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The New United States Model Income Tax Convention

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1. Introduction

On 15 November 2006, the United States Treasury released its long-awaited new Model Income Tax Convention ("New Model"), which replaced the 1996 US Model ("Old Model"). This article reviews some of the major differences between the New and Old Models, as well as some of the major differences between the New Model and the current (2005) OECD Model Tax Convention. The article also discusses some new trends in US treaty policy which are not reflected in the New Model. The article concludes by evaluating the New Model in light of the emerging trend to use tax treaties not just to prevent double taxation, but also to combat double non-taxation.

2. Major Differences Between the New and Old Models

2.1. Arts. 1 and 2 – General scope and taxes covered

The New Model includes a new provision, Art. 1(6), that states that income derived through a fiscally transparent entity is considered to be derived by a resident only to the extent that the person taxable on the income is a resident. Art. 1(6) is based on the OECD Commentary on Art. 1 and denies treaty benefits to partnerships and other pass-through entities unless their partners are subject to tax as residents. Similar language was found in Art. 4(1)(d) of the Old Model.

Art. 2 (Taxes covered) of the New Model includes language in Art. 2(2) that defines income taxes as "all taxes imposed on total income, or on elements of income." Art. 2(1) states that the New Model applies to all taxes on income imposed irrespective of the manner in which they are levied. Both of these provisions track the OECD Model; neither is found in the Old Model.

2.2. Art. 3 – General definitions

Arts. 3(1)(d) and (e) of the New Model contain new definitions of "enterprise" and "business" which are required...
because of the deletion of Art. 14 (Independent personal services) of the Old Model. This is in line with the OECD Model.

2.3. Art. 4 – Resident

The main innovation in Art. 4 is found in the provision on dual resident companies. Under the Old Model (Art. 4(3)), if a company was resident in both contracting states, it was treated as resident in the state of incorporation. Thus, a company incorporated in the United States but managed and controlled in the United Kingdom was treated for treaty purposes as a US resident. This rule still applies under the New Model (Art. 4(4)), but in all other cases involving dual resident companies (e.g., companies treated as incorporated under the laws of both contracting states), if the competent authorities cannot agree, the company is to be treated as resident in neither state.

2.4. Art. 5 – Permanent establishment

The list of exclusions from the definition of permanent establishment (PE) in the New Model contains a provision (Art. 5(4)(f)) stating that a combination of the excluded activities also does not constitute a PE “provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character”. This language tracks the OECD Model and was missing from the Old Model.

2.5. Art. 6 – Income from real property

The definition of real property in Art. 6(2) of the New Model was expanded to include accessory items and mineral deposits. This is in line with the OECD Model and was missing from the Old Model.

2.6. Art. 7 – Business profits

The definition of business profits attributable to a PE in Art. 7(2) of the New Model refers to “profits derived from the assets used, risks assumed, and activities performed by the permanent establishment”. The Old Model (Art. 7(2)) referred only to the assets and activities. A separate protocol or note provides that the principles of the OECD Transfer Pricing Guidelines will apply for this purpose, in line with the trend to treat PEs more like subsidiaries.

In discussing the expenses of a PE, the New Model (Art. 7(3)) follows the OECD Model in referring only to executive and general administrative expenses. The New Model does not include the references in the Old Model to interest and to research and development.

2.7. Art. 8 – Shipping and air transport

The New Model reversed the standard regarding the taxation of container profits. Where Art. 8(3) of the Old Model awarded taxation to the residence state with respect to profits from containers “used in international traffic,” the New Model (Art. 8(3)) has struck the language regarding international traffic and awards exclusive taxation to the residence state with respect to all container profits “except to the extent that [the] containers are used for transport solely between places within the other Contracting State.”

2.8. Arts. 10, 11 and 12 – Dividends, interest and royalties

Arts. 10, 11 and 12 of the New Model conform to Arts. 10, 11 and 12 of the OECD Model by restricting the definitions of dividends (in Art. 10(5)), interest (in Art. 11(3)) and royalties (in Art. 12(2)) to the respective article, rather than applying the definitions to the Convention as a whole, as the Old Model had done.

New Model Art. 10 also includes a new paragraph, Art. 10(3), which exempts dividends from withholding tax in the source state if the beneficial owner is a pension fund not engaged in a trade or business. In addition, New Model Art. 10(4) has new language providing for a 15% withholding tax on dividends paid by US regulated investment companies (RICs) and some real estate investment trusts (REITs).

Art. 11(2) provides a broader exclusion for various types of contingent interest. Art. 11(2) further provides that the excluded interest may be taxed in the source state, but if the beneficial owner is a resident of the other state, the maximum rate of tax is 15%. The Old Model (Art. 11(5)) had a narrower list of exclusions.

In addition to the change mentioned above, Art. 12(2)(a) has been modified so that it is almost identical to Art. 12(2) of the OECD Model.

2.9. Art. 13 – Gains

New Model Art. 13(2) restricts the definition of “real property situated in the other Contracting State” to Art. 13, rather than applying it to the Convention as a whole, as the Old Model had done. New Model Art. 13(2)(c) replaced the Old Model phrase “equivalent interest in real property” with two subparagraphs that limit such an interest to non-publicly-traded shares and partnership or trust interests whose value arises from Art. 6 real property situated in the other contracting state.

2.10. Art. 14 – Income from employment

As mentioned above (see 2.2.), the New Model eliminated Old Model Art. 14 (Independent personal services), in line with the OECD Model. New Model Art. 14 tracks the language of Old Model Art. 15 with one exception: the term “fixed base” has been deleted.

3. The Old Model also contained a Convention-wide definition of business profits in Art. 7(7). That definition has been deleted in the New Model.
4. Asterisk (*) to Art. 7(3) of the New Model.
6. The 2006 Technical Explanation, supra note 1, cites the definition of contingent interest in US Internal Revenue Code (IRC) Sec. 871(h)(4) in its discussion of Art. 11.
7. The only difference is that the New Model retains the Old Model phrase “literary, artistic, scientific or other work” instead of using the OECD Model phrase “literary, artistic or scientific work.”
2.11. Art. 16 – Entertainers and sportsmen
New Model Art. 16(2) changed the standard for source-state taxation of funds received by a third party. The Old Model standard was the beneficial enjoyment of the underlying income by the entertainer/sportsman or a related party. The New Model standard is the lack of free agency by the third party with respect to designating the individual whose services generated the income.

2.12. Art. 17 – Pensions, social security, annuities, alimony and child support
New Model Art. 17 differs from the parallel provision, Art. 18, in the Old Model in three ways. First, Art. 17(1)(a) deleted the residence-state offset for taxation by the non-residence state. Second, new Art. 17(1)(b) added a reciprocal exemption: a pension that would be non-taxable when paid to a resident of one contracting state is also non-taxable in the other contracting state if the recipient relocates there. Third, in light of new Art. 18 (Pension funds), most of Art. 17(6) has been deleted.

2.13. Art. 18 – Pension funds
New Model Art. 18 rearranged the provisions of Old Model Art. 18(6) and expanded one of them significantly. Old Model Art. 18(6) provided three benefits: (a) cross-deductibility of pension contributions, (b) tax exemption of pension plan earnings until distribution, and (c) exemption of rollovers and transfers between plans.

These three benefits were subject to three limitations. First, an individual’s participation in the plan must have predated his arrival in the other state; second, the plan must have been comparable to pension plans in the other state; and third, the effect of the treaty provisions may not have been more favourable than the benefits otherwise accorded by the other state.

New Model Art. 18(2) incorporates the first of these benefits – cross-deductibility of contributions – along with all three limitations and expands it to include contributions made by or on behalf of a US citizen to a pension plan established in the other state. Art. 18(1) duplicates the second benefit in Old Model Art. 18(6) – tax exemption of plan earnings until distribution – but without the three limitations. The third benefit – exemption of rollovers and transfers – is not included in New Model Art. 18, but, as noted, it falls within the ambit of new Art. 17(1)(b).

The addition of new Art. 18 of the New Model offsets the mismatch created by the deletion of Old Model Art. 14, and Arts. 19 to 29 of the New Model address the same issues as the similar articles of the Old Model. New Model Art. 19 contains several conforming changes, but only one significant addition – in Art. 19(3): to the extent income is received from a “business carried on by a Contracting State” or a political subdivision, that income is governed, not by Art. 19, but by Art. 14, 15, 16 or 17.

2.15. Art. 20 – Students and trainees
New Model Art. 20 contains two new paragraphs. Art. 20(2) allows students and business trainees to earn USD 9,000 or the foreign equivalent per year tax free. The 2006 Technical Explanation of Art. 20 states that this amount is “intended to equalize the position of a U.S. resident who is entitled to the standard deduction and the personal exemption with that of a student who files as a non-resident alien and therefore does not [qualify for these offsets].”

Art. 20(3) provides two definitions of “business trainee.” One definition, in New Model Art. 20(3)(a), is for individuals who lack the qualifications to practise a profession or professional specialty and therefore would encompass those formerly referred to as apprentices. The second definition, in New Model Art. 20(3)(b), applies to those who have already met the entry-level requirements for their work and are “acquiring technical, professional, or business experience” from a person unrelated to the foreign employer.

2.16. Art. 22 – Limitation on benefits
New Model Art. 22(1) is grammatically reframed in the negative: instead of the Old Model language “a resident ... shall be entitled to benefits ... only to the extent provided in this Article,” the New Model says “[e]xcept as otherwise provided in this Article, a resident ... shall not be entitled to the benefits of this Convention ... unless ...”

New Model Art. 22(2) contains several changes. First, in the front language, the per se beneficiaries of the New Model are cumulatively termed “qualified persons.” Next, Art. 22(2)(d) allows benefits for pension funds and tax-exempt organizations only if more than 50% of their beneficiaries, members or participants are individuals resident in either Contracting State. Finally, Arts. 22(2)(c) and (d) introduce new terms, including “principal class of shares,” “disproportionate class of shares,” and “primary place of management.”

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8. Art. 17(1)(b) is a modified version of the exemption provision suggested in Para 23 of the Commentary on Art. 18 of the OECD Model.
9. This provision duplicates Art. 18(6)(c) of the Old Model with respect to rollovers and transfers between pension plans, but it provides a new benefit for other non-taxable distributions, such as those from a Roth IRA (individual retirement account). See 2006 Technical Explanation, supra note 1, regarding Art. 17.
10. The provisions of Old Model Art. 18(6)(b) are included and revised in New Model Art. 18(1).
11. New Model Art. 18(4)(c) contains a provision that prevents “double-up,” contributions to or benefits accrued under a non-US pension fund are treated as US contributions/benefits for purposes of determining an individual’s eligibility to participate in and receive tax benefits from a US plan.
12. This new provision is patterned closely after Art. 20(3) of the OECD Model.
13. This amount is to be revised every five years by the competent authorities. See note 25, infra.
14. The term “apprentice” has been deleted from Art. 20, but this definition of “business trainee” is broad enough to bring apprentices within its ambit. See e.g. Rev. Rul. 73-19, 1976-1 C.B. 441 (stating, with respect to the 1942 United States–Canada treaty, that “[i]n the ordinary sense an apprentice is a person who serves another for a specific time in order to learn some art, trade, profession or business. He must be considered a beginner or inexperienced person who is gaining basic experience by practicing under skilled workers’); and Rev. Rul. 66-386, 1966-2 C.B. 566 (stating, in interpreting the United States–South Africa treaty, that “an apprentice must be considered to be a beginner or inexperienced person who is gaining basic experience by practicing under skilled workers”).
15. Cf. Art. 22(2) of the OECD Model: “A resident of a Contracting State is a qualified person for a fiscal year only if ...”
and control”. These terms are defined in Arts. 22(5)(b) to (d).

There are three significant changes in New Model Art. 22(3). First, the Old Model safe harbor for a substantial trade or business has been deleted, leaving substantiality to be determined solely on a facts and circumstances basis. Second, while the “connected with or incidental to” requirements in Old Model Art. 22(3)(a)(ii) are retained in New Model Art. 22(3)(a), the Old Model definitions of those requirements in Art. 22(3)(d) have been deleted. That throws their meaning back to Art. 3(2), the domestic law catchall. Third, a look-through provision has been added to Art. 22(3)(c) for “activities conducted by persons connected to a person.” “Connection” is determined by a facts and circumstances control standard, with possession of a 50% or greater beneficial interest usually being sufficient.

2.17. Art. 23 – Relief from double taxation

There are two significant changes in New Model Art. 23 (Relief from double taxation). First, it discards entirely Old Model Art. 23(2), which provided only a credit method for double taxation relief for US treaty partners, and substitutes a new paragraph, Art. 23(1), that can be customized for a credit method, exemption method or a combination of the two. Second, the New Model added a new paragraph, Art. 23(3), according to which, for double taxation purposes, any income of a US resident that the treaty partner taxes is sourced to the treaty partner.

2.18. Art. 24 – Non-discrimination

New Model Art. 24(1) contains a new concluding sentence making it clear that “for purposes of United States taxation, United States nationals who are subject to tax on a worldwide basis are not in the same circumstances as nationals of ____ who are not residents of the United States”. This addition is not a new provision but rather an explication of the phrase in Old Model Art. 24(1) “particularly with respect to taxation on worldwide income”, which has been deleted from the New Model.16

2.19. Arts. 26 and 28 – Exchange of information and administrative assistance, entry into force

New Model Art. 26 reorganized the provisions of Old Model Art. 26 substantially, but it contains only two new provisions. First, Art. 26(5) specifically overrides Art. 26(3), so that a contracting state’s bank secrecy laws can no longer be invoked pursuant to Art. 26(3)(c) to override the state’s obligations under Art. 26(1). Second, in the new final paragraph, the competent authorities are authorized to develop agreements on the implementation of Art. 26.17 According to the 2006 Technical Explanation of Art. 26, these agreements could include such matters as procedures and timetables for the regular exchange of information and minimum thresholds for the tax at stake.

New Art. 28(3) of New Model Art. 28 provides that the provisions of Art. 26 shall go into effect on the date that the instruments of ratification are exchanged.

3. Major Differences Between the New Model and OECD Model

In many articles, the New Model carries forward without change the differences between the Old Model and the OECD Model. Rather than assuming (or hoping) that readers remember the pre-New Model differences, the summaries below include all significant differences between the New Model and the OECD Model and note the instances in which the distinctions trace back to the Old Model.

3.1. Arts. 1 and 2 – General scope and taxes covered

OECD Model Art. 1 provides only: “This Convention shall apply to persons who are residents of one or both of the Contracting States.” The New Model carries forward, with some modification, five Old Model additions to Art. 1:

– addition of language to Art. 1(1) restricting the application of the Convention “only” to residents of the contracting states “except as otherwise provided”;

– a prohibition on restricting the benefits available under the laws or other treaties of the contracting states;

– two GATS (General Agreement on Trade in Services) exceptions to that prohibition;

– a saving clause; and

– a list of exceptions to the saving clause.

As mentioned above (see 2.1.), the New Model added new Art. 1(6) (regarding income derived through a fiscally transparent) which is based on the OECD Commentary on Art. 1 and denies treaty benefits to partnerships and other pass-through entities unless their partners are subject to tax as residents.

Regarding Art. 2 (Taxes covered), the New Model follows the four paragraphs of the OECD Model with the following three modifications:

– in Arts. 2(1) and (2), Art. 2 omits the references to taxes on capital and capital appreciation;

– in Art. 2(2), Art. 2 omits, as an example of the taxes covered by the Convention, “taxes on the total amounts of wages or salaries paid by enterprises”; and

– in Art. 2(3)(b), Art. 2 defines the “existing taxes” of the United States to which the Convention applies.
3.2. Art. 3 – General definitions

New Model Art. 3 follows the general outline of the parallel article in the OECD Model with eight significant additions and modifications, some of which were already present in the Old Model. The eight significant changes are:

(a) In Art. 3(1)(a), the definition of “person” is expanded to include “an estate, a trust, [and] a partnership” (also in Old Model Art. 3(1)(a)).

(b) In Art. 3(1)(b), the definition of “company” as “any body corporate or any entity that is treated as a body corporate for tax purposes” is qualified by addition of the words “according to the laws of the state in which it is organized” (also in Old Model Art. 3(1)(b)). Thus, if a non-US entity that does not satisfy the expanded definition elects, for US tax purposes, to be treated as a corporation,18 the entity would not qualify as a “company” unless it could make a similar election in the state in which it was organized.

(c) In Art. 3(1)(c) (Art. 3(1)(d) of the OECD Model), the terms “enterprise of a Contracting State” and “enterprise of the other Contracting State” are expanded to include “an enterprise carried on by a resident of a Contracting State through an entity that is treated as fiscally transparent in that Contracting State” (also in Old Model Art. 3(1)(c)).

(d) In Art. 3(1)(f) (Art. 3(1)(e) of the OECD Model), the portion of the definition of “international traffic” which refers to the place of effective management of an enterprise operating a ship or aircraft is omitted (also in Old Model Art. 3(1)(d)).

(e) In Art. 3(1)(h), the New Model inserts a placeholder for the definition of a new term (the Old Model did this in Art. 3(1)(g)).

(f) In Art. 3(1)(i), the New Model duplicates the definition of “United States” in Old Model Art. 3(1)(f).

(g) In new Art. 3(1)(k), the New Model inserts a definition of “pension fund”, which complements the initial appearance in the New Model of Art. 18 (Pension funds).

(h) In Art. 3(2), the New Model inserts language, as did Old Model Art. 3(2), allowing the competent authorities to agree on a common meaning of any term not defined in the Convention pursuant to Art. 25 (Mutual agreement procedure).

3.3. Art. 4 – Resident

New Model Art. 4 tracks closely the structure of OECD Model Art. 4. The New Model alters Art. 4(1), as did Old Model Art. 4(1), by adding “citizenship” and “place of incorporation” to the bases for taxation that identify a person as a resident. New Model Art. 4(1) excludes from the definition of “resident”, as did Old Model Art. 4(1), persons liable to tax in a state only in respect of “profits attributable to a permanent establishment.”

The New Model contains a new paragraph, Art. 4(2), that added pension funds and various tax-exempt organizations to the definition of resident. In Art. 4(4) (Art. 4(3) of the OECD Model), the New Model substitutes “place of creation/organization” for the OECD Model “place of effective management” tie-breaker for dual resident companies (Old Model 4(3) made the same substitution). In Art. 4(4), the New Model also addresses for the first time the problem of companies that are considered created or organized under the laws of both contracting states. In such a case, the competent authorities are to “endeavor to determine the mode of application of the Convention to such a company.” If they fail to reach an agreement, the company in question is not treated as a resident of either state.

The New Model added a catch-all provision, Art. 4(5), requiring the competent authorities to endeavour to determine the residence of any person other than an individual or a company that, by reason of the provisions of Arts. 4(1) and (2), is a resident of both contracting states (Old Model Art. 4(5) contained the same catch-all provision). Unlike the new parallel provision for dual resident companies, no predetermined status results if the competent authorities fail to reach an agreement.

3.4. Art. 5 – Permanent establishment

New Model Art. 5 has only one substantive difference vis-à-vis the parallel provision (Art. 5) in the OECD Model. Art. 5(3) of the OECD Model provides special temporal rules for determining whether a “building site or construction or installation project” becomes a PE. New Model Art. 5(3) duplicates the Old Model in broadening the reach of the rules to provide that “an installation or drilling rig or ship used for the exploration of natural resources” also qualifies as a PE if it or the “exploration activity” continues for more than the specified 12-month period.

3.5. Art. 6 – Income from real property

The New Model changes the OECD Model term “immovable property” to “real property” throughout Art. 6, but its main distinction lies in Art. 6(5), which allows a resident to make a binding, one-time election to compute tax on income from real property “on a net basis as if such income were business profits attributable to a permanent establishment.” This provision is carried forward from Art. 6(5) of the Old Model.

3.6. Art. 7 – Business profits

New Model Art. 7(2) adds a definition of “business profits attributable to a permanent establishment” to Art. 7(2) of the OECD Model by saying that they “shall include only the profits derived from the assets used, risks assumed, and activities performed by the permanent establishment.”

With respect to Art. 7(3) of the OECD Model, which addresses the allocation of expenses incurred elsewhere to a PE, the New Model provides language for a separate protocol or note that states that the principles of the OECD Transfer Pricing Guidelines should apply for this purpose. See 2.6.

The New Model does not contain a provision comparable to OECD Model Art. 7(4), which allows apportioning the total profits of an enterprise to a PE, because the arm’s length standard incorporated in New Model Arts. 7(2) and (3) allow the use (by analogy) of any of the methods in the OECD Transfer Pricing Guidelines, including the profits methods. 19

Finally, the New Model follows the pattern of Old Model Art. 7(7) in adding a new paragraph, Art. 7(7), to the OECD Model article which allows for taxing some of a PE’s income “even if the payments are deferred until such permanent establishment has ceased to exist”.

3.7. Art. 8 – Shipping and air transport

The New Model contains the same changes to OECD Model Art. 8 as the Old Model. The portions of OECD Art. 8 that address inland waterways transport enterprises are deleted; taxation in the state of effective management is replaced with taxation in the enterprise’s residence state; non-exclusive examples are provided for profits from the operation of ships or aircraft; and there are special rules regarding profits from the use, maintenance or rental of containers.

3.8. Art. 10 – Dividends

New Model Art. 10 modifies the limitations in OECD Model Art. 10(2) on source-state taxation with two additional paragraphs. New Model Art. 10(3) totally exempts pension funds not engaged in a trade or business from source-state taxation.

New Model Art. 10(4)(a) first denies both US RICs and REITs the 5% rate in Art. 10(2)(a). Then, just for REITs, it goes further, allowing them access to the 15% rate in Art. 10(2)(b) and the pension fund exemption in Art. 10(3), but only if one of three conditions is met: (a) a maximum 10% interest in the REIT by a beneficial owner who is an individual or pension fund; (b) a maximum 10% interest in a diversified REIT by any person; or (c) a maximum 5% interest in a REIT by any person if the dividend is paid on publicly-traded shares. The term “diversified REIT” is defined in New Model Art. 10(4)(b).

New Model Art. 10(6) replicates the PE provision in OECD Model Art. 10(4), but with one curious and probably inconsequential exception. OECD Model Art. 10(4) first sets aside both Art. 10(1), which allows residence-state taxation of the recipient, and Art. 10(2), which limits source-state taxation. New Model Art. 10(6) first sets aside Arts. 10(2) through (4), all of which address limitations on source-state taxation, but it leaves Art. 10(1), which is virtually the same as the OECD Model, in play. This difference is probably inconsequential because New Model Art. 10(6), like OECD Model Art. 10(4), ends by invoking the provisions of Art. 7 (Business profits) for situations to which Art. 10(6) applies, and Art. 7 does not restrict residence-state taxation. 20

Finally, New Model Art. 10(7) follows OECD Model Art. 10(5) in prohibiting a “secondary” dividend withholding tax, 21 but it reverses the OECD prohibition on taxes on a corporation’s undistributed profits by specifically allowing the branch profits tax (limited to 5%), which New Model Art. 10(8) carries forward from Old Model Art. 10(8).

3.9. Art. 11 – Interest

OECD Model Art. 11(1) allows the residence state of the beneficial owner to tax cross-border payments of interest. In contrast to the OECD Model, New Model Art. 11(1) assigns exclusive taxing rights to the residence state, as did Old Model Art. 11(1). Like the Old Model, the New Model also omits Art. 11(5) of the OECD Model, which provides general source rules, in line with the observation in the OECD Commentary that the exclusive right to tax by the residence state makes source irrelevant. 22

Art. 11(2) of the New Model makes two changes to the parallel paragraph in the OECD Model. First, it limits the source-state taxation authorized by OECD Model Art. 11(2) to certain types of contingent interest and to REMIC (real estate mortgage investment conduit) excess inclusions. Second, it changes the stated maximum tax rate from 10% to 15%. (Compare Art. 11(2) of the New Model with Art. 11(2)(a) of the OECD Model.)

New Model Art. 11(3) added a catch-all provision to the definition of interest in OECD Model Art. 11(3). New Model Art. 11(3) also provides that income addressed by Art. 10 (Dividends) and penalty charges for late payments are not considered interest for purposes of the entire Convention. The OECD Model does not address dividend income in this regard, and OECD Model Art. 11(3) exempts late fees from being considered interest only for purposes of Art. 11, not the Convention as a whole.

3.10. Art. 12 – Royalties

New Model Art. 12(2)(a) alters the text of the parallel provision in the Old Model so that it is almost identical to OECD Model Art. 12(2). 23 Like the Old Model, the New Model also added Art. 12(2)(b) which includes any “gain derived from the alienation of any property described in subparagraph a)” in the definition of “royalties” to the extent the gain is “contingent on the productivity, use, or disposition of the property”.

3.11. Art. 13 – Gains

New Model Art. 13 makes three important changes to the parallel article in the OECD Model. First, in Art. 13(2), it provides an expanded definition of real/immovable property rather than just referring back to Art. 6, as does OECD
Model Art. 13(1). Next, in Art. 13(3), it substitutes residence for the "place of effective management" as a jurisdictional predicate for certain gains. Finally, in Art. 13(5), it added a special provision regarding gains from the alienation of "containers", a term that includes "trailers, barges and related equipment for the transport of containers".

3.12. Art. 14 – Income from employment

As mentioned above, the New Model follows the OECD Model in eliminating Old Model Art. 14 (Independent personal services). New Model Art. 14 tracks the language of OECD Model Art. 15 with four exceptions, two of which are relatively minor, i.e. substitution of the term "taxable year" for "fiscal year" (New Model Art. 14(2)(a)) and deletion of the provision addressing a "boat engaged in inland waterways transport" (New Model Art. 14(3)).

The two more significant differences are both in Art. 14(3), and they overlap. The first is that the New Model sharply circumscribes the ability of the non-residence state to tax income from employment on a ship or aircraft operated in international traffic. The OECD Model allows the non-residence state to tax any and all employment that is "exercised aboard" a ship or aircraft addressed by Art. 15(3). New Model Art. 14(3), on the other hand, allows the non-residence state to tax only if the recipient is not a "member of the regular complement" of the vessel or plane. All those employed by the shipping or air transport company are subject to tax only in their residence state.24 The 2006 Technical Explanation of Art. 14 provides that "the term 'regular complement' is intended to clarify that a person who exercises his employment as, for example, an insurance salesman while aboard a ship or aircraft is not covered by this paragraph."

The second substantive difference pertains to the state entitled to tax the income addressed by Art. 14(3). As noted, regarding crew members, New Model Art. 14(3) limits taxation to their residence state. Under OECD Model Art. 15(3), however, both crew and non-crew remuneration can be taxed "in the Contracting State in which the place of effective management of the enterprise is situated".

3.13. Art. 15 – Directors' fees

Like Old Model Art. 16, New Model Art. 15 is narrower than the parallel provision in the OECD Model (Art. 16) because it allows source-state taxation of fees and other compensation paid to non-resident directors only if the income results from services rendered in the source state.

3.14. Art. 16 – Entertainers and sportsmen

Like the Old Model, the New Model deviates from the parallel provision in the OECD Model (Art. 17) by adding exceptions to application of the article. Art. 16(1) contains (as did Old Model Art. 17(1)) a de minimis exception of USD 20,000 per year or the equivalent in the treaty partner's currency. Art. 16(2) excepts income received by a third party if the third party had "free agency" in deciding who performed the personal activities that resulted in the income.

3.15. Art. 17 – Pensions, social security, annuities, alimony and child support

As was the case with Old Model Art. 18, New Model Art. 17 accepts the standard of residence-state taxation in OECD Model Art. 18, but added provisions addressing social security, annuity, alimony and child support payments. Art. 17 also added a new provision, Art. 17(1)(b), suggested by Para. 23 of the OECD Commentary on Art. 18, which mandates a reciprocal exemption when a pension that would be exempt in the source state is paid to a resident of the other contracting state.

3.16. Art. 18 – Pension funds

New Model Art. 18 has no parallel in the OECD Model. Arts. 18(2) and (3), however, adapt the cross-border deductibility of contributions modelled in Para. 37 of the OECD Commentary on Art. 18, and Art. 18(4) inverts these provisions to insure that a US citizen's participation in a non-US pension fund is accompanied by appropriate US tax deductions and exclusions.

3.17. Art. 19 – Government service

New Model Art. 19 varies slightly from the OECD Model in three significant respects. First, it specifically notes that Art. 19(1), which addresses government salaries, wages and other remuneration, controls in the event of a conflict with Art. 14, 15, 16 or 20. Second, in Art. 19(2), which addresses government pension payments, Art. 19 alters the front language so that it specifically overrides the provision in Art. 17(1) for exclusive taxation in the residence state.

Finally, the New Model clarifies Art. 19(2)(a), which sets out the general rule for taxing government pensions, by excluding social security payments from its scope. That exclusion is not significant for the general rule because both social security payments and government pensions are subject only to source-state taxation. It does, however, insure that the exception to the general rule in Art. 19(2)(b), which provides for residence-state taxation under certain circumstances, cannot be misunderstood to apply to social security payments.

3.18. Art. 20 – Students and trainees

New Model Art. 20 is considerably broader than the parallel provision (Art. 20) in the OECD Model. First, New Model Art. 20(1) allows the state where the student or trainee is located to tax "compensation for personal services". This provision applies even if the compensation meets the other criteria for exclusion but, as mentioned above, it is subject to an annual exclusion of USD 9,000 or the foreign equivalent.25

24. This policy and the use of the term 'regular complement' are carried forward from Old Model Art. 15.

25. New Model Arts. 20(1) and (2). The competent authorities of the contracting states are required to adjust the amount of the exclusion every five years "to take into account changes in the US personal exemption and the standard deduction", both of which are indexed. Regarding the purpose of the exclusion amount, see 2.15, first paragraph, quoting from the 2006 Technical Explanation of Art. 20.
Second, New Model Art. 20(1) limits the tax holiday for business trainees to a one-year period, but excludes students from this limitation.

Third, New Model Art. 20 adopts "business trainee" as a substitute for "business apprentice" and provides two definitions of "business trainee." They are explained in 2.15.

3.19. Art. 21 – Other income

New Model Art. 21 omits the OECD references to "recipients" of income and income "of" a resident and substitutes for them the concepts of "beneficial owner" and "beneficial ownership." According to the 2006 Technical Explanation of Art. 21, the purpose is:

merely to make explicit the implicit understanding in other treaties that the exclusive residence taxation provided by paragraph 1 applies only when a resident of a Contracting State is the beneficial owner of the income. Thus, source taxation of income not dealt with in other articles of the Convention is not limited by paragraph 1 if it is nominally paid to a resident of the other Contracting State, but is beneficially owned by a resident of a third State. However, income received by a nominee on behalf of a resident of that other State would be entitled to benefits.

The term "beneficially owned" is not defined in the Convention, and is, therefore, defined as under the internal law of the country imposing tax (i.e., the source country). The person who beneficially owns the income for purposes of Article 21 is the person to whom the income is attributable for tax purposes under the laws of the source State.”

3.20. Art. 22 – Limitation on benefits

The OECD Model does not contain a limitation on benefits article. However, Para. 20 of the OECD Commentary on Art. 1 does contain suggested language for such an article ("OECD article"), and New Model Art. 22, while it follows the general outline of that language, deviates in several respects.

First, and least important, New Model Art. 22(1) is grammatically reframed in the negative, but its import is left unchanged. Next, in New Model Art. 22(2), as in Art. 14, the term "taxable year" is substituted for "fiscal year".

More significantly, the "disproportionate class of shares" provision in Para. 4 of the OECD article is moved to Art. 22(2)(c) and broadened. Under Para. 4, if a company has a class of shares that participates disproportionately in the company's income, treaty benefits are not extended to the disproportionate part of the income if 50% or more of those shares (measured by voting power and value) are owned by persons who are not "qualified persons" under Para. 2 (of the OECD article).

Under New Model Art. 22(2)(c)(i), a publicly-traded company that has one or more disproportionate classes of shares may nevertheless be a qualified person, regardless of the ownership of those shares, if the shares are regularly traded on one or more recognized stock exchanges and either a 'principal class of shares' or a 'primary place of management and control' test is satisfied. (These terms are defined in Art. 22(5), see below.) For US purposes, "regularly traded" means that at least 10% of the average number of outstanding shares are traded during the taxable year and that more than de minimis quantities of those shares are traded on 60 or more days. For subsidiaries of public companies, however, the OECD suggested 50% requirement is imposed and, according to New Model Art. 22(2)(c)(ii), that 50% must be held, directly or indirectly, by five or fewer companies that are qualified persons under Art. 22(2)(c)(i). Art. 22(2)(c)(ii) further provides: "[I]n the case of indirect ownership, each intermediate owner [must be] a resident of either Contracting State."

Art. 22(2)(e) of the New Model contains the same ownership and base erosion prongs as its counterpart in the OECD article, but it adds and subtracts from each. The OECD ownership prong requires direct or indirect ownership by certain qualified persons of at least 50% of the shares by vote and value on at least half the days of the year. The New Model, in Art. 22(2)(e)(i), includes these provisions but adds the following bells and whistles:

(a) the ownership of the Art. 22(2)(e) "person other than an individual" can be either via shares or via beneficial interests;
(b) where the OECD article would allow ownership by qualified persons of either treaty state, the New Model requires that the they be residents of the same state as the Art. 22(2)(e) person; and
(c) in the case of indirect ownership, the requirement of same-state residence applies to each intermediate owner.

The OECD/Art. 22(2)(e)(ii) base erosion prong requires that less than 50% of the entity's gross income be paid or accrued to persons who are not residents of either treaty state in the form of payments that are deductible for tax purposes. Exceptions are arm's length payments in the ordinary course of business for services or tangible property and payments in respect of financial obligations to a bank or PE of a bank in one of the treaty states. New Model Art. 22(2)(e)(ii) makes three changes to these provisions:

(a) it accepts the arm's length exception, but omits the bank payments exception;
(b) it adds a "residence state" provision for determining gross income; and
(c) it expands the class of base erosion recipients from "persons who are not residents of either Contracting State" to "persons who are not residents of either Contracting State entitled to benefits under [subparagraph 2(a), (b), (c)(i) or (d)]".

The active trade or business provisions in Para. 3 of the OECD article are incorporated into the New Model (Art. 22(3)) with the minor addition of "beneficial equity interest[s]" as an alternative to shares of a company.

The provision for competent authority override in Para. 5 of the OECD article is adopted in Art. 22(4) of the New Model with minor alterations.

27. See 2006 Technical Explanation, supra note 1, regarding Art. 22.
Finally, Art. 22(5), which in the OECD article contains little more than placeholders for the names of stock exchanges, is expanded in the New Model to include the definitions of “principal class of shares,” “disproportionate class of shares” and “primary place of management and control.”

3.21. Art. 23 – Relief from double taxation

The OECD Model has two separate versions of Art. 23: one to implement an exemption method for avoiding double taxation, and another to implement a credit method. New Model Art. 23 straddles the fence. Art. 23(1), which addresses the treaty partner’s double taxation relief scheme, is blank and therefore can be customized for a system based on the credit method, the exemption method or a variant in between. Art. 23(2), which addresses double taxation relief for US citizens and residents, implements a credit method (as did Old Model Art. 23(1)). New Model Art. 23(3) assists the implementation of Art. 23(2) by providing that, for double taxation purposes, any income of a US resident that is taxed by the treaty partner is sourced to the treaty partner. Like Old Model Art. 23(3)(a), New Model Art. 23(4)(a) insures that a US treaty partner does not have to give larger tax credits to US citizens who are residents of that country (due to the imposition of US tax on their worldwide income) than it does to non-US citizen/residents who have US-source income. Arts. 22(4)(b) and (c) resolve the US tax complications created by the Art. 4(a) regime (as did Old Model Arts. 23(3)(b) and (c)).

3.22. Art. 24 – Non-discrimination

New Model Art. 24 follows the OECD Model fairly closely with six differences. First, in Arts. 24(1) and (5), it follows the Old Model (Arts. 24(1) and (4)) by deleting the OECD requirement that nationals of the other contracting state not be subjected to taxation that is “other than” the taxation applied to nationals. According to the 2006 Technical Explanation of Art. 24, the rationale for the deletion is that “the only relevant question ... should be whether the requirement imposed on a national of the other Contracting State is more burdensome. A requirement may be different from the requirements imposed on U.S. nationals without being more burdensome.”

Second, and also in Art. 24(1), the New Model clarifies the phrase “in the same circumstances” by adding the following concluding sentence to Art. 24(1): “However, for purposes of United States taxation, United States nationals who are subject to tax on a worldwide basis are not in the same circumstances as nationals of ______ who are not residents of the United States.”

Third, like Old Model Art. 24(2), New Model Art. 24(2) deletes the opening sentence in Art. 24(2) of the OECD Model, which addresses stateless persons.

Fourth, the New Model applies the rule in Art. 24(3), i.e. that a contracting state is not required to grant to non-residents the personal allowances and reliefs that it grants to its residents, with respect to both Arts. 24(1) and (2), rather than only to Art. 24(2).28

Fifth, although the New Model replaces the OECD term “enterprise” in Art. 24(4) with “resident,” the 2006 Technical Explanation uses both terms interchangeably in discussing Art. 24(4).29

Finally, the New Model adds a new paragraph, Art. 24(6), that overrides the remainder of the article, if necessary, to allow the imposition of a branch profits tax (under New Model Art. 10(8)) by either treaty partner. See Old Model Art. 24(5).

3.23. Art. 25 – Mutual agreement procedure

The New Model expanded the mutual agreement procedure in the OECD Model in four ways. First, in Art. 25(1), the New Model eliminated both the three-year statute of limitations in the OECD Model for presenting a case to the relevant competent authority and any domestic time limit that might apply to a claim for a refund. Second, also in Art. 25(1), the New Model allows a taxpayer to bring its case to the attention of either competent authority, not just the competent authority of the state of which it is a resident or national. Third, in Art. 25(2), the New Model specifically suspends domestic assessment and collection proceedings while the case is pending and provides for implementation of the agreement reached by the competent authorities “notwithstanding any time limits or other procedural limitations in the domestic law.” Fourth, in Arts. 25(3) and (4), the New Model details particular problems that competent authorities are specifically authorized to address, including allocation of income and deductions; attributions from an enterprise to its PE; settlement of characterization, timing and definitional issues; advance pricing agreements; application of domestic penalties, fines and interest; and adjustment of specific monetary amounts referred to in the Convention. With regard to all of these provisions, the New Model follows Old Model Art. 25.

3.24. Art. 26 – Exchange of information and administrative assistance

New Model Art. 26 tracks closely the five paragraphs of OECD Model Art. 26.30 It then added four more paragraphs, three of which address issues relating to collection and the evidence that may be needed to pursue collection efforts. Art. 26(6) provides for production of information in the form of depositions and “authenticated copies of unedited original documents.” Art. 26(7) requires collection assistance in the case of third parties who are not entitled to treaty benefits. Art. 26(8) allows representatives of one country to enter the other to conduct voluntary interviews.

28. As part of expanding the rule, the exception regarding personal allowances and reliefs is moved to a separate paragraph. See New Model Art. 24(3). Cf Old Model Art. 24(2).

29. See 2006 Technical Explanation, supra note 1, regarding Art. 24: “When a resident or an enterprise of a Contracting State pays interest, royalties or other disbursements to a resident of the other Contracting State; the first-mentioned Contracting State must allow a deduction ...”

30. New Model Art. 26(1) added the following examples of information addressed by the article: “information relating to the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, [the domestic taxes of the treaty partners].”
and examinations of books and records. These three paragraphs modify similar paragraphs in Old Model Art. 26.

The final additional paragraph authorizes the competent authorities to develop agreements for implementing the article. According to the 2006 Technical Explanation of Art. 26, these agreements could include such matters as procedures and timetables for the regular exchange of information and minimum thresholds for the tax at stake.

3.25. Arts. 28 and 29 – Entry into force and termination

New Model Art. 28 varies from the parallel provision, Art. 30, in the OECD Model in two ways. First, rather than describing the effect of the entry into force in each contracting state, New Model Art. 28(2) sets one timetable for applying the treaty to taxes withheld at source (the first day of the second month after entry into force) and a second timetable for applying the treaty to all other taxes (the first day of January next following the entry into force). Second, new Art. 28(3) provides that, notwithstanding the two timetables for taxes, Art. 26 will go into effect on the date of entry into force, “without regard to the taxable period to which the matter relates”.

New Model Art. 29 varies from the parallel provision, Art. 31, in the OECD Model in two ways. First, Art. 29 omits the limitation in the OECD language regarding when notice of termination can be given. Second, like Art. 28, Art. 29 sets separate timetables for applying the termination to taxes withheld at source (six months after termination) and to all other taxes (taxable periods that begin six months or later after termination).


As indicated above, the differences between the Old and New Models are not very dramatic and mostly indicate the need to update the Old Model to reflect changes in the OECD Model and in US treaty policy since 1996. There are, however, two areas in which actual US treaty policy was recently changed in significant ways, but which are not reflected in the New Model: the treatment of direct dividends and dispute resolution.

4.1. Direct dividends

In the recent treaty with the United Kingdom, the United States deviated from its historic policy of requiring a 5% withholding tax on direct dividends (i.e. dividends to shareholders that control at least 10% by vote of the payer). Instead, the US negotiated a zero rate for direct dividends paid to controlling corporate shareholders (holding over 80% of the voting shares of the payer).

The US policy on treaty dividends has always been somewhat incongruous. Why insist on levying a withholding tax on dividends that are not deductible while allowing a zero rate on both interest and royalties (which are deductible) and exempting capital gains (which reflect the same underlying earnings as a dividend)? Until 2003, the rationale was that the US persisted in maintaining the classical system of taxing domestic shareholders, so that corporate income distributed in the form of dividends was subject to double taxation. Since 2003, however, the US has followed most other industrialized countries in adopting a partial integration regime by taxing dividends (including most dividends from foreign corporations) at a reduced rate. Thus, it makes sense for the US to now move toward reducing its tax on outbound dividends as well.

This is particularly true for direct dividends. Under the New Model, portfolio dividends are subject to a nominal rate of 15%, but it is doubtful how many investors actually bear this rate given the ability to avoid the withholding tax on portfolio dividends by entering into a total return equity swap on the underlying shares. But the tax on direct dividends cannot be avoided this way, and it is particularly inappropriate to tax direct dividends since they are distributed to corporate shareholders and therefore potentially subject to three or more levels of tax.

Why, then, does the New Model not reflect this policy? Presumably, the US Treasury felt that it did not want to give away the 5% tax in the New Model, reserving this to treaty negotiations. But we hope that the zero tax on direct dividends will become the norm and will be reflected in future updates of the US Model.

4.2. Dispute resolution

The New Model maintains the traditional US reluctance to enter into binding arbitration under tax treaties. However, the OECD recently adopted a binding arbitration procedure in its Model, and the US recently agreed to binding arbitration in the new treaty with Belgium and in a protocol to the treaty with Germany.

We believe that the New Model should be amended to include a binding arbitration provision. In the absence of arbitration, double taxation can result. The US has already conceded that binding arbitration is consistent with tax sovereignty, and there is no reason not to adopt it as a general policy.

In a February 2007 letter to the US Treasury, the Securities Industry and Financial Markets Association suggested that the following arbitration provisions be incorporated into the New Model:

31. The final paragraph is erroneously numbered “8”, see note 17, supra.
32. For a description of this common technique of avoiding the tax, see e.g. Harston, David, “Equity Derivatives, Inbound Capital and Outbound Withholding Tax” (forthcoming in 2007 in The Tax Lawyer).
34. See e.g. Boulez v. Commissioner, 83 T.C. 584 (1984). It is not clear whether Glasso, which recently settled a transfer pricing case with the US Internal Revenue Service for USD 3.4 billion, can avoid double taxation on the amount shifted from the UK to the US since the US–UK treaty requires a correlative adjustment only if the UK agrees to the shift.
(1) unresolved disputes relating to all subject matters covered by a treaty should be eligible for arbitration;
(2) a treaty party should not be able unilaterally to block unresolved disputes from proceeding to arbitration;
(3) the members of an arbitration panel should be independent and impartial (and thus should not include current employees of either party) and remunerated at a level sufficient to attract the most experienced and accomplished experts;
(4) taxpayers should be able to participate directly and meaningfully in the arbitration proceeding;
(5) an arbitration panel should be able to adopt procedures that are appropriate to the subject matter of the dispute, e.g.:

(i) a decision between each party’s last best offer (i.e. “baseball arbitration”) for disputes involving straightforward numerical determinations of tax liability; or
(ii) a decision accompanied by a reasoned opinion when the dispute requires interpretation of the treaty;
(6) the decision of an arbitration panel should be binding on the parties and enforceable in their domestic courts; and
(7) the standard of review for arbitral decisions should balance the need for finality with the need to protect the integrity of the arbitral process.

We agree with all these suggestions.

5. Conclusion: Toward a Model Treaty for the 21st Century

The most interesting development in US treaty policy in recent years has been its stance toward double non-taxation. Historically, the US was perfectly willing to reduce its withholding tax, even when there was no residence-based tax on the same income, as long as the other country reduced its withholding taxes on a reciprocal basis. The first US tax treaty with France (1937) reduced withholding taxes at a time when France was purely territorial, so that it was clear that US-source income would not be subject to tax by France. Nor was the US unwilling to enter into treaties with jurisdictions that did not tax their residents, such as the Netherlands Antilles.

This position began to change in 1984, when the US terminated its treaty with the Netherlands Antilles. Subsequently, the US began to insert limitation on benefits provisions in all its treaties, first as a treaty override in 1986 and then by negotiation (beginning with the 1989 treaty with Germany). It is now clear that the US will not negotiate a treaty without a limitation on benefits provision because the US is unwilling to extend treaty benefits to residents of third countries that may be tax havens. In addition, the US inserted beneficial ownership limitations to the articles in its treaties which reduce the rate of withholding tax. In 1997, the US went one step further and enacted a Code provision to combat treaty-based tax arbitrage that could result in double non-taxation. Finally, the US has insisted in the New Model that income derived through a fiscally transparent entity be entitled to treaty benefits only to the extent that the income is attributed to and taxable in the hands of a resident (New Model Art. 1(6)).

All of these developments (as well as unilateral domestic legislation) reflect the current US position, maintained by both Republican and Democratic administrations, that it is inappropriate to use treaties to achieve double non-taxation and that reductions in source-based taxation should therefore be conditioned on residence-based taxation. Moreover, the US has been able to persuade the OECD to endorse this view as well, as indicated by the recent changes to the OECD Commentary (Para. 20) on Art. 1, regarding limitation on benefits and the treatment of fiscally transparent entities.

If this view is correct, it suggests that further revisions to the US Model may be appropriate. For example, the US Model could be called “Convention... for the Avoidance of Double Taxation and Double Non-Taxation,” and reductions in withholding tax could be explicitly conditioned on actual taxation by the residence country. But this is a broader topic, better left for another day.

6. IRC Sec. 894(c).
7. See e.g. IRC Sec. 7701(l) (restricting treaty benefits for conduits), IRC Sec. 163(j) (the thin capitalization rule) and IRC Sec. 1503(c) (the dual consolidated loss rule), all of which are designed to prevent double non-taxation.
8. See Paras. 5 and 6.2 to 6.6 of the OECD Commentary on Art. 1.
9. For an explanation why one of the authors regards such changes as appropriate, see Avi-Yonah, Reuven S., “Tax Competition, Tax Arbitrage and the International Tax Regime,” 61 Bulletin for International Taxation 4 (2007), at 130.