981 U.S. Model states that “[t]he taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be *less favorably levied* in that other State than the taxation levied on enterprises of that other State carrying on the same activities.”¹¹⁶

In addition, Article 24(1) of the 1981 U.S. Model provides that “[n]ationals of a Contracting State shall not be subjected in the other Contracting State to *any taxation or any requirement* connected therewith which is *other or more burdensome* than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected.”¹¹⁷ Would these provisions prevent the United States from adopting a provision that increased the interest rate on any deficiency of a foreign corporation to twice that applicable to a U.S. taxpayer? Such a rule might be justified on the basis that it is more difficult and time-consuming for the Internal Revenue Service to audit the tax returns of a permanent establishment of a foreign enterprise in the United States than it is to audit the returns of a U.S. corporation. Arguably, the interest charge is not taxation “less favorable,” nor the imposition of any requirement which is “other or more burdensome” than those applicable to a U.S. taxpayer, *given the different audit circumstances*.

Similar questions arise under the penalty provisions applicable to information reporting under sections 6038A and 6038C of the Code. Both

115. 1977 OECD Commentaries, *supra* note 4, art. 24, para. 26(a) (emphasis added).

116. See 1981 U.S. Model, *supra* note 7, art. 24, para. 3 (emphasis added).

117. See *id.* at para. 1 (emphasis added).

sections require information reporting, one from twenty-five percent foreign-owned domestic corporations and the other from foreign corporations engaged in a U.S. trade or business.¹¹⁸ If the taxpayer fails to supply adequate information at the audit stage to support its treatment of intercompany transactions, the proper treatment is determined by the Internal Revenue Service in its sole discretion.¹¹⁹ The legislative history of the provisions emphasizes that a court is not to overturn the Service's decision except in rare circumstances.¹²⁰ While the Treasury Department contends that these rules are similar to those applicable to U.S. taxpayers,¹²¹ it seems clear that they are not similar. In an intercompany pricing case, for example, all taxpayers have the burden of proving that the Service acted arbitrarily in asserting a deficiency,¹²² yet taxpayers to whom sections 6038A and 6038C apply appear to have fewer rights, since the Service's determination is apparently given greater weight.

These sections, although arguably justifiable on the grounds of "procedural" needs of enforcement, clearly impose more burdens on foreign-owned U.S. corporations and on foreign corporations engaged in a U.S. trade of business. As such, they appear to violate one or more of the typical treaty nondiscrimination provisions. Perhaps all taxpayers should be forced to supply information at the audit stage or be prevented from introducing it into court. The problem is not unique to foreign taxpayers. Without admitting any nondiscrimination problems, the Service provided in the section 6038A final regulations that it will first seek to obtain information under treaty information exchange provisions before invoking penalties under Section 6038A.¹²³

2. *Additional record keeping and information reporting.*—Is it discriminatory to require more information reporting or different record keeping requirements for foreign taxpayers or foreign-controlled domestic enterprises? Article 24(5) of the 1981 U.S. Model prohibits, with respect to foreign owned or controlled U.S. enterprises, "taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which" a domestic corporation controlled by domestic taxpayers is or may be subjected.

118. IRC §§ 6038A(a), 6038C(a).

119. IRC §§ 6038A(e)(3), 6038C(d)(3).

120. See H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. 594-95 (1989), reprinted in 1989 U.S.C.C.A.N. 3197-98.

121. T.D. 8353, 1991-2 C.B. 402, 404.

122. See *G.D. Searle & Co. v. Commissioner*, 88 T.C. 252, 358 (1987); *Foster v. Commissioner*, 80 T.C. 34, 143 (1983), modified on other grounds, 756 F.2d 1430 (1985), cert. denied, 474 U.S. 1055 (1986).

123. Treas. Reg. § 1.6038A-6(b) (1991); see Preamble to Regs. § 6038A, 1991-2 C.B. 402, 405.

Section 6038A of the Code generally requires reporting corporations to report transactions with foreign related parties. Since U.S. corporations with U.S. owners do not report their intercompany dealings on separate information returns, or by separate lines of business, as section 6038A requires, this provision arguably is discriminatory. In the preamble to the final regulations under section 6038A, the Treasury Department stated that in view of the possible application of the nondiscrimination articles in many treaties, it was amending the proposed regulations to make them no more burdensome than the reporting requirements imposed on U.S. owners of foreign corporations.¹²⁴ The comparison may be justifiable but it is not technically the comparison called for by Article 24(5) of the 1981 U.S. Model. Nor is it clear that the claim of no more burden is factually correct.

Congress apparently did not believe that the reporting requirements of section 6038A were discriminatory because the purpose of the provision was to impose "equivalent reporting obligations on U.S. corporations irrespective of capital ownership, while recognizing the unique tax administration problems" presented by the foreign ownership of such corporations.¹²⁵ In any event, the Congressional reports state that if the new requirements do conflict with any nondiscrimination provisions, the statute overrides the treaty.¹²⁶

State reporting and record keeping requirements have also recently provoked claims under the nondiscrimination provision of treaties. One such claim arose under New York law. New York State, like many other states, imposes its corporate tax on an allocable portion of the worldwide income of the corporation. The allocation method is based upon a typical three-factor formula: property, net sales and payroll. In *Reuters, Ltd. v. Tax Appeals Tribunal*,¹²⁷ Reuters, operating as a branch of a U.K. corporation, recently claimed that the State of New York had violated the nondiscrimination provision of the U.S.-U.K. treaty, as well as the foreign commerce clause of the Constitution, by adopting reporting and record keeping requirements that were more burdensome for a foreign taxpayer than for a domestic taxpayer. In part, the taxpayer noted that currency fluctuation made its cost of compliance much greater. Indeed, although unsuccessful, Reuters argued that the cost of compliance for an alien taxpayer outweighed the advantages to New York of

124. See Chief Counsel Directive Manual Transmittal (42)910 (Sept. 12, 1991), reprinted in BNA Daily Tax Report (Nov. 19, 1991) at L-1; IRS Official says Section 6038A Procedures to Ensure Uniform, Judicious Application, BNA Daily Tax Report (Dec. 9, 1991) at G-11; Treasury and IRS Said To Be Aware of Concerns Over New Recordkeeping Rules, BNA Daily Tax Report (Sept. 19, 1990) at G-4.

125. See H.R. Conf. Rep. No. 247, 101st Cong., 1st Sess. 1301-02 (1989).

126. *Id.*

127. *Reuters Ltd. v. Tax Appeals Tribunal*, 584 N.Y.S. 2d 932 (A.D. 3 Dept. 1992).

complying.¹²⁸

3. *Statute of limitations.*—The difficulty of auditing foreign transactions led to a 1990 legislative proposal that would have permitted the Internal Revenue Service to extend the normal three-year statute of limitations to six years for foreign corporations or domestic corporations with twenty-five percent foreign shareholders, where the Service determined that the taxpayer prevented a timely audit of its transactions by delay or other actions.¹²⁹ The proposal was criticized as violating the nondiscrimination article in typical U.S. income tax treaties.¹³⁰ Article 24(5) of the 1981 U.S. Model protects foreign-owned U.S. corporations from “any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements” to which other similar enterprises of the United States are or may be subjected,¹³¹ and Article 24(3) mandates no less favorable levies on a permanent establishment of an enterprise of the treaty country than those on a domestic enterprise carrying on the same activities. Since a statute of limitations does not itself impose a tax, the issue is whether it is a “requirement” or “connected requirement” that is more burdensome under Article 24(5) or results in a less favorable levy under Article 24(3). One commentator believes it is not more burdensome under Article 24(5).¹³² The authors believe that such a provision *could* be discriminatory in certain cases, depending on how the provision is implemented.

128. Reuters estimated its additional accounting at \$1,000,000 a year. It is not clear whether Reuters introduced evidence of the compliance costs forced by domestic corporations with similar worldwide corporations. Of interest, the New York court stated that the relevant comparison under the treaty's nondiscrimination provision dealing with permanent establishments is between a United Kingdom corporation and a domestic corporation each conducting the same worldwide business through branches, rather than (as Reuters had argued) a New York branch of the United Kingdom corporation and a New York corporation conducting *only* the branch's activities. The court also stated that, like a domestic corporation, a United Kingdom corporation could have elected to operate in New York through a separate subsidiary rather than a branch. Approximately one week after the New York court's decision, however, the U.S. Supreme Court, in *Kraft General Foods Inc.*, 112 S.Ct. 2365, overturned on Foreign Commerce Clause grounds Iowa's denial of a dividends received deduction for dividends received from a foreign subsidiary.

129. H.R. 4308, 101st Cong., 2d Sess. (1990).

130. See Task Force of A.B.A. Comm. on U.S. Activities of Foreigners and Tax Treaties, ABA Comments on the Foreign Tax Equity Act of 1990 (H.R. 4308 & S. 2410), 19 Tax Mgmt. Int'l J. 503, 504 (1990); Note Verbale from the Delegation of the Commission of European Communities and the Embassy of Ireland to the U.S. Department of State, in Highlights and Documents, Aug. 14, 1990, at 1757-58.

131. 1981 U.S. Model, *supra* note 7, art. 24, para. 5.

132. See Michael J. McIntyre, Happiness Deferred—Extending the Statute of Limitations for Taxpayers with Complex Returns, Tax Notes Int'l 1019, 1020 (October 1990).

4. *Advance rulings.*—An interesting General Counsel's Memorandum,¹³³ which is discussed above,¹³⁴ considers whether an early version of section 367 was discriminatory as applied to foreign corporations engaged in a U.S. trade or business. At the time of the transaction in question, in determining the extent to which gain was required to be recognized in a corporate reorganization, section 367 provided that a foreign corporation would not be considered a corporation unless *prior* to the transaction it was established to the satisfaction of the Internal Revenue Service that the transaction was not pursuant to a plan having as one of its principal purposes the avoidance of U.S. income tax. The transaction involved the merger of two Japanese corporations, each with a branch in the United States. The treaty involved was the Treaty of Friendship, Commerce, and Navigation between the United States and Japan, effective October 30, 1953.¹³⁵

The General Counsel's Memorandum concluded that the nondiscrimination provision was inapplicable. It said that the Internal Revenue Service was not aware of any situation in which the application of an *administrative* provision, adopted for the purpose of administering a country's revenue acts, was viewed as in conflict with a treaty nondiscrimination clause.¹³⁶ If discrimination existed solely for administrative reasons, the General Counsel's Memorandum considered it acceptable. Moreover, the General Counsel did not consider this the type of provision encompassed by the phrase "requirements with respect to levy and collection" in the Friendship, Commerce, and Navigation treaty. That phrase, the General Counsel's Memorandum concluded, was intended to cover such matters as statutory restrictions on the assessment and collection of tax, the issuance of statutory notices of deficiency, the payment of interest on overpayments, the right to sue for refunds of tax and the right to petition the Tax Court. The General Counsel's Memorandum also stated: "There is no indication that the respective parties to the treaty had any intention to contractually modify the application of a longstanding provision so essential to the administration of the revenue laws of the United States as Code section 367 (or its counterpart in prior revenue acts)."¹³⁷ Yet, both the ALI's¹³⁸ and ordinary methods of treaty interpreta-

133. G.C.M. 35444 (Aug. 21, 1973).

134. See *supra* text accompanying notes 64-67.

135. The income tax convention with Japan was signed two years later, in 1955, and did not include a nondiscrimination provision. In GCM 35444 the Service initially considered whether the income tax convention had implicitly repealed the nondiscrimination provision in the Treaty of Friendship, Commerce, and Navigation. G.C.M. 35444, *supra* note 133. Although there was apparently some internal disagreement within the Service, the Chief Counsel ultimately concluded that the nondiscrimination provision survived. G.C.M. 35444, *supra* note 133.

136. G.C.M. 35444, *supra* note 133.

137. G.C.M. 35444, *supra* note 133.

tion would suggest that modification of the application of section 367 could well be required by a later-enacted treaty.

B. *Withholding Taxes*

Generally, a withholding tax on a gross basis has been accepted as a surrogate for a tax computed on a net income basis where the taxpayer is not engaged in business or has no permanent establishment in the source country or if the income is not effectively connected or attributable to that trade or business or permanent establishment. This approach generally applied in the United States during years in which the tax rate on net income was much higher than it is today; but tax rates on net income for individuals are now generally below thirty percent and there seems little or no rationale for retaining the withholding rate at thirty percent. However, treaties reduce most withholding rates to at least fifteen percent, and such a reduced rate may still be justified as a surrogate for taxation on a net basis, except perhaps in low-margin industries like financial institutions. In order to be nondiscriminatory, the premise must be that the income being withheld upon has a high content of net income because any related expenses are not significant.¹³⁹ Where this is not true, then, a withholding on gross income could well be discriminatory.

For example, it is recognized that normally rental income does not contain a high degree of net income. Older treaties compensated for this by permitting a foreign taxpayer to elect to be taxed on a net basis. Similarly, royalty income from intangibles is permitted an offset for basis adjustments when treated as a sale for contingent payments. Otherwise, deductions attributable to royalty income from intangibles, such as royalties paid, are ignored.

Interest is a much more troublesome area. It is not unusual for the recipient of interest to have offsetting interest payments on borrowings that are not taken into account for withholding purposes. A potential solution to this problem would be to permit foreign taxpayers to elect to be taxed on a net basis if they file worldwide income returns and prove their deductions. Prior to 1936, foreign taxpayers were permitted to elect to be taxed on a net income basis in the United States.¹⁴⁰ The problems with this alternative include enforcement concerns and similar administrative matters. Enforcement may not really be a problem, however, since withholding on gross income would always be available as a "backup" enforcement mechanism. Administrative matters, like auditing foreign deductions, could also be a problem.

138. See *supra* note 24 and accompanying text.

139. But see Rev. Rul. 89-91, 1989-2 C.B. 129, modifying Rev. Rul. 80-222, 1982-2 C.B. 211.

140. See Revenue Act of 1934, § 214(a).

Such matters presumably could be resolved since the United States can obtain information from the taxpayer's treaty country under the treaty and such countries generally impose tax at comparable rates.

The ALI apparently believes that there is no discrimination in cases of withholding taxes since the more narrow withholding issue has been specifically dealt with by parties to the treaty in establishing withholding rates.¹⁴¹ In general, this conclusion may be correct, but changes in U.S. domestic rates make the argument seem weaker. In addition, if discrimination is tested using a specific-taxpayer's facts, the conclusion may be questioned in many cases. Finally, since the discrimination here is based on residence and not nationality, there may be no discrimination under Article 24(1). A more detailed analysis of that provision and the other provisions of the non-discrimination article of the 1981 U.S. Model follows.

IV. THE NATIONALITY PROVISION

Article 24(1) of the 1981 U.S. Model provides:

Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected. This provision shall apply to persons who are not residents of one or both of the Contracting States. However, for the purposes of United States tax, a United States national who is not a resident of the United States and a ... national who is not a resident of the United States are not in the same circumstances.¹⁴²

A. *Personal Scope*

Article 24(1) of the 1981 U.S. Model provides nondiscrimination protection to "nationals of a Contracting State." From the United States' perspective, "nationals" means citizens whether or not they are resident in the contracting state in which they have citizenship.¹⁴³ Although the 1981 U.S. Model would limit this provision to individuals,¹⁴⁴ the 1977 OECD Model and most of the actual U.S. treaties extend this provision to "all legal persons,

141. A.L.I. Treaty Project, *supra* note 5, I.A.3 and III, at 257, 263.

142. 1981 U.S. Model, *supra* note 7, art. 24, para. 1.

143. *Id.* Cf. U.S.-Can. Treaty, *supra* note 15 (utilizing a most favored nation comparison for nonresident citizens).

144. 1981 U.S. Model, *supra* note 7, art. 24, para. 2(b).

partnerships and associations deriving their status as such from the laws in force in a Contracting State.”¹⁴⁵

The failure to define “partnership” or to limit the definition raises the issue whether a partnership, some or all of whose partners are not residents of the United States for tax purposes, or a trust or estate, some or all of whose beneficiaries are not subject to U.S. tax, is covered by this provision. Normally, the question would be answered by Article 4 of the 1981 U.S. Model, which states:

in the case of income derived or paid by a partnership, estate, or trust, this term [“resident”] applies only to the extent that the income derived by such partnership, estate, or trust is subject to tax in that State as the income of a resident, either in its hands or in the hands of its partners or beneficiaries.¹⁴⁶

However, the term employed in the nondiscrimination provision of the 1981 U.S. Model is “national” not “resident.”

Under civil law a partnership is generally considered a legal person and would presumably be considered a national; but under common law it is not considered a legal person. Although the United States is a common law jurisdiction, the treatment of partnerships in the United States is not presently clear. Early drafts of the Uniform Partnership Act treated a partnership as a legal person: “A partnership is a legal person formed by the association of two or more individuals for the purpose of carrying on a business with a view to profit.”¹⁴⁷ However, after the death of the chief draftsman of the Uniform Partnership Act, his successors eliminated the reference to a legal person and left the law unclear.¹⁴⁸

In *Unger v. Commissioner*,¹⁴⁹ involving whether a Canadian limited partner in a U.S. partnership had a permanent establishment in the United States, the Tax Court responded as follows to the Canadian taxpayer’s argument that the “modern theory” of a partnership was to treat it as a legal entity:

The interpretation of the law of partnership which petitioner alleges is more ‘modern’ is *not* a recently evolved

145. 1977 OECD Model, *supra* note 4, art. 24, para. 2(b).

146. 1981 U.S. Model, *supra* note 7, art. 4, para. 1(b).

147. Cf. Unif. Partnership Act § 1(1) (2d Tent. Draft 1909).

148. See generally 1 Alan R. Bromberg & Larry E. Ribstein, *Bromberg and Ribstein on Partnership* § 1.03 (1991).

149. 58 T.C.M. (CCH) 1157, 1160, T.C.M. (P-H) ¶ 90,015 (1990).

interpretation. Rather it is merely a competing view which places more emphasis on the entity theory of partnership than on the aggregate theory of partnership.

The entity theory holds the nature of a partnership to be such that the partnership is a distinct legal entity separate from its partners. The aggregate theory on the other hand considers the partners of a partnership as not forming a collective whole. Rather the partnership is viewed as merely an aggregate of the individual partners of which it is comprised.

A resolution of the dispute concerning whether the entity theory or aggregate theory of partnership should be applied for all purposes has not been reached. The character attributed to a partnership varies from case to case, sometimes even within jurisdictions, often depending on the issue to be decided.¹⁵⁰

Even if a U.S. partnership composed of all nonresident alien partners was a "national" of the United States, since a partnership is not subject to tax, the application of the nondiscrimination provision to it would be limited to the "connected requirements." Nevertheless, the U.S. taxation of a treaty-country national who is a partner may still be subject to nondiscrimination protection under a treaty corresponding to the 1981 U.S. Model if the aggregate theory of partnerships is applied for this purpose.

It would seem that a trust created under U.S. law will not qualify as a national, since, even though it derives its status as such from the law in force in the United States, it is not a "legal person." Both Scott¹⁵¹ and the Second Restatement of the Law of Trusts¹⁵² state that a trust is a legal "relationship." Article 2 of the Hague Convention on the Law Applicable to Trusts and on Their Recognition¹⁵³ also defines a trust as a legal relationship but attributes to it the following characteristics:

- a. the assets constitute a separate fund and are not a part of the trustee's own estate;
- b. title to the trust assets stands in the name of the trustee; and
- c. the trustee has the power and the duty, in respect of

150. *Id.*

151. 1 Austin W. Scott & William F. Fratcher, *The Law of Trusts* § 2.4 (4th ed. 1987).

152. *Restatement (Second) of the Law of Trusts* § 2 (1957).

153. *Convention on the Law Applicable to Trusts and on Their Recognition*, Oct. 20, 1984, art. 2, 23 I.L.M. 1388, 1389.

which he is accountable, to manage, employ or dispose of the assets in accordance with the terms of the trust and the special duties imposed upon him by law.¹⁵⁴

Article 11 of the Hague Convention on trusts states that “[s]uch recognition shall imply, as a minimum, that the trust property constitutes a *separate fund*, that the trustee may sue and be sued in his capacity as trustee, and that he may appear or act in this capacity before a notary or any person acting in an official capacity.”¹⁵⁵ Thus, it is not clear that a trust will be treated as a “national” under any U.S. treaty.

B. Application of the Savings Provision

Every U.S. income tax treaty reserves to the United States, in a “savings” provision, the power to tax its citizens *and residents* as if the treaty had not come into effect. If the same reservation were applied to the nondiscrimination article, however, there would be very little room, if any, for the nationality provision to apply to a non-United States national, resident in the United States, since by its terms the savings provision is to be applied to such persons.

Section 911 of the Internal Revenue Code of 1954 granted an exemption from U.S. tax for personal service income earned outside the United States by a citizen of the United States. Aliens, although resident in the United States, were not eligible for the foreign earned income exclusion. After concluding that the savings article was not applicable, the Internal Revenue Service has determined that resident aliens were in similar circumstances to U.S. citizens, since they were both taxed on their worldwide income, and that section 911 resulted in more burdensome taxation on resident aliens than on U.S. citizens.¹⁵⁶ Section 911 has subsequently been modified to cover both resident aliens and U.S. citizens. Significantly, however, this appears to be one of the only instances in which the Internal Revenue Service (as distinguished from the Treasury Department) has determined that a statute adopted by Congress violated the nondiscrimination article.¹⁵⁷

154. *Id.*

155. *Id.* art. 11, 23 I.L.M. at 1390 (emphasis added).

156. Rev. Rul. 72-330, 1972-2 C.B. 444, amplified by Rev. Rul. 72-598, 1972-2 C.B. 451, declared obsolete, Rev. Rul. 91-58, 1991-2 C.B. 340.

157. See the discussion of Treasury Department regulations under the branch profits tax at text accompanying notes 192-215 *infra*.

The ALI also considered certain private rulings under the foreign insurance company excise tax to illustrate the IRS's recognition of potentially discriminatory treatment. A.L.I.,

C. *Derivation of Status*

Under the laws of a number of foreign countries, a corporation is treated as domiciled in the country in which its management is located. A corporation could be incorporated in country X and managed and controlled in country Y. It is not clear whether a treaty which contains the 1977 OECD Model "all legal persons" language will treat such a corporation as a national of the country in which it is incorporated, the country in which it is managed and controlled, or both. The latter interpretation could prove quite interesting, as it results in multiple comparisons for purposes of determining discrimination.

D. *"In the Same Circumstances"*

A more important and more often disputed question is the meaning of the phrase "in the same circumstances" in Article 24(1) of the 1981 U.S. Model and of similar language in the 1977 OECD Model.¹⁵⁸ Little guidance is given in the treaties or in the U.S. Treasury Department's Technical Explanations accompanying them. In fact, the only interpretative assistance in Article 24(1) of the 1981 U.S. Model relates to the meaning of "national." In this case, since the United States taxes its citizens on their worldwide income irrespective of their residence while other countries do not, the United States added to the 1977 OECD Model the following language: "a United States national who is not a resident of the United States and a ... national who is not a resident of the United States are not in the same circumstances."¹⁵⁹ This limits the comparison under the 1981 U.S. Model to one between resident citizens and resident aliens and eliminates the comparison of nonresident citizens with nonresident aliens.

The phrase "in the same circumstances" would appear to mean the same *factual* circumstances, since the question being addressed is whether the situations are treated the same under the law. Thus, "in the same circumstances" should be thought of as referring to situations in which all of the facts are identical *except* for the difference that is being tested, for example, resident versus nonresident, permanent establishment versus domestic corporation.

The OECD Commentaries state that "[t]he expression 'in the same circumstances' refers to taxpayers (individuals, legal persons, partnerships and associations) placed, from the point of view of the application of the ordinary taxation laws and regulations, in *substantially similar* circumstances *both* in

Treaty Project, *supra* note 5, at 255.

158. See 1981 U.S. Model, *supra* note 7, art. 24, para. 1; 1977 OECD Model, *supra* note 4, art. 24, para. 1.

159. 1981 U.S. Model, *supra* note 7, art. 24, para. 1.

law and in fact.”¹⁶⁰ It is not clear what was intended by the language “substantially similar circumstances both in law and in fact.” Webster’s Third New International Dictionary defines “similar” as “having characteristics in common: very much alike: ... alike in substance or essentials.”¹⁶¹ *Similar* circumstances in fact would appear to mean that slight differences in fact, for example, married versus unmarried taxpayers, should be ignored. Similar circumstances in *law* is a more difficult concept. If the factor that is being contested is the basis for alleged discrimination, then that factor alone should not be determinative, yet some questions that seem factual, such as residence, may really be mixed questions of fact and law. Perhaps that is what the OECD Commentaries mean here.

In the other paragraphs of Article 24 of the 1981 U.S. Model, the language appears less susceptible to interpretative difficulty. In paragraph 3 of Article 24 (paragraph 4 of Article 24 of the 1977 OECD Model), for example, the phrase used is “same activities” of a permanent establishment. Paragraph 5 of the 1981 U.S. Model (paragraph 6 of the 1977 OECD Model) uses the phrase “similar enterprises” which is widely read to mean ownership of a domestic subsidiary. Similarly, paragraph 4 of the 1981 U.S. Model (paragraph 5 of the 1977 OECD Model) uses the phrase “same conditions” when referring to deductions permitted to an enterprise of the other state.

O’Brien¹⁶² and van Raad¹⁶³ would adopt a strict interpretation, giving meaning to use of the term “same circumstances” in the treaty provision. It is possible that the United States may have taken this view when it did *not* agree that a U.S. citizen who is taxable on his or her worldwide income is the same as a nonresident non-U.S. citizen who is taxable in the United States only on his effectively connected income and certain gross income from U.S. sources.¹⁶⁴ On the other hand, the United States could have accepted a more liberal view of “in the same circumstances” and still have reached that conclusion. Indeed, as discussed further below, the Internal Revenue Service appears to treat “in the same circumstances,” in Article

160. 1977 OECD Commentaries, *supra* note 4, art. 24, para. 1 at 3 (emphasis added).

161. Webster’s Third New International Dictionary 2120 (1986) (unabridged).

162. See generally O’Brien, *supra* note 3.

163. See generally van Raad, *Nondiscrimination and International Tax Law* (1986).

164. 1981 U.S. Model, *supra* note 7, art. 24, para. 1. Perhaps the following, even broader, language of the Australian and New Zealand treaties should be adopted by the United States.

Without limiting by implication the interpretation of this Article, it is hereby declared that, except to the extent expressly so provided, nothing in the Article prevents a Contracting State from distinguishing in its taxation laws between residents and nonresidents solely on the ground of their residence.

U.S.-Austl. Treaty, art. 23, para. 3. See also U.S.-N.Z. Treaty, art. 23, para. 6.

24(1) and carrying on “the same activities” in Article 24(3) of the 1981 U.S. Model as having the same meaning.

V. TAXATION OF A PERMANENT ESTABLISHMENT

Paragraph 3 of Article 24 of the 1981 U.S. Model (paragraph 4 of the 1977 OECD Model) protects domestic permanent establishments of foreign enterprises as follows:

The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favorably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, relief, and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.¹⁶⁵

As explained above, paragraphs 1 and 2 of Article 24 of the 1977 OECD Model, and of those U.S. treaties that adopt the 1977 OECD Model, pertaining to nondiscrimination with respect to “nationals” of a contracting state apply to both individuals and legal persons. To the extent that these nationals have a permanent establishment in the United States, it would appear that there is an overlap: both the provision applicable to individuals and legal persons and the provision protecting permanent establishments may apply simultaneously. Even in the case of the 1981 U.S. Model, where a “national” can only be an individual, both the “national” and “permanent establishment” provisions can apply simultaneously to individuals.

The interpretative issues that arise in other cases under the permanent establishment provision are more serious and they generally involve greater amounts of tax.

A. “Enterprise”

The term “permanent establishment” is defined under Article 5 of both the 1981 U.S. Model and 1977 OECD Model. The term “enterprise,” although contained in all of the U.S. treaties for many years, is not defined. In the absence of a treaty definition of the term “enterprise,” the meaning

165. 1981 U.S. Model, *supra* note 7, art. 24, para. 3; 1977 OECD Model, *supra* note 4, art. 24, para. 4.

would normally be determined under domestic law,¹⁶⁶ but it is not a term frequently used in the United States. Recently, the United States sought to give the term content in its treaties. For example, in explaining Article 3 of the U.S.-China treaty, which defines an enterprise of a country as an enterprise carried on by a resident of that country, the Senate report added, “[a]lthough the treaty does not define the term ‘enterprise,’ it will have the same meaning that it has in other U.S. tax treaties—the trade or business activities undertaken by an individual, company, partnership, or other entity.”¹⁶⁷ In contrast, however, the Technical Explanation of the U.S.-Spain treaty states that it is understood that most activities carried on by individuals will be covered by the independent and dependent personal service provisions and will *not* be considered an “enterprise” except where the trade or business involves the risk of capital.

B. *Personal Allowance*

Both the 1981 U.S. Model and the 1977 OECD Model provide that the Contracting States are not required to grant the personal allowances or credits that they grant to their own residents to reflect differing family responsibilities. This provision is applicable to those situations where an individual is maintaining a permanent establishment, such as a sole proprietorship utilizing capital.

C. *Carrying on the Same Activities*

Paragraph 4 of Article 24 of the 1977 OECD Model and paragraph 3 of Article 24 of the 1981 U.S. Model determine discrimination by comparing the taxation of a permanent establishment in a contracting state with the taxation levied on an enterprise of that state, such as a domestic corporation, carrying on the same activities.¹⁶⁸ The comparison is a source-jurisdiction comparison: comparing a permanent establishment in the United States of a foreign enterprise with a U.S. corporation carrying on the same activities also in the United States.¹⁶⁹ But is it meant to compare, for purposes of the “carrying on the same activities” test, only the permanent establishment and its U.S. counterpart or the *entire* foreign corporation and its U.S. counterpart? Is the test a factual one or a legal one? Do only identical activities satisfy the test of the “same activity”? How far from identical can the business be?

166. See e.g., 1977 OECD Model, *supra* note 4, art. 3, para. 2.

167. Report of the Senate Committee on Foreign Relations, Exec. Rep. No. 7, 99th Cong., 1st Sess. 19 (1985).

168. 1977 OECD Model, *supra* note 4, art. 24, para. 4.

169. 1977 OECD Commentaries, *supra* note 4, art. 24, para. 4 at 23.

The Internal Revenue Service apparently does not believe it is sufficient to have factual congruity; there must be legal congruity as well. The problem can be illustrated by the special treatment of dividends received by a permanent establishment. The OECD Commentaries recognize that there is a problem and recommends that treaty countries make their position clear in a protocol.¹⁷⁰ The United States has often done so. For example, Article XXV(6)(b) of the U.S.-Canada treaty states that the nondiscrimination article shall not be construed as obliging a Contracting State “[t]o grant to a company which is a resident of the other Contracting State the same tax relief that it provides to a company which is a resident of the first-mentioned State with respect to dividends received by it from a company.”¹⁷¹ The Technical Explanation to the U.S.-Canada treaty states that this provision is merely clarifying in nature, since neither the United States nor Canada would interpret the language as providing the same relief anyway.¹⁷² However, a claim for the one hundred percent dividends received deduction on dividends received by a permanent establishment in the United States appears to have been settled in favor of at least one taxpayer in an unreported case.¹⁷³

Thus, if the stock of the distributing company is owned by the permanent establishment, and the dividend is effectively connected with the permanent establishment so that it is *not* eligible for the lower treaty withholding rate, it is difficult to justify any disallowance of the dividends received deduction.¹⁷⁴ One explanation might be that the distribution by the foreign parent corporation of a dividend out of the earnings of its U.S. permanent establishment would not be subject to a withholding tax, while a similar distribution (to the extent made to foreign shareholders) from a U.S. corporation would be. This argument has been seriously weakened, if not eliminated, however, by adoption of the U.S. branch profits tax, which is considered below.¹⁷⁵ A second possible explanation is that the comparison should be made between a U.S. corporation and the *entire* foreign enterprise, for instance the “foreign parent” of the U.S. permanent establishment, rather than only the permanent establishment. In that case, it would be the position of the Service that the “same activity” be interpreted in the same manner as

170. 1977 OECD Commentaries, *supra* note 4, art. 24, para. 31-37.

171. U.S.-Can. Treaty, *supra* note 15, art. XXV, para. 6(b).

172. Treas. Tech. Expl. of Can. Treaty, *supra* note 98, art. XXV (providing that the nondiscrimination provisions applies with respect to a fixed base as well as a permanent establishment).

173. *Schlumberger Limited v. United States*, 195-75 (Ct. Cl. petition filed June 27, 1975); see also A.L.I. Treaty Project, *supra* note 5, at 269-72.

174. France now permits the deduction as a result of a French Supreme Administrative Court decision under the nondiscrimination article of the French-Italian income tax treaty. Judgment of Nov. 18, 1985, conseil d’Etat (Fr.), discussed in 26 *European Tax’n* 157 (1986).

175. See *infra* text accompanying notes 192-215.

“in the same circumstances” under Article 24(1). The Service does in fact appear to take the view that the “same circumstances” test includes the payment of a U.S. tax and is not satisfied where the foreign taxpayer, unlike a U.S. citizen, is not subject to U.S. tax on its worldwide income.¹⁷⁶ In IRS Technical Advice Memorandum 8030005, the Service explicitly extended the “similar circumstances” concept of Article 24(1) to permanent establishments under Article 24(4) of treaties corresponding to the 1977 OECD Model.¹⁷⁷

A comparison to the whole foreign corporation, however, rather than merely to its U.S. permanent establishment, clearly seems incorrect. Since that part of the foreign corporation’s income that is not effectively connected with the U.S. permanent establishment is not subject to any U.S. tax,¹⁷⁸ the foreign corporation could only be comparable to a U.S. corporation if *all* of its income were effectively connected with its U.S. trades or businesses. Even in that situation, if the test were generic (rather than specific), a permanent establishment could never be protected under Article 24(4), because another hypothetical corporation may have income not subjected to tax in the United States. It appears that the Treasury Department’s interpretation could effectively eliminate paragraph 4 from its treaties altogether, since a permanent establishment is generically never in the same U.S. tax circumstances as a U.S. corporation.¹⁷⁹

A similar rationale would also justify the denial of the right to file a consolidated return between a permanent establishment and its domestic subsidiaries. It would also justify section 906 of the Code, which restricts the foreign tax credit to foreign income taxes paid “with respect to income effectively connected with the conduct of a trade or business within the United States,”¹⁸⁰ while denying it to foreign taxes that are imposed on other income from sources within the United States which is not effectively connected.¹⁸¹ In contrast, no such limitations apply to a domestic corporation that is managed and controlled in a foreign jurisdiction.

D. “Taxation ... not ... less favorably levied”

The language of the nondiscrimination provision applicable to permanent establishments is different than that of the nondiscrimination provision applicable to foreign nationals. The provision applicable to foreign nationals

176. See e.g., I.R.S. T.A.M. 8030005 (Mar. 28, 1980).

177. *Id.*; see also Rev. Rul. 74-239, 1974-1 C.B. 372.

178. This is true as long as the other income is not from a U.S. source. See IRC §§ 881(a), 882(a).

179. See William C. Gifford, *Permanent Establishments Under the Nondiscrimination Clause in Income Tax Treaties*, 11 *Cornell Int'l L.J.* 51, 63 (1978).

180. IRC § 906(a).

181. IRC § 906(b)(1).

prevents taxation and connected requirements that are “other or more burdensome” than those applicable to nationals.¹⁸² The provision applicable to permanent establishments only requires that taxation “not be less favorably levied” on permanent establishments than on residents.¹⁸³ Thus, the permanent establishment provision seems to be limited to the quantum of the tax. If the provision is limited to the quantum of the tax, then it would clearly not prevent discrimination in relation to certain administrative matters, such as information requirements, limitation periods, interest and penalties.¹⁸⁴

As previously noted, even under the foreign nationals provision the tax imposed on foreign taxpayers generally need not be *identical* to that imposed on nationals of the taxing State.¹⁸⁵ Yet, Article 24(4) of the 1977 OECD Model, applicable to permanent establishments, does not even include the limiting term “other.” If a different (other) method of taxation applies to a permanent establishment but it produces no greater tax, Article 24(4) is not violated—it is the effective tax rate alone that counts.¹⁸⁶

Nevertheless, it appears incongruous for the United States to import the meaning of “same circumstances” in Article 24(1) to the interpretation of “same activities” in Article 24(4) but not import the meaning of “other or more burdensome” in Article 24(1) to “taxation ... not be less favorably levied” in Article 24(4).

E. FIRPTA

When the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) was enacted,¹⁸⁷ Congress adopted rules to tax indirect dispositions of U.S. real property by foreign persons. For example, a nonresident alien or foreign corporation is subject to tax under FIRPTA upon a sale of shares of certain U.S. corporations that are considered U.S. real property holding corporations.¹⁸⁸ Gain from the sale is treated as effectively connect-

182. 1981 U.S. Model, *supra* note 7, art. 24, para. 1.

183. 1981 U.S. Model, *supra* note 7, art. 24, para. 3. In fact, a number of U.S. treaties adopt the same expression, in both nationality and permanent establishment paragraphs; in those cases the term adopted is usually “more burdensome.”

184. Cf. 1977 OECD Commentaries, *supra* note 4, art. 24, para. 1 at 10 (“[T]he formalities connected with the taxation (returns, payment, prescribed times, etc.) must not be more onerous for foreigners than for nationals.”).

185. See *supra* text accompanying notes 39-56.

186. See 1977 OECD Commentaries, *supra* note 4, art. 24, para. 4 at 22; cf. G.C.M. 35066 (Oct. 2, 1972) modified on other grounds, G.C.M. 38052 (Aug. 20, 1979) (considering whether double taxation violates an anti-discrimination clause in insurance excise and income tax context).

187. Pub. L. No. 96-499 §§ 1121-1125, 94 Stat. 2682 (codified in scattered sections of 26 U.S.C.).

188. Id. §§ 1122, 1124 (codified as amended at IRC §§ 897(c), 861(a)(5)).

ed income. Dispositions of shares of foreign corporations are not taxed directly under FIRPTA,¹⁸⁹ but rules were adopted to override certain nonrecognition provisions that otherwise would have applied to foreign corporations having interests in U.S. real property, such as the transfer of U.S. real property by a nonresident alien individual or foreign corporation to a newly created foreign corporation in a section 351 exchange.¹⁹⁰

Congress also decided to override any existing treaties that would have prevented imposition of the FIRPTA tax, but phased in such overrides.¹⁹¹ In addition, because Congress acknowledged that the rules overriding nonrecognition provisions could in fact result in discriminatory taxation of foreign taxpayers, it adopted a novel approach—it included section 897(i) in the Code. That section allows a foreign corporation that has a permanent establishment in the United States and to which a nondiscrimination article of the treaty applies to elect to be treated as a domestic corporation for purposes of FIRPTA. A condition of the election, however, is waiver of any treaty benefits that might otherwise apply including benefits under the nondiscrimination provision.

F. Branch Profits Tax

In 1986, the United States adopted a branch profits tax which actually consists of three taxes—the branch profits tax, the branch-level interest tax, and the excess interest tax.¹⁹²

1. *Branch profits tax.*—The branch profits tax is a tax levied in addition to the general corporate tax on the U.S. earnings of a foreign corporation. It is imposed on the earnings that are available for distribution as a dividend by any foreign corporation that is doing business in the United States. Such available earnings, in the terms of the Code, are called the “dividend equivalent amount.”¹⁹³ The dividend equivalent amount is equal to current net earnings of the branch less any reinvestment in the United States, with certain modifications that are not relevant for this analysis.¹⁹⁴ A domestic corporation is not subject to such a tax, but its non-U.S. shareholders may be subject to U.S. tax on the U.S. source dividend paid by such a corporation, and such tax is only imposed if a dividend is actually paid. As

189. See *id.* But see FIRPTA § 1122(i), 94 Stat. 2682 (codified as amended at IRC § 897(i)).

190. See IRC §§ 897(d) and (e). See also Temp. Treas. Reg. § 1.897-6T(b).

191. FIRPTA § 1125, 94 Stat. 2690.

192. Pub. L. No. 99-514, § 1241(a), 100 Stat. 2085, 2576 (1986) (codified as amended at IRC § 884).

193. IRC § 884(b).

194. *Id.*

described further below, prior to the enactment of the branch profits tax, dividends paid by certain foreign corporations with substantial U.S. income were also considered U.S. source dividends which were subject to tax in the hands of non-U.S. shareholders. The branch profits tax can be viewed as an anticipatory withholding tax on future dividends. Since no domestic corporation bears a branch profits tax, however, the tax violates the permanent establishment nondiscrimination provision.

In 1986 the Joint Committee staff was of the view that it was uncertain whether the new branch profits tax violated the treaty nondiscrimination articles.¹⁹⁵ In deference to the Treasury Department's view that the branch profits tax *was* discriminatory under Article 24(3) of the 1981 U.S. Model, however, the Conferees took pains to give assurance that treaty protection would be available in the absence of treaty shopping.

The conferees also do not intend that the branch tax be imposed on income not attributable to a permanent establishment (even though the income is effectively connected with a U.S. trade or business under Code rules) if the treaty in question in fact precludes the United States from imposing its regular corporate income tax on income not attributable to a permanent establishment, so long as the shareholders of a foreign corporation are not treaty shopping.¹⁹⁶

The treaty protection was to be limited to income tax treaties only and was to be applicable only if the foreign corporation that had a permanent establishment in the United States was a "qualified resident of such foreign country."¹⁹⁷ In addition, the branch profits tax was not necessarily eliminated, but rather was in some cases only reduced to the tax rate applicable to dividends paid by a domestic corporation to a corporation resident in the treaty country if it wholly owned such domestic corporation.¹⁹⁸ The branch profits tax was thus adopted based upon the Treasury Department's contention that the proper comparison is between a domestic branch of a foreign corporation and a domestic corporation wholly owned by the foreign corporation. This approach does not seem to comport with the comparison required under Article 24(5) of the 1981 U.S. Model (the foreign ownership provision), even if there is some novel justification for this approach under Article

195. See Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 1038 (1987).

196. 2 H.R. Conf. Rep. No. 841, 99th Cong. 2d Sess. 650 (1986). Cf. Article 24(5) U.S.-Germany treaty excepting branch profits tax from nondiscrimination.

197. IRC § 884(e)(1).

198. IRC § 884(e)(2)(A)(ii).

24(3) (the permanent establishment provision).

Imposition of the anti-treaty shopping provision as a condition to nondiscrimination treatment may itself discriminate in some sense against foreign enterprises, because no similar limitation applies under the Code to *foreign-owned U.S. corporations*.¹⁹⁹

2. *Branch-level interest tax*.—The branch-level *interest tax* is a withholding tax imposed on interest considered paid by the U.S. permanent establishment of a foreign corporation to a foreign lender.²⁰⁰ The mechanism adopted to implement this tax is to characterize such interest payments as being from a U.S. source.²⁰¹

Previously, interest payments made by a foreign corporation, and similar payments of dividends, were considered U.S. source payments and were subjected to U.S. withholding tax only if more than fifty percent of the foreign corporation's earnings for the preceding three-year period were effectively connected with a U.S. trade or business. If fifty percent or more of the earnings were effectively connected with a U.S. trade or business during that period, then a proportionate amount of the payment was subjected to U.S. withholding tax unless a Code or treaty provision exempted the payment.²⁰² This tax was difficult to enforce.²⁰³

A branch-level interest tax is now imposed upon any interest considered *paid* by the U.S. permanent establishment.²⁰⁴ The statute does not define the method of determining the amount of interest paid by the U.S. permanent establishment. Given the problems of fungibility inherent in the payment of interest, such a system can work only if some sort of identification is possible. The regulations permit a timely identification of such liabilities by a taxpayer.²⁰⁵ Since the interest is actually paid, and since a domestic corporation would be required to withhold on such interest, this provision as a whole does not appear to violate the nondiscrimination article. In a specific case, however, it is possible for different tax results to be achieved by a U.S. corporation and a foreign corporation with a U.S. permanent establishment.

199. It is also interesting that the anti-treaty shopping rule may apply in a way that a corporation owned by nationals of a third country (1) may not be subject to regular U.S. tax on their U.S. business income that is not attributable to a permanent establishment, but (2) would be subject to the branch profits tax attributable to the same income.

200. IRC §§ 861(a)(1), 881(a)(1), 884(f)(1)(A), 1442(a); Temp. Treas. Reg. § 1.884-4T(a).

201. IRC § 884(f).

202. IRC § 861(a)(1)(D), (2)(B) (1954).

203. See Staff of the Joint Committee on Taxation, *supra* note 195, at 1036.

204. IRC §§ 861(a)(1), 881(a)(1), 884(f)(1)(A).

205. Treas. Reg. § 1.884-4(b)(1).

3. *Excess interest tax.*—The United States also imposes a tax on the “excess interest” of a U.S. branch of a foreign corporation.²⁰⁶ Excess interest is generally the excess of (1) the amount of interest that is allocated to and deducted by the U.S. branch in computing its taxable income over (2) the amount treated as U.S. source interest under the branch-level interest tax.²⁰⁷ Under the U.S. tax system applicable to a branch of a foreign corporation, the branch is able to deduct a portion of the interest paid by the entire foreign corporation. The deductible portion is determined under a formula that generally allocates the entire interest paid by the corporation among all of its branches and its home office in accordance with the assets of each.²⁰⁸ If the amount apportioned to the U.S. branch and, therefore deductible by it, exceeds the interest actually paid by the branch, then this excess is treated as interest paid by the U.S. branch *to the home office*. It is also subjected to a surrogate withholding tax at the rate that would have been applicable under the Code or under a treaty if the excess interest had actually been paid by a U.S. corporation to the foreign corporation.²⁰⁹

Congress recognized that this provision could be in conflict with nondiscrimination provisions of treaties, but left that determination for later consideration. Neither the Code nor the temporary regulations addressed the nondiscrimination issue under the excess interest tax. The Service first explained that the matter is “under consideration in connection with the Treasury [D]epartment study of the tax treaty program.”²¹⁰ In Notice 89-80, however, the Internal Revenue Service announced: “[t]he Treasury Department has concluded that the tax on excess interest is not prohibited by the nondiscrimination provision or any other provision in any income tax treaty to which the United States is a party.”²¹¹ This is also the position reflected in the final regulations. According to Notice 89-80, the nondiscrimination provisions do not require “structural or mechanical identity” between the tax computations for foreign and domestic corporations “so long as the net result of such method is approximately the same, i.e., the tax burden imposed on a foreign corporation in respect of its United States permanent establishment approximates the tax burden that is imposed on an enterprise of the United States engaged in the same activities.”²¹² The notice also states that “[t]his treatment recognizes that excess interest with respect to a branch is the functional equivalent of interest paid on parent debt funding with respect to a

206. IRC §§ 861(a)(1), 881(a)(1), 884(f)(1)(B).

207. IRC §§ 861(a)(1), 882(c)(1), 884(f)(1)(B).

208. Treas. Reg. § 1.882-5. See also Prop. Treas. Reg. § 1.882-5.

209. IRC § 884(f)(1)(B); Treas. Reg. § 1.884-4T(a)(2).

210. Preamble to Treas. Reg. § 1.884-4, T.D. 8223, 1988-2 C.B. 182, 186.

211. I.R.S. Notice 89-80, 1989-2 C.B. 394, 397.

212. *Id.*

subsidiary.”²¹³ In the view of the Service then, there is no discrimination since the overall tax treatment is similar to the payment of interest by a U.S. subsidiary to its foreign parent.

This conclusion seems to be based on the wrong comparison. The better comparison seems to be interest paid by a U.S. subsidiary to a U.S. parent, rather than to a foreign parent. This is the comparison required under Article 24(4) of the 1981 U.S. Model (the deduction provision), where the interest and other disbursements paid by a resident of the United States to a resident of the other treaty country are compared to interest and other disbursement paid to a resident of the United States.²¹⁴ In any case, it appears that the Service has persuaded the full Treasury Department that its view is correct.²¹⁵

G. *Minimum Taxable Income Proposal*

A controversial provision in recently proposed legislation²¹⁶ would deem certain corporations to have minimum taxable income. These corporations would include twenty-five percent foreign-owned U.S. corporations and foreign corporations that are subject to tax on a net basis in the United States which, in either case, also have transactions with related foreign persons equal to at least two million dollars or ten percent of the corporation's gross income.²¹⁷ The minimum taxable income of such a corporation for any category of business activities would be equal to seventy-five percent of the amount determined by applying the average profit-level indicator for the industry, apparently applying book rather than tax profit-level indicators.

The proposed legislation would favor covered corporations that apply for a private ruling by providing an exception to the minimum taxable income rule once a ruling has been obtained. The Joint Committee staff's explanation of the bill indicates a belief that the bill does *not* violate treaties, at least in light of certain other provisions of the bill which would eliminate

213. *Id.*

214. 1981 U.S. Model, *supra* note 7, art. 24, para. 4. But the technical incidence of the tax is on the foreign corporation, rather than on the recipient of the payment.

215. See Preamble to Treas. Reg. § 1.884-4, T.D. 8432, 1992-2 C.B. ____; see also A.L.I. Treaty Project *supra* note 5, at 265-72.

216. H.R. 5270, 102d Cong., 2d Sess. § 304 (1992) (Foreign Income Tax Rationalization and Simplification Act of 1992).

217. *Id.* The explanation of the Joint Committee staff indicates that amounts not taken into account in determining taxable income, such as contributions to capital or the principal amount of the loan, are disregarded for purposes of determining whether this transactional threshold is met. Staff of the Joint Committee on Taxation, 102d Cong., 2d Sess., Explanation of H.R. 5270, 52 (1992).

deferral for U.S.-controlled foreign corporations.²¹⁸ Similarly, the Joint Committee staff indicated that the minimum taxable income requirement is generally consistent with the business profits and associated enterprises articles of U.S. treaties.²¹⁹ Turning taxpayer difficulties on their head, the Joint Committee staff also indicates that the minimum profit rule is “prima facie” reasonable because of the difficulties of proof otherwise applicable to taxpayers.²²⁰ In any event, the staff believes there is no discrimination because a covered corporation would be free to get a private ruling, presumably at some substantial cost.²²¹ Finally, the Joint Committee indicates that if this proposal were considered to violate a treaty obligation in the United States, it was intended that the provisions apply nonetheless.²²²

VI. THE OWNERSHIP PROVISION

Paragraph 5 of Article 24 of the 1981 U.S. Model provides:

Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.²²³

Paragraph 5 protects business enterprises located in the United States and owned by residents of the other contracting state from discriminatory treatment. The provision is commonly interpreted as an *ownership* provision comparing, for example, a U.S. corporation owned by treaty-country residents to U.S. corporations owned by U.S. residents. The language would appear to cover other entities and businesses as well as corporations.²²⁴ The wording of the provision closely parallels that of paragraph 1 of Article 24 which deals with nationals.²²⁵ However, paragraph 5 uses a different basis of com-

218. *Id.* at 54.

219. See *id.* at 55.

220. *Id.*

221. See *id.*

222. *Id.*

223. 1981 U.S. Model, *supra* note 7, art. 24, para. 5.

224. 1977 OECD Commentaries, *supra* note 4, art. 24, para. 5 (focusing directly on the tax treatment of U.S. enterprises, not on the indirect tax treatment of the capital invested in such enterprises).

225. 1981 U.S. Model, *supra* note 7, art. 24, para. 1.

parison: paragraph 1 refers to nationals in the “same circumstances,” while paragraph 5 refers to “similar enterprises.”²²⁶ As suggested above, it is to be hoped that paragraph 5 also applies a *factual* comparison.

A. Consolidated Returns

Where two or more domestic corporations are commonly owned by another domestic corporation, they are generally permitted to file a consolidated U.S. income tax return.²²⁷ The same benefit is not permitted under the Code, however, for two or more commonly owned domestic corporations where the parent corporation is foreign.²²⁸ Apart from such a difference, the two sets of domestic corporations appear to be similar enterprises. The Treasury Department is of the view that the two groups of corporations are *not* similar enterprises, because the foreign parent corporation is not necessarily subject to U.S. tax on a worldwide basis. While it is clearly justifiable not to permit domestic corporations to distribute funds to their foreign shareholders without having paid a U.S. tax, it is not as clear why the United States should not permit the offsetting of profits and losses among affiliated domestic corporations, notwithstanding that their common parent is not a domestic corporation. However, other jurisdictions have reached the same result as the United States on this issue.²²⁹

The ALI states that while the legislative history is obscure, limiting the privilege of filing consolidated returns to situations involving a domestic parent and domestic subsidiaries “seems to be premised on the idea that only when dividends to the common shareholder are free of tax can transactions among sister companies in the group be allowed to proceed on a tax-deferred basis without concern that these might involve shifts of value amounting in substance to constructive dividends to the shareholder(s).”²³⁰ A compromise might be to permit the offsetting consolidation of gains and losses of sister domestic corporations owned by a foreign parent company without permitting the deferred intercompany transaction rules, but this idea has not gained currency.

226. 1981 U.S. Model, *supra* note 7, art. 24, para. 5. The permanent establishment provision (paragraph 3) uses a third comparison: enterprises carrying on the same activities. 1981 U.S. Model, *supra* note 7, art. 24, para. 3.

227. IRC § 1501.

228. IRC §§ 1501, 1504(b)(3).

229. See e.g., Decision of the Tax Court Cologne, 13 V 300/90 (May 30, 1990). In the U.K., something similar to the benefits of consolidation are available to U.K. parent-U.K. subsidiary companies and to a U.K. company owned by a qualifying consortium (members of which own at least five percent of the first company). See generally T.M. Portfolio 68-8th, at A-29 to A-30.

230. A.L.I. Treaty Project, *supra* note 5, pt. 4, V.C.

B. *Integrated Tax Systems*

One of the more controversial issues in international taxation is the economic discriminatory effect of integrated tax systems that limit credits or refunds to resident shareholders of domestic corporations. An integrated tax system or, as it is frequently called, an imputation system, is one in which the corporate and shareholder taxes are dependent and integrated. In contrast, under the classic corporate tax system, the corporation's and the shareholder's taxes do not depend on each other.

In a pure integrated or "split-rate" system, the corporation pays no tax or a lower rate of tax on the earnings it distributes as dividends. A variation is the allowance of a deduction from earnings for dividends distributed. In these instances, the shareholder pays a full rate of tax on the dividend received. An alternate means to the same end is to permit the recipient shareholder to gross up the amount he receives by the tax paid by the corporation in determining his taxable income and permit him a credit against his individual tax for the corporate tax paid, such as in the French "avoir fiscal" and the United Kingdom's ACT.

Most, if not all, integrated tax systems deny their benefits for distributions to nonresident shareholders. Where the system is a pure integrated or split-rate system, it clearly violates Articles 24(6) (the ownership provision) and 24(5) (the deduction provision) of the 1977 OECD Model. Limitations on shareholder credits seem less likely to violate the nondiscrimination provisions of treaties. It may be argued that the split-rate system of Germany is not discriminatory because it is dependent on dividend distributions and the discrimination against nonresident shareholders is therefore only indirect. However, the argument itself admits that discrimination exists.

Neither the split-rate nor the shareholder credit system would violate article 24(1) of the 1977 OECD Model. The discrimination is not because of nationality; it is because of nonresidence. Were the foreign country to grant its national nonresidents a credit, or the corporate deduction for distributions to them, the provision would violate Article 24(1) of the 1981 U.S. Model.

A more difficult question is whether the shareholder credit system amounts to a reduction of the tax at the corporate level and therefore results in a more burdensome tax to a corporation having foreign shareholders. Although the credit for the tax paid by the corporation results economically in a lower overall burden on corporate earnings, the credit or reduction is not given to the corporation, and it therefore does not appear to violate Articles 24(6) and 24(5) of the 1977 OECD Model, which apply only to the enterprise.

C. Corporate Liquidations

Section 337 of the Code provides that no gain or loss shall be recognized to the liquidating corporation on the distribution to an eighty percent corporate distributee of any property in a complete liquidation qualifying under section 332 of the Code. Section 332 requires that the distributee own the stock of the liquidating corporation from the date of the adoption of the plan of liquidation until the property is received. In addition, the distribution must be in complete cancellation or redemption of the corporation's stock and the transfer of the property must occur within a single taxable year or be part of a series of distributions completed within three years.²³¹

Section 367(e)(2) of the Code denies the benefit of these tax-free provisions where the eighty percent distributee is a foreign corporation, unless regulations are adopted by the Treasury Department that provide otherwise. Initially, the Internal Revenue Service stated in Notice 87-5,²³² that regulations would provide that section 367(e)(2) will be inapplicable to the liquidation of domestic subsidiaries where a treaty nondiscrimination provision was available, because such an application would violate the ownership provision (similar to Article 24(5) of the 1981 U.S. Model.)

Shortly thereafter, in Notice 87-66,²³³ the Internal Revenue Service withdrew that portion of the notice applicable to future distributions, claiming that a domestic enterprise owned by a U.S. corporation is *not* a similar enterprise to a domestic corporation owned by a foreign corporation. The Service said in Notice 87-66:

The capital ownership nondiscrimination provision requires that a foreign-owned corporation be treated no worse than a similar domestically-owned corporation. This rule, like all nondiscrimination provisions, does not prohibit differing treatment of entities that are in differing circumstances. Rather, a protected enterprise is only required to be treated in the same manner as other enterprises that, from the point of view of the application of the tax law, are in substantially similar circumstances both in law and in fact.

Accordingly, section 367(e)(2)'s denial of section 337 nonrecognition treatment constitutes prohibited capital ownership discrimination only if a U.S. corporation owned by a foreign corporation is, in the context of a liquidation,

231. IRC §§ 332(b)(2), (3).

232. I.R.S. Notice 87-5, 1987-1 C.B. 416, 417.

233. I.R.S. Notice 87-66, 1987-1 C.B. 376.

similar to a U.S. corporation owned by another U.S. corporation. It is clear that such enterprises are not similar, since a liquidating distribution by the foreign-owned corporation may remove U.S. corporate assets from U.S. corporate-level taxing jurisdiction, while in the liquidation of the U.S.-owned corporation the assets will remain in U.S. corporate solution, assuring U.S. corporate-level taxation.²³⁴

The conclusion reached by the Internal Revenue Service is rational, but cannot be easily justified under the wording of Article 24(5) of the 1981 U.S. Model. The comparison in that provision is between "similar enterprises."²³⁵ The Service's analysis in Notice 87-66 concludes that similar enterprises are not similar if they are owned by differing shareholders. Yet, that is the exact situation to which paragraph 5 is supposed to apply! The entities involved are taxed the same way. That a later transaction by a shareholder would not be subject to tax should not be relevant. Under Article 24(5), the tax on the U.S. corporation should be the same whether the similar enterprise is owned by foreign or domestic shareholders. Indeed, since section 367(e)(2) provides the same sort of "compensatory" tax as that imposed under certain provisions of FIRPTA and the branch profits tax, and since the Congress and Treasury Departments agree that nondiscrimination provisions apply in the latter cases, they should apply to section 367(e)(2) as well.

The ALI contends that the imposition of one "layer" of tax on appreciated assets passing in the jurisdiction should not be considered discriminatory.²³⁶ Using the same analysis, the ALI concludes that gain should not be recognized by a U.S. corporation on a spin-off or a split-off of a U.S. subsidiary to foreign shareholders since the gain remains subject to U.S. tax in the future, except for gain which accrued on the stock of the distributed corporation while held by the distributing corporation. If the ALI suggests these results as a policy matter, it is hard to disagree with that conclusion. However, treaties should be modified by the parties or by an appropriate agreement of the competent authorities; they should not be modified by a tortured analysis, no matter how apparently justified.²³⁷

D. *Treaty Gain on Stock as a Dividend*

During the last few years, Congress has considered treating the gain

234. *Id.*

235. 1981 U.S. Model, *supra* note 7, art. 24, para. 5.

236. A.L.I. Treaty Project, *supra* note 5, V.B.

237. Note that the temporary regulations defer the tax on assets that remain used in a business in the United States. See Temp. Treas. Reg. § 1.367(e)-2T(b)(2).

or loss from the disposition of stock of a domestic corporation by a ten percent foreign shareholder as income effectively connected with a trade or business and attributable to a permanent establishment in the United States.²³⁸ Since many of the U.S. treaties prevent imposition of a U.S. tax on the sale of stock, this proposed legislation has included provisions that would treat liquidating distributions and redemptions as dividends in those situations. In response to claims of discrimination, the explanation accompanying one of these bills stated:

It is further understood that application of the bill's dividend definition rule only to liquidating and redemption gains realized by certain foreign persons does not violate a typical treaty nondiscrimination provision. Among other things, it is believed that a U.S. shareholder and a foreign shareholder are not similarly situated for this purpose. A liquidating distribution or redemption distribution by a foreign-owned corporation may permanently remove U.S. corporate earnings from U.S. shareholder-level taxing jurisdiction (which all U.S. treaties retain to some extent), while in the liquidation of (or redemption of shares in) the U.S.-owned corporation the earnings will remain in U.S. taxing jurisdiction, assuring U.S. shareholder-level taxation.²³⁹

This is the same justification given for section 367(e)(2) and it suffers from the same infirmities. However, these proposals seem more odious coming from Congress and adopting so transparent a mechanism of overriding treaties.

E. *Partnership Withholding*

As noted above, Article 24(5) of the 1981 U.S. Model is not limited to corporations, since it covers "enterprises."²⁴⁰ A partnership conducting a business is such an enterprise. Since a partnership is not generally a taxable entity in the United States,²⁴¹ it is rare that this provision will be applicable in the United States. On the other hand, a nonresident alien individual or foreign corporation is considered as being engaged in a trade or business in

238. See e.g., H.R. 5270, 102d Cong., 2d Sess. § 301 (1992); H.R. 4308, 101st Cong., 2d Sess. § 201 (1990).

239. Technical Description accompanying H.R. 4308, 101st Cong., 2d Sess. (1990), Tax Notes Microfiche Database, Doc. 90-2228, Fiche 462.

240. See *supra* text accompanying note 224.

241. IRC § 701.

the United States if the partnership of which such individual or corporation is a member is so engaged.²⁴² Thus, it would appear that the ownership provision is applicable to the individual partners in the partnership.

Section 1446 of the Code requires a partnership that includes non-resident alien partners to withhold tax on those partners' shares of partnership income where the partnership has income effectively connected, or treated as effectively connected, with the conduct of a trade or business in the United States. Each foreign partner of the partnership is allowed a credit for such partner's share of the withholding tax paid by the partnership.²⁴³

Article 24(5) of the 1981 U.S. Model provides that the foreign-owned domestic enterprise shall not be subjected to any taxation or any requirement connected therewith that is other or more burdensome than the taxation and connected requirements to which a similar enterprise of the United States is subjected. A partnership owned by U.S. taxpayers is not required to withhold on payments to its partners. It could be argued, however, that the withholding tax is only a necessary procedural and collection device; since the foreign partner may claim a credit for the tax withheld. In other words, some would say this is just another example of permitted "procedural" discrimination.

This has not always been the view of Congress, however. In 1966, the House Ways and Means Committee, while discussing the reasons for changes proposed in the withholding provisions applicable to foreign taxpayers, stated: "[a]lthough an alien may obtain a refund of the excess withholding when he files his return at the end of the year, overwithholding in these circumstances can create a substantial hardship for the alien."²⁴⁴ The Internal Revenue Service, during the course of a lengthy discussion of the history of the withholding provisions from 1913 through 1979, stated that Congress has recognized the hardship that may result from overwithholding even when a refund can be obtained at the end of the tax year.²⁴⁵ Nevertheless, withholding does not violate the nationality, permanent establishment, or ownership provisions, since it is not based on citizenship and is not a burden on the enterprise.

F. *Subchapter S*

A domestic corporation that qualifies and elects to be taxed under Subchapter S is generally not subject to corporate tax;²⁴⁶ its income is taxed

242. IRC § 875(1).

243. IRC § 1446(d)(1).

244. H.R. Conf. Rep. No. 1450, 89th Cong., 2d Sess. (1966), 1966-2 C.B. 965, 983.

245. G.C.M. 38052 (Aug. 20, 1979). Cf. Treas. Regs. §§ 1.445-3(g), -6(g) ("quick" refund procedures for overwithheld FIRPTA taxes).

246. IRC § 1363(a).

to its shareholders.²⁴⁷ A corporation cannot qualify to make the election if any of its shareholders are nonresident aliens.²⁴⁸ Since an S corporation bears no tax and a regular corporation does, an enterprise denied S corporation status is subject to taxation that is other or more burdensome solely because it has nonresident alien shareholders. The election can be made with nonresident shareholders who are citizens, and it can be made with aliens who are residents. Thus, it might be argued that the discrimination is not because of residency or nationality. That argument seems to be weak, however. The Technical Explanation to the new U.S.-Germany treaty states that the reason for the exclusion of nonresident aliens is that they are not net-basis taxpayers, rather than because they are nonresidents.²⁴⁹ That may sound rational, but it does not seem reconcilable with the language of Article 24(5) of the 1981 U.S. Model. In order to avoid violating Article 24(5), the statute should probably permit nonresident alien shareholders for S corporations, if those shareholders consent to be taxed on a net basis, as is required for nonresident alien individuals and foreign corporate shareholders of Domestic International Sales Corporations and under FIRPTA.²⁵⁰

VII. THE DEDUCTION PROVISION

Paragraph 4 of Article 24 of the 1981 U.S. Model provides:

Except where the provisions of paragraph 1 of Article 9 (Associated Enterprises), paragraph 5 of Article 11 (Interest), or paragraph 4 of Article 12 (Royalties) apply, interest, royalties, and other disbursements paid by a resident of a Contracting State to a resident of the other Contracting State shall, for the purposes of determining the taxable profits of the first-mentioned resident, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. Similarly, any debts of a resident of a Contracting State to a resident of the other Contracting State shall, for the purposes of determining the taxable capital of the first-mentioned resident, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.²⁵¹

247. IRC § 1366.

248. IRC §§ 1361(b)(1)(C), 1362(a)(1).

249. Treasury Dept. Technical Explanation of U.S.-Germany Treaty, Art. 24, Fed. Tax Treaties II (P-H) ¶ 39,066 at 39,060-2.9.

250. See IRC §§ 871(b), 882(a), 897, 996(g).

251. 1981 U.S. Model, *supra* note 7, art. 24, para. 4.

This provision appears to be merely an elaboration of the more general "not less favorably levied" language of paragraph 3; the disallowance of any of these deductions would result in a greater taxable income and, accordingly, a greater tax burden on the permanent establishment. Moreover, it appears to overlap Article 24(5) of the 1981 U.S. Model, which prevents taxation that is other or more burdensome on an enterprise the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State.

The United States income tax law contains a number of limitations on the deductibility of interest peculiar to foreign taxpayers. In general, interest is deductible on an accrual basis for taxpayers not using the cash method of accounting. Similarly, original issue discount on a loan is generally deductible on an accrual basis. However, original issue discount is not deductible on an accrual basis if the holder is a related nonresident; it is only deductible at the time of payment.²⁵² In addition, under the broad power granted under section 267(a)(3) of the Code, the Service has deferred the deduction for interest accrued to a related foreign person until paid.²⁵³ The deferral of the deduction would appear to be discriminatory. However, the wording of Article 24(4) of the 1981 U.S. Model is limited to amounts "paid" and thus the article may not be applicable. Moreover, a similar limitation is imposed upon related domestic taxpayers. Section 267(a)(2) of the Code limits the deduction of interest paid by a related party if the person to whom the payment is to be made is not required to include the amount in its gross income by reason of the taxpayer's method of accounting. For U.S. tax purposes, with one exception, foreign taxpayers are taxable on a cash rather than an accrual basis. Methods of accounting other than the cash method are available with respect to income of a business that is effectively connected with a United States trade or business. Where there is no U.S. tax on the foreign recipient of the interest, the argument that the domestic recipient's rule of section 267 provides justification for the deduction limitation may lack validity, although the regulations will provide otherwise.²⁵⁴

VIII. ESTATE TAX

As noted above, the nondiscrimination article applies to taxes of every kind and description imposed by a treaty nation or a political subdi-

252. IRC § 163(e)(3). See generally *supra* text accompanying notes 76-85.

253. Prop. Treas. Reg. § 1.267(a)-3, 56 Fed. Reg. 11532 (1991); see also I.R.S. Notice 89-84, 1989-2 C.B. 402.

254. See Prop. Treas. Reg. § 1.267(a)-3, 56 Fed. Reg. 11532 (1991); see also I.R.S. Notice 89-94, 1989-2 C.B. 402.

vision or local authority thereof.²⁵⁵ Thus, it applies to the federal estate tax. The nondiscrimination article has not always been as broad. For example, the former Canadian estate tax treaty was not terminated even after Canada abandoned its federal estate and gift tax. The effect of maintaining the estate tax treaty was to preserve the nondiscrimination article which was important because the nondiscrimination article of the income tax treaty then in effect was limited to income taxes. The estate tax treaty was abandoned only after a new income tax treaty, with its own, broader nondiscrimination article was adopted.

A few years ago, Revenue Canada expressed the view that U.S. tax law violates the broader nondiscrimination clause in the current U.S.-Canada income tax treaty because U.S. residents are entitled to an exemption in respect of at least \$600,000 of their estate, while nonresidents were entitled to a smaller exemption. Paragraph 10 of Article XXV of the U.S.-Canada treaty extends the nondiscrimination article to "all taxes imposed under the Internal Revenue Code."²⁵⁶ The only provision of Article 24 of the 1981 U.S. Model that relates to non-business income is the nationality provision which is generally found in paragraph 1.²⁵⁷ The Canadian treaty is identical to the 1981 U.S. Model except that citizens of a Contracting State who are not residents of the other Contracting State are compared with citizens of a third state in the same circumstances.²⁵⁸ The nondiscrimination provision of the Canadian income tax treaty was negotiated in the context of the income tax.²⁵⁹

The problem raised by the application of an income tax treaty to an estate tax situation is not simple. The treaty protects a citizen of Canada who is a resident of the United States.²⁶⁰ The term "resident" is a defined term under Article IV(1) and means any person who, under the laws of that state, is liable for tax therein by reason of his domicile.²⁶¹ Thus, the question is whether the term "resident" means resident in terms of the U.S. *income* tax law or in terms of the U.S. *estate* tax law. Under U.S. law, for income tax purposes, a resident is generally defined as an individual who either has a "green card" or is a resident because of the number of days spent in the United States.²⁶² For purposes of the estate tax, however, residence means domicile.²⁶³ If the Canadian taxpayer is a resident of the United States

255. See *supra* text accompanying notes 13-15.

256. U.S.-Can. Treaty, *supra* note 15, art. XXV, para. 10.

257. 1981 U.S. Model, *supra* note 7, art. 24, para. 1.

258. U.S.-Can. Treaty, *supra* note 15, art. XXV, para. 2.

259. U.S.-Can. Treaty, *supra* note 15, art. XXV, para. 10.

260. U.S.-Can. Treaty, *supra* note 15, art. XXV, para. 1.

261. U.S.-Can. Treaty, *supra* note 15, art. IV, para. 1.

262. IRC § 7701(b).

263. Treas. Reg. § 20.0-1(b)(1).

because he is domiciled in the United States, then all of his worldwide assets will be subject to U.S. estate tax and he will be entitled to the full estate tax credit, equivalent to a \$600,000 exemption.²⁶⁴ If, on the other hand, the taxpayer is a resident only within the meaning of the income tax provision, then he or she is not taxable on worldwide assets and is *not* entitled even to the benefit of a proportionate share of the \$600,000 exemption.²⁶⁵ In such cases, there may be some merit in some circumstances to the nondiscrimination contention. If a Canadian citizen resides outside of the United States, then under Article XXV(2) the contention would be unsuccessful since the United States applies the same rule with respect to nonresident aliens of all countries, regardless of their citizenship: discrimination no longer exists. It should be noted, however, that in 1990 the Code was amended to grant the proportionate credit to the extent required under a treaty obligation.²⁶⁶

Another recent controversy involving claimed discrimination arose under an amendment to the U.S. estate tax that disallowed the full marital deduction where the surviving spouse is not a U.S. citizen.²⁶⁷ As disturbing as this provision may be to couples where one or both of the spouses are not U.S. citizens, it is difficult to see how this change violates a nondiscrimination provision, since the estate tax is not technically imposed on the surviving spouse, but rather affects estates of decedents who were U.S. citizens as well as those who were not U.S. citizens.²⁶⁸ Thus, it is neither "other" or "more burdensome" to the taxpayer. However, Germany held up ratification of its new *income* tax treaty because it viewed the estate tax provision as giving rise to discriminatory treatment of German spouses as compared to U.S. spouses.²⁶⁹

IX. CONCLUSIONS

Neither the Treasury Department nor Congress seems to have a strong commitment to nondiscrimination despite the existence of a nondiscrimination provision in all modern U.S. tax treaties. In addition, while those provisions include rather sweeping terms, they appear to be read narrowly. Even Congress cannot be viewed as respecting nondiscrimination as a serious U.S. obligation, since it has recently, rather indiscriminately, overridden U.S. treaties in the process of expanding the level of U.S. taxation of foreign

264. See IRC §§ 2001(a); 2010(a).

265. See IRC §§ 2001(a); 2010(a); Treas. Reg. § 20.0-1(b)(1).

266. See IRC § 2102(c)(3)(A).

267. See IRC § 2056(d)(1)(A).

268. See H.R. Conf. Rep. No. 795, 100th Cong., 2d Sess. 592, 593 (1988).

269. See e.g., Mary Gael Timberlake, U.S. Treasury Department says Germany is Delaying Income Tax Treaty for Estate Tax Deal, Germany Blames U.S., 3 Tax Notes Int'l 375, 376 (April 1991).

taxpayers and their U.S. subsidiaries. Finally, in view of the recent suspension of the 1981 U.S. Model, it appears timely to suggest two approaches that may be more palatable to Congress and the Treasury Department.

Under the first approach, U.S. treaties would begin to incorporate the “most-favored nation” approach described above and now found in most of the treaties of Canada, Australia, and New Zealand. The most-favored nation approach would afford nationals (or enterprises) of any treaty country only treatment as favorable as the treatment afforded nationals of any *other* country.

The second approach would be to tailor the language of the nondiscrimination provisions more closely to the allowances that the U.S. should be ready to make. Under this approach, at a minimum, the language would permit different treatment reflecting reasonably different tax regimes applicable to foreign and foreign-owned taxpayers on the one hand and U.S. and U.S.-owned taxpayers on the other hand, to account for the fact that foreigners are not subject in the U.S. to worldwide taxation. In addition, this approach would require that the nondiscrimination provision set forth the types of comparison to apply, such as a source-jurisdiction comparison, and include a mechanism for the competent authorities to agree on interpretative guidelines to be applied under the nondiscrimination provision in both jurisdictions. If possible, that mechanism would apply to resolve disputes between competent authorities, if a treaty party asserts that the United States has overstepped its bounds in enacting new legislation.

The authors believe that it is time for the United States to decide which, if any, nondiscrimination principle it is willing to follow. They also believe that either approach suggested above would represent an improvement over the present “now-you-see-it-now-you-don’t” situation.

APPENDIX A

1981 U.S. Model Income Tax Treaty

Article 24

NON-DISCRIMINATION

1. Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected. This provision shall apply to persons who are not residents of one or both of the Contracting States. However, for the purposes of United States tax, a United States national who is not a resident of the United States and a ... national who is not a resident of the United States are not in the same circumstances.

2. For the purposes of this Convention, the term "nationals" means

- a) in relation to ...; and
- b) in relation to the United States, United States citizens.

3. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favorably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs, and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.

4. Except where the provisions of paragraph 1 of Article 9 (Associated Enterprises), paragraph 5 of Article 11 (Interest), or paragraph 4 of Article 12 (Royalties) apply, interest, royalties, and other disbursements paid by a resident of a Contracting State to a resident of the other Contracting State shall, for the purposes of determining the taxable profits of the first-mentioned resident, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. Similarly, any debts of a resident of a Contracting State to a resident of the other Contracting State shall, for the purposes of determining the taxable capital of the first-mentioned resident, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.

5. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.

6. The provisions of this Article shall, notwithstanding the provisions of Article 2 (Taxes Covered), apply to taxes of every kind and description imposed by a Contracting State or a political subdivision or local authority thereof.

APPENDIX B

1977 OECD Model

Article 24

NON-DISCRIMINATION

1. Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected. This provision shall, notwithstanding the provisions of Article 1, also apply to persons who are not residents of one or both of the Contracting States.
2. The term “nationals” means:
 - a) all individuals possessing the nationality of a Contracting State;
 - b) all legal persons, partnerships and associations deriving their status as such from the laws in force in a Contracting State.
3. Stateless persons who are residents of a Contracting State shall not be subjected in either Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of the State concerned in the same circumstances are or may be subjected.
4. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favorably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.
5. Except where the provisions of paragraph 1 of Article 9, paragraph 6 of Article 11, or paragraph 4 of Article 12, apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. Similarly, any

debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of such enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.

6. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.

7. The provisions of this Article shall, notwithstanding the provisions of Article 2, apply to taxes of every kind and description.