

## Reflections on the Intersection of U.S. Tax Treaty Policy, U.S. Tax Reform, and BEPS

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# SPECIAL REPORT

## Reflections on the Intersection of U.S. Tax Treaty Policy, U.S. Tax Reform, and BEPS

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The OECD's base erosion and profit-shifting project is the most important development in cross-border taxation for decades. The authors observe that BEPS can be seen as, in essence, a call for enhanced source-basis taxation. They suggest that its inevitable practical impact in countries throughout the world, possibly reflected in eventual U.S. tax reform, could and probably should lead to a rethinking of the strong residence-basis orientation of traditional U.S. treaty policy.

This article explores the questions whether and how U.S. tax treaty policy might be affected by pressures for tax reform from within the United States, and by major developments in international taxation from without. Talk of U.S. tax reform has been widespread for years, though it is sometimes hard to gauge how much of the talk is serious. Similarly, the OECD's project on base erosion and profit shifting represents an unprecedented worldwide challenge to received wisdom regarding the taxation of cross-border investment, though it is difficult to see how the ambitious goals of this project can be reconciled with the parochial interests of individual countries.

If there is any eventual reality in either of these movements, they are likely to cast a shadow over the policies that have long underlain U.S. tax treaties and tax treaty policy. Neither U.S. tax reform as it is likely to progress nor BEPS as it may unfold is accommodating to that policy. The question on the table is how that policy might change.

### I. The Hallmarks of U.S. Tax Treaty Policy

The U.S. Model Income Tax Convention dates from November 15, 2006. The fifth in a series of model conventions first issued in 1976, it exhibits three features sharply distinguishing it not only from the OECD Model Tax Convention on Income and on Capital but from all other model conventions produced by international organizations or other countries. The U.S. model is the document in which the United States stakes out a position for negotiations with prospective treaty partners. Therefore, its distinguishing features can fairly be characterized as the pillars of U.S. tax treaty policy.<sup>1</sup> These features are what set the United States apart.

One unique feature of U.S. tax treaty policy, which is unlikely to be affected by either tax reform or BEPS, is the very limited grant of treaty benefits to U.S. persons. The United States has been consistently reluctant, for more than 55 years, to grant those benefits to its citizens and residents. Flowing directly from a hearing

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<sup>1</sup>The United States stands prepared to diverge significantly from the U.S. model in negotiating with developing countries. See Eric J. Smith, "The U.S.-Mexico Tax Treaty," 8 *Fla. J. Int'l L.* 97, 102 (1993) ("In order to take into account the importance of source-based taxation for [developing] countries, the United States often includes several provisions based on the U.N. Model in its treaties with [those] countries").

of the Senate Foreign Relations Committee in 1957, when Harvard Law School professor Stanley Surrey spoke out forcefully against a “tax sparing” provision in a proposed treaty with Pakistan, U.S. policy has remained remarkably firm on this issue over the years regardless of the political map or the persons inhabiting the U.S. Treasury.<sup>2</sup> U.S. treaties are not used to encourage foreign investment or other foreign activities by U.S. persons.<sup>3</sup> The United States cannot, however, withhold all treaty benefits from U.S. persons because the basic “deal” inherent in a tax treaty involves a reduction or elimination of tax in the country of source and a commitment by the country of residence to avoid double international taxation. This commitment is essential to any tax treaty. If it were not accorded to U.S. persons, such treaties could not be concluded.

The mechanism devised to accommodate a policy of using treaties primarily to make concessions to foreign persons investing in the United States, and not to U.S. persons investing abroad, while nevertheless abiding by commitments to residents that are indispensable to any treaty, is the “saving clause.” Found in paragraphs 4 and 5 of article 1 of the U.S. model, the article dealing with the general scope of the treaty, the saving clause declares that the treaty has no application — does not exist — for U.S. persons, including both U.S. citizens and U.S. residents (after application of the dual resident provisions of article 4 of the model). Having thus removed U.S. persons from any entitlement to treaty benefits, a second paragraph, article 1(5), carefully and gingerly restores a limited number of benefits to all U.S. persons and a second group of narrow benefits to U.S. persons who are neither U.S. citizens nor U.S. permanent residents. In the first group fall the articles on relief from double taxation, nondiscrimination, and the mutual agreement procedure, as well as the commitment in article 9 to make correlative adjustments in transfer pricing cases<sup>4</sup> and rules for pensions, social security payments, child support,<sup>5</sup> and the treatment of pension funds.<sup>6</sup> In the latter category are other rules for pension funds, the treatment of income from government service,<sup>7</sup> and income of students, trainees,<sup>8</sup> and diplomats.<sup>9</sup> The saving clause can sometimes be overlooked or its potency underestimated, but it ap-

pears in every U.S. tax treaty; U.S. treaty policy cannot be understood without it. Nothing in the tax reform debate or in the discussions on BEPS suggests a need for any change.

A second unique feature of the U.S. model lies in its extraordinary tilt toward the country of residence. The most common species of international double taxation in cross-border operations is the taxation of income by both the country of source (where income is earned) and the country of residence (where the taxpayer resides). All countries, of course, are countries of both source and residence, but the relative degree to which they fall in those categories differs greatly from country to country, as does their perception of that degree (which may be a different matter). The OECD model is relatively favorable to the country of residence, and that is hardly surprising. The roots of the OECD are in Europe, and until relatively recently its membership has been limited to capital-exporting nations. The U.S. model, however, goes much further than the OECD model in favoring the country of residence. This can be clearly seen in article 11, on interest, in which the U.S. model calls for a reciprocal maximum rate of zero in the source country while the OECD model proposes 10 percent. Interest probably represents the largest of cross-border income flows.

Nor is article 11 the only evidence of the U.S. approach. The U.S. model contains a paragraph in article 6 dealing with income from real property, which allows taxpayers to elect to be taxed at source on that income on a net, rather than a gross, basis.<sup>10</sup> In article 16, dealing with “entertainers and sportsmen,” the U.S. model provides that relatively low-paid taxpayers are excepted from the article’s provisions calling for taxation of the first dollar of income earned in the source country.<sup>11</sup> In article 20, concerning students and trainees, the U.S. model provides for exemption at source of a modest amount of income from personal services.<sup>12</sup> There are other provisions, directionally similar, that could be cited.<sup>13</sup>

The U.S. model reflects the view of the United States that it is overwhelmingly a capital-exporting

<sup>2</sup>See generally Stanley S. Surrey, “The Pakistan Tax Treaty and ‘Tax Sparing,’” 11 *Nat’l Tax J.* 156 (1958).

<sup>3</sup>Ernest R. Larkins, “U.S. Income Tax Treaties in Research and Planning: A Primer,” 18 *Va. Tax Rev.* 133, 185 (1998) (“The intended treaty benefit to U.S. citizens and U.S. corporations is a decrease in their foreign taxes, not their U.S. tax burdens”).

<sup>4</sup>See U.S. model article 9(2).

<sup>5</sup>U.S. model article 17.

<sup>6</sup>U.S. model article 18.

<sup>7</sup>U.S. model article 19.

<sup>8</sup>U.S. model article 20.

<sup>9</sup>U.S. model article 27.

<sup>10</sup>See U.S. model article 6(5).

<sup>11</sup>U.S. model article 16(1).

<sup>12</sup>U.S. model article 20(2).

<sup>13</sup>In recent U.S. treaties, but not yet the U.S. model, the United States has agreed to a zero rate of tax at source on specific dividends concerning direct investment. This provision, of course, speaks volumes in regard to the U.S. embrace of residence-based taxation. See, e.g., Convention Between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and Capital and With Respect to Certain Other Taxes, Aug. 29, 1989, article 10(3), 1708 U.N.T.S. 3, incorporating Protocol 1, June 1, 2006 (providing for zero rate on dividends paid from subsidiaries to parent companies owning at least 80 percent of subsidiaries’ shares).

country and, in its treaty relations with other developed countries, it should approach the world seeking maximum, reciprocal, source-country concessions.<sup>14</sup>

Arguably, there are two reasons for this. One is selfish: As a capital exporter, the United States would stand to benefit economically from reductions in taxation in source countries. The tax burden on U.S. resident taxpayers would be lower, and thus more residence-based tax would be collected by the U.S. fisc. Given expected cross-border income flows, with much larger amounts coming back to the United States than going out, the cost in terms of U.S. source-based taxation forgone is well worth the trade.<sup>15</sup>

Another explanation, more altruistic, is that a residence country is inevitably better positioned to address the threat of international double taxation than a source country, because the residence country sees a taxpayer's entire world while any given source country sees only the part of the taxpayer's operations that crosses its borders.<sup>16</sup> For some industries — shipping would be a prime example — deferring to a greater extent to the source country would invite not merely double but multiple taxation.

So for either or both of these reasons, the United States has staked out a position that is more favorable to the residence country than even the OECD model. This stands in marked contrast with the position of the United Nations, whose own model convention, developed with the active participation of many capital-importing countries, is much more oriented toward source-based taxation than the OECD model.<sup>17</sup>

A third unique feature of U.S. tax treaty policy flows from the U.S. view that treaties should aim for substantial source-country reductions of tax. The United States has long taken a dim view of treaty shopping, in which persons having no or only tenuous relations with a U.S. treaty partner form an entity in that country for the purpose of taking advantage of the

reduction in source taxation that all U.S. treaties, and especially those with developed countries, provide.<sup>18</sup> This policy against treaty shopping is a logical extension of the U.S. favoritism of residence-based taxation, because the U.S. effort to seek maximum reductions of tax at source is likely to produce disparate results in actual negotiations. Some countries, such as the United Kingdom or the Netherlands, will be pleased to accede to the U.S. proposal to reduce source-based taxation as much as possible. Their own views of the world coincide with those expressed in the U.S. model, and it will not be difficult to achieve the kinds of reciprocal reduction called for by that model. Some countries, however, even among OECD members and in the developed world, are less enthusiastic about wholesale reductions of tax at source and, in negotiations with the United States, will not willingly go so far as the U.S. model would. If the United States remains steadfast in seeking reciprocal reductions at source, it will wish to maintain a degree of pressure on these countries (such as Canada, Japan, or Italy) with the far-ranging goal that in time, they can be persuaded to accept ever greater reductions of tax at source.

It is obviously a hindrance to this goal if taxpayers from countries that balk at accepting reductions in source taxation can achieve reductions on their own by investing in the United States through entities formed in third countries, whose treaties with the United States are closer to the U.S. model. If an Italian or Canadian investor can obtain a better deal than is available under the treaty between the United States and Italy or Canada by forming an entity in the Netherlands and having that entity claim benefits under the Netherlands-U.S. treaty, the investor and management will have little interest in the level of source-based taxation in the U.S. treaty with their home countries.<sup>19</sup>

Hence the negative view of treaty shopping taken by the United States — or, more specifically, the U.S. interest in maintaining the integrity of each bilateral treaty that it negotiates. The United States wishes to discourage third-country investors from taking advantage of its treaties, because that advantage would dilute the pressure to reduce source-based tax that the United States seeks to maintain on all countries, at least in the developed world.<sup>20</sup>

<sup>14</sup>Curiously, this perception does not seem to have squared with the facts for at least several decades. See, e.g., Julie Roin, "Rethinking Tax Treaties in a Strategic World With Disparate Tax Systems," 81 *Va. L. Rev.* 1753, 1758 n. 17 (noting that there is "no question that the United States is a net importer of capital on a current basis").

<sup>15</sup>For converse reasons, developing nations are often reluctant to relinquish source taxation. See Charles I. Kingson, "The Coherence of International Taxation," 81 *Colum. L. Rev.* 1151, 1166-1167 (1981).

<sup>16</sup>See, e.g., Michael J. Graetz and Itai Grinberg, "Taxing International Portfolio Income," 56 *Tax L. Rev.* 537, 570 (2003) (claiming that source countries are poorly situated to gauge taxpayers' ability to pay).

<sup>17</sup>See Hugo Hurtado, "Is Latin American Taxation Policy Appropriate for Promoting Foreign Direct Investment in the Region?" 31 *N.W.J. Int'l L. & Bus.* 313, 333 ("Basically, the UN Model increases the source country's right to tax income aimed at benefitting the developing country").

<sup>18</sup>See generally Simone M. Haug, "The United States Policy of Stringent Anti-Treaty Shopping Provisions: A Comparative Analysis," 29 *Vand. J. Transnat'l L.* 191 (1996).

<sup>19</sup>Indeed, some of the most popular avoidance structures have involved use of Netherlands tax treaties by shell entities. See Richard A. Westin, *The Tax Lexicon* 158 (1989) (describing the "Dutch Sandwich," involving the tax treaty networks of both the Netherlands and the Netherlands Antilles).

<sup>20</sup>See American Law Institute, *International Aspects of United States Income Taxation II: Proposals on United States Income Tax Treaties*, 152 (1992) (noting that if companies from non-treaty nations

(Footnote continued on next page.)

There have long been judicial doctrines serving to inhibit tax treaty abuse, but they have always been somewhat imprecise and unpredictable in their application to real-world transactions.<sup>21</sup> And so the concept of “limitation on benefits” was born. The idea, by now a standard feature of every modern U.S. income tax convention, is that within the body of the treaty there should be a separate article requiring a purported claimant of U.S. treaty benefits to establish, according to mostly objective criteria, that it is a genuine resident of the treaty partner for reasons other than merely seeking those benefits. The LOB article has changed over the years, but the original concept remains intact. If the United States is successful in restricting treaty benefits with, say, the Netherlands to persons with a real, nontax nexus with the Netherlands, that may have some effect on persons from Canada or Italy who are deterred from using the Netherlands as a conduit for investment into the United States. Those persons, in turn, may approach their own governments with a request that they negotiate treaties with the United States providing directly (and reciprocally) for low taxes at source. Though the process takes years, even decades, this has basically been the story of article 22, the LOB article of the U.S. model.

## II. The Potential Shape of Reform

The call for tax reform has been so omnipresent in the United States for so many years that the meaning of reform has been thoroughly blurred. An actual attempt at a comprehensive change of the U.S. tax laws produced by the House Ways and Means Committee<sup>22</sup> was rejected by the larger House of Representatives before the ink was dry. Apart from myriad conferences, panels, law review articles, coverage by the tax press, and blather by elected officials, there has been little in the nature of progress or activity. It is not even clear whether the debate, such as it is, encompasses all of the income tax or only corporate taxation or perhaps only corporate international taxation.

Wherever the debate goes, it is safe to predict that anything of substance that comes of it will include some bedrock changes. For example, though the details of a viable reform are far from settled, it is reasonable to assume that it would entail a reduction of the 35 percent maximum corporate tax rate, since the fact that 35 per-

are permitted to form corporate entities in order to obtain treaty benefits, this reduces pressure on their home countries to enter into treaties).

<sup>21</sup> See, e.g., *Aiken Indus. v. Comm’r*, 56 T.C. 925 (1971); *Northern Ind. Public Service Co. v. Comm’r*, 105 T.C. 22 (1995); *Del Commercial Prop. v. Comm’r*, 78 T.C.M. (CCH) 1183 (1999), *aff’d*, 251 F.3d 210 (D.C. Cir. 2001).

<sup>22</sup> Jonathan Weisman, “A Republican’s Tax Overhaul Envisions Big Changes,” *N.Y. Times* (Feb. 26, 2014), available at [http://www.nytimes.com/2014/02/27/us/politics/sweeping-tax-overhaul-plan-would-bring-big-changes.html?\\_r=0](http://www.nytimes.com/2014/02/27/us/politics/sweeping-tax-overhaul-plan-would-bring-big-changes.html?_r=0).

cent is the highest statutory rate in the world figures in most of the critiques of the current U.S. rules.

If there is an attempt to devise a reform that collects as much revenue as the present U.S. tax system, preferences studded throughout the Internal Revenue Code would have to be reduced. There would be fewer special rates and benefits, and permissible reductions of the tax base would be limited. This is entirely appropriate, since the arguments for not taxing all income in the same manner and to the same extent are strained and theoretical.<sup>23</sup> Moreover, the fewer categories that are established in the law, the easier it will be to understand and administer that law, and the more difficult it will be to play games with it.

In the best of circumstances, reform would place a premium on simplification. The Internal Revenue Code is a peculiar, even laughable, document.<sup>24</sup> It is nearly impossible for taxpayers to decipher, or for the IRS to apply uniformly and consistently. The result has been that the United States has developed two completely different tax laws — one embodied in two volumes each resembling in appearance the Manhattan telephone directory (“interpreted” in no fewer than six equally thick and impenetrable books of regulations); the other found in the practices and policies of individual IRS offices around the country, which labor with greater or lesser consistency to collect the revenue.

Of course, simplicity by itself cannot be an engine of change.<sup>25</sup> There are too many constituencies with a vested interest in complexity. For those persons who think seriously about changing U.S. tax laws, however, even if their reasons may be other than simplification, sharply pruning the existing rules should be a priority. As a necessary complement, the rules for taxing foreign income will change. At least to some extent, the foreign credit will yield to a territorial regime.<sup>26</sup> U.S. multinational companies have been lobbying for this

<sup>23</sup> See, e.g., Noel B. Cunningham and Deborah H. Schenk, “The Case for a Capital Gains Preference,” 48 *Tax L. Rev.* 319, 320 (1993) (noting that others have made a “persuasive case that the arguments in favor of a [capital gains] preference are weak”).

<sup>24</sup> Our own favorite candidate for a laugh appears in the flush language of section 509(a):

For purposes of paragraph (3), an organization described in paragraph (2) shall be deemed to include an organization described in section 501(c)(4), (5), or (6) which would be described in paragraph (2) if it were an organization described in section 501(c)(3).

<sup>25</sup> See Robert J. Peroni, J. Clifton Fleming Jr., and Stephen E. Shay, “Reform and Simplification of the U.S. Foreign Tax Credit Rules,” *Tax Notes Int’l*, Sept. 29, 2003, p. 1177 (describing reduction in complexity of the code as a “worthwhile, although somewhat elusive, objective of tax reform efforts”).

<sup>26</sup> See Fleming Jr., Peroni, and Shay, “Designing a U.S. Exemption System for Foreign Income When the Treasury Is Empty,” 13 *Fla. Tax Rev.* 397, 400 (“[T]here is a significant likelihood that Congress will sooner or later be considering legislation to create a U.S. territorial or exemption system”).

change for years now — a reversal of their prior opposition to a change that might encourage calls for distributions to shareholders. Though we believe a territorial system for the United States would require some safeguards, and these might not be so readily accepted by the international community, the foreign tax credit regime as we know it has become too cumbersome and expensive to retain.

Finally, there should also be a much greater focus than we have witnessed to date on income earned in the United States. The will is not there to end deferral, to pierce the corporate veil for taxation purposes, to tax all U.S. persons currently on their worldwide income, or to run down all the schemes and strategies the existing byzantine rules have engendered. There is no way to stuff more than 50 years of tax history back into a bottle, and we would spend enormous energy and time trying to do so. In the modern world, with its communications possibilities, limited resources accorded tax administrations, and armies of sophisticated advisers having sprung up around the world, a complete worldwide tax reach is hard to defend.

Moreover, the United States can ill afford to act as if it was 1945. This country exports considerable capital, but for decades it has also imported considerable capital. The U.S. market is not going anywhere, regardless of how entities or instruments are characterized, or the vanishing acts that have been devised to shunt income into black holes. The domestic rules on inbound taxation have remained substantially unchanged since the Foreign Investors Tax Act of 1966. As the United States begins the overdue process of revamping its tax system, it should think more, if not exclusively, about the home tax base and home-grown income; that focus should be maintained insistently and vigorously. For too long it has been common to equate international taxation with outbound taxation, giving near exclusive attention to the concerns and issues of U.S. multinational companies.

Taxation is moving away from a world in which the source country reduces or eliminates its tax to attract investment, and the residence country assumes the responsibility for providing relief from double taxation. Arguably, these developments were inevitable with a shrinking world, a growing population, and increasing understanding (by everyone) of what is going on beyond the borders. Residence countries have abetted the movement by abdicating their role as tax imposers in favor of subtle and sophisticated enabling of tax avoidance. And, of course, there have always been, and there will continue to be, parasitic jurisdictions seeking to turn a quick (and often transitory) profit through beggar-thy-neighbor policies designed to reduce the tax take of other countries.<sup>27</sup>

<sup>27</sup>The European Commission has recently taken the view that Ireland, Luxembourg, and the Netherlands belong in this category. See European Commission, “State aid: Commission investigates transfer pricing arrangements on corporate taxation of

(Footnote continued in next column.)

Perhaps the United States should adopt a leaf from the book of India, of Brazil, and of every source country that finds it expedient and politically advantageous to enhance its taxation of income earned within its markets. As we have seen in recent months with developments in France and the United Kingdom, it is not only developing countries that are thinking about greater taxation at source.<sup>28</sup> Would such a development, if adopted by the United States, have a dampening effect on U.S. investments by foreign persons? At the margin, perhaps. There are, however, reasons for doubt.

The lobbyists will make every effort to persuade Congress that serious taxation of income earned in the U.S. market would have a deleterious effect. After all, the notion that an ounce of taxation will give rise to a ton of deterrence is one of the core theories that brought the Internal Revenue Code to its present unhappy state. Taxes definitely deter. The question, however, is not the abstract disincentive effect of taxation but the practical one of how much taxation it takes to deter prospective investors from coming to the United States.

The answer almost surely is: A great deal more than we presently have. It is imperative to undertake a thoroughgoing review and revision of the rules regarding inbound investment, with the United States coming to think of itself more as a country of source, which it plainly is, and less as the country of near exclusive residence taxation that it was immediately following World War II.

### III. The Direction of the BEPS Project

The BEPS project, which began in 2013, consists of 15 actions.<sup>29</sup> These are: (1) address the tax challenges of the digital economy; (2) neutralize the effects of hybrid mismatch arrangements; (3) strengthen controlled foreign corporation rules; (4) limit base erosion via interest deductions and other financial payments; (5) counter harmful tax practices more effectively, taking into account transparency and substance; (6) prevent treaty abuse; (7) prevent the artificial avoidance of permanent establishment status; (8, 9, and 10) assure that

Apple (Ireland) Starbucks (Netherlands) and Fiat Finance and Trade (Luxembourg)” (June 11, 2014), available at [http://europa.eu/rapid/press-release\\_IP-14-663\\_en.htm](http://europa.eu/rapid/press-release_IP-14-663_en.htm).

<sup>28</sup>U.K. Chancellor George Osborne has recently proposed a controversial diverted profits tax, which would impose a 25 percent levy on companies using “contrived arrangements” to shift profits outside the U.K. See Vanessa Houlder, “Business Leaders Attack UK ‘Google Tax,’” *Fin. Times* (Dec. 10, 2014), available at <http://www.ft.com/intl/cms/s/0/12e12e3a-7fd9-11e4-adff-00144feabdc0.html>.

<sup>29</sup>See generally OECD Centre for Tax Policy and Administration, “BEPS 2014 Deliverables,” available at <http://www.oecd.org/ctp/beeps-2014-deliverables.htm>.

transfer pricing outcomes are in line with value creation; intangibles, risks, and capital; and other high-risk transactions; (11) establish methodologies to collect and analyze data on BEPS and the actions to address it; (12) require taxpayers to disclose their aggressive tax planning arrangements; (13) reexamine transfer pricing documentation; (14) make dispute resolution mechanisms more effective; and (15) develop a multilateral instrument.

Although some of these actions are directed to the residence country — the effort, for example, to alter the design of the rules regarding CFCs — and several others are neutral as between the country of residence and the country of source, many of the actions point clearly in the direction of greater source-basis taxation. Thus, the actions addressed to the digital economy, base erosion, neutralizing the effects of hybrid mismatch arrangements, preventing the artificial avoidance of PE status, and assuring that transfer pricing outcomes are in line with value creation either explicitly or implicitly invite more robust taxation in the country where income is earned. Several other actions — for example, requiring taxpayers to disclose their aggressive tax planning arrangements — can easily be interpreted to produce that result.

The stated goal of BEPS is a coordinated effort to reduce corporate tax avoidance. The real-world effect, however, is more likely to be seen in the efforts of individual countries to impose a greater tax burden on inbound investment.<sup>30</sup> Coordination of the BEPS actions seems unlikely in a world with hugely disparate views of the function of an income tax. The more foreseeable result is a cacophony of new rules, predicated on BEPS and tempered only by the views of individual countries regarding adverse impacts on the inflow of capital. For countries convinced that their markets will remain attractive regardless of how far they push their income tax, there really are no limitations. The implications for the volume of cross-border disputes, the role of tax treaties, and the difficulties of satisfactory resolution are apt to be dramatic.

BEPS is likely to have a far-reaching and long-lasting impact. Developing countries, increasingly aware that taxation is a critical element in their growth strategies, are engaged in the debate. They are focused on the implications of the BEPS action plans for source-basis taxation.<sup>31</sup> If base erosion and profit-shifting are curtailed, there should be greater collection of revenue in the source country. The perception is that

<sup>30</sup>BEPS project head Pascal Saint-Amans has stated that “source taxation is more on the table than in the past.” PwC, “An interview with Pascal Saint-Amans” (Feb. 2014), at 2, available at [www.pwc.com/en\\_GX/gx/tax/tax-policy-administration/beps/assets/pwc-tax-interview-transcript.pdf](http://www.pwc.com/en_GX/gx/tax/tax-policy-administration/beps/assets/pwc-tax-interview-transcript.pdf).

<sup>31</sup>See, e.g., Yariv Brauner, “What the BEPS?” 16 *Fla. Tax Rev.* 55, 74-75 (2014) (describing characterization and sourcing rules as a “major bone of controversy between developing countries and the OECD”).

large amounts of income are going untaxed, and there is a growing realization that investments will not be deterred if greater taxation is imposed by a jurisdiction having sufficient economic appeal.<sup>32</sup>

In the classic view of international taxation, the source-country’s claim to tax is superior to that of the residence country.<sup>33</sup> The strength of the source country claim varies with the type of income in question, so the claim to tax income from real property, which is immobile, is stronger than the claim to tax interest and other mobile items of income. The BEPS project flows in large part from the perception that source-country claims are being siphoned off by base erosion, while residence countries have not been doing a very good job of levying the tax to which they claim entitlement. This situation fuels the lament of the developing countries, but it is hardly limited to them. Prominent taxpayers have succeeded in reducing their worldwide obligations to zero or nearly zero. Politicians who normally would not pay much attention to the subject of international taxation seem to be paying attention now. They have enlisted international organizations, primarily the OECD but also the United Nations, in an intensive search for new rules and approaches.

#### IV. Implications for U.S. Treaty Policy

In these circumstances, tax treaties are being rethought, revoked, or avoided altogether. Some previously lonely voices expressing skepticism about the desirability of treaties are finding new audiences.<sup>34</sup> A movement throughout the world toward territorial regimes arguably reduces the need for treaties in any case.

Another major element in any rational effort to reform the U.S. rules regarding taxation of cross-border operations would be the intelligent use of tax treaties. The treaties are increasingly important in a world with large and growing investments in and from other countries. We need information. We need to be able to resolve disputes. We need some understanding of the rules of the road.<sup>35</sup> The treaties provide all that, regardless of whether they tilt toward source or residence. The treaties are a useful, even indispensable,

<sup>32</sup>See generally Bret Wells and Cym Lowell, “Tax Base Erosion and Homeless Income: Collection at Source Is the Linchpin,” 65 *Tax L. Rev.* 535 (2011).

<sup>33</sup>See Ruth Mason and Michael S. Knoll, “What Is Tax Discrimination?” 121 *Yale L. J.* 1014, 1029 (2014) (“Under longstanding custom, the tax entitlement of the source state is superior to that of the residence state”).

<sup>34</sup>See Antonio Hugo Figueroa, “Tax treaties to avoid international double taxation or to transfer resources from developing countries to developed ones?” 2:14 *Voces en el Fenix* 128 (May 2012); Tsilly Dagan, “The Tax Treaties Myth,” 32 *N.Y.U. J. Int’l L. & Politics* 939 (2000).

<sup>35</sup>See Joseph Isenbergh, *International Taxation* (2014), section 101.4 (“[T]he mere fact of exposure to the tax system of another

(Footnote continued on next page.)

part of a cross-border strategy, and any U.S. reform should include a much greater integration of the treaties into national policy.

Anyone reading the daily press, or even glancing at the headlines, realizes that there are U.S. policies in many fields for which the concept of “rationality” is a misnomer. Nevertheless, it is worth making the point, in this small (but important) niche of U.S. policy, that its tax treaties and its tax laws should be better coordinated. The problem is not that the negotiators of treaties are flying solo and in the face of statutory rules. The problem is that U.S. treaty policy is set in a vacuum with little contribution from outside the Treasury Department and without ongoing attention from those who make the laws. This is a missed opportunity.

Even without the greater focus on inbound taxation that seems appropriate, U.S. tax treaty policy is not synchronized with the facts of modern life. Foreign investment in the United States is large and growing.<sup>36</sup> If Congress declines to address the phenomenon of U.S. companies “inverting” to claim to foreign status — that is, becoming foreign companies — the importance of inbound investment will only increase.<sup>37</sup>

There are profound implications for U.S. tax treaty policy in any greater U.S. assertion of source-basis taxation, as a result of BEPS, U.S. tax reform, or otherwise. The United States in its treaties cannot realistically cling to its extraordinary emphasis on residence taxation in a world moving in the opposite direction. The result will simply be a migration of the tax base out of the country. The pressures on U.S. policy regarding treaty shopping will increase exponentially. This is the direction in which the BEPS project is likely to carry, though developments may be uneven, even ragged. Countries will adopt those portions of the BEPS agenda — whether it is an approach to hybrid mismatches or creative assertions of the PE concept — that they perceive as serving their individual interests. U.S. companies, those that are left after the inversion craze fades, will find themselves footing the bill — all to their own detriment and that of the U.S. Treasury.

## V. Some Candidates for Rethinking

If the U.S. tax system does begin to focus more seriously on source-basis taxation, it would seem that U.S.

country imposes significant transactional complexities on enterprises venturing beyond their national boundaries”).

<sup>36</sup>According to Economy Watch, the value of direct inbound investment at the end of 2013 was \$2.815 trillion; the value of direct outbound investment was \$4.854 trillion. See “United States FDI Statistics,” Economy Watch (Mar. 17, 2015), available at [http://www.economywatch.com/economic-statistics/United-States/FDI\\_Statistics/](http://www.economywatch.com/economic-statistics/United-States/FDI_Statistics/).

<sup>37</sup>A large proportion of the tax savings generated by corporate inversions occurs through post-inversion earnings stripping transactions. See Jim A. Seida and William F. Wempe, “Effective Tax Rate Changes and Earnings Stripping Following Corporate Inversion,” 57 *Nat'l Tax J.* 805 (2004).

treaty policy will have to be reconsidered. In particular, the insistent favoritism of residence taxation will be a hindrance to new policies expressed in the Internal Revenue Code. Further, the LOB concept will require strengthening.

A natural starting point would be article 24, the nondiscrimination article. This “baffling”<sup>38</sup> provision represents a significant obstacle to a more vigorous U.S. inbound regime. The United States might consider either downplaying it or removing it altogether from the U.S. model.

In general, the nondiscrimination article forbids a source country from taxing residents (or nationals, or capital) of the treaty partner country more heavily than it taxes its own. Commentary to the OECD model notes that the principle did not originate in tax law but instead was borrowed from commerce, navigation, and shipping conventions.<sup>39</sup> Early tax treaties were often accompanied by explanations that the parties had included the nondiscrimination article for customary, nontax reasons.<sup>40</sup>

The current U.S. model contains four paragraphs proscribing different varieties of discrimination. Article 24(1) bans taxation in the source country of “nationals” of the other country if that taxation is “more burdensome” than the source country’s nationals would face “in the same circumstances.” The 1996 U.S. model broadened the term “nationals” to include not only individuals but entities.<sup>41</sup>

A second operative paragraph of article 24 addresses PEs. It prevents a source country from levying tax “less favorably” on a PE than it imposes on domestic firms “carrying on the same activities.” A third paragraph, article 24(4) of the U.S. model, guards against so-called “indirect” discrimination, preventing source countries from denying deductions for remittances to foreigners “under the same conditions” as those made to domestic recipients. Finally, article 24(5) deals with

<sup>38</sup>See Mary Bennett, “The David R. Tillinghast Lecture: Nondiscrimination in International Tax Law: A Concept in Search of a Principle,” 59 *Tax L. Rev.* 439, 439 (2006).

<sup>39</sup>See commentary to OECD model, article 24(6) (2010).

<sup>40</sup>See, e.g., U.S. Treasury Department Memorandum Explaining Article XXI of the 1945 U.S.-U.K. Treaty (“It will be observed that this article extends to all taxes, both Federal and local. Such extension, however, is in keeping with several commercial treaties (such as that with Norway, of 1928, and that with Germany, of 1923) to which the United States is now a party. It has no practical effect, since our domestic taxation does not discriminate as between United States citizens and British nationals residing in the United States”).

<sup>41</sup>Compare Sanford H. Goldberg and Peter A. Glicklich, “Treaty-Based Nondiscrimination: Now You See It Now You Don’t,” 1 *Fla. Tax Rev.* 51, 82 (1992) (noting that 1981 U.S. model limits this paragraph to individuals) with 1996 U.S. model, available at <http://www.irs.gov/pub/irs-trty/usmodel.pdf> (paragraph applies to both individuals and entities).

capital, providing that foreign-owned capital may not be taxed in a manner that is “more burdensome” than that of domestic “similar enterprises.”

These rules may be high-minded and virtuous, but they crimp the U.S.’s ability to tax inbound investment. In spite of Americans’ characteristic distaste for discrimination of any kind, there are sound reasons to tax investment by foreign persons differently than investment by U.S. persons. It is obviously more difficult to collect tax from foreigners.<sup>42</sup> And jurisdictional constraints limit the scope of our taxing power once the tax base has left the country.<sup>43</sup> In the international tax realm, therefore, measured forms of discrimination may be both desirable and reasonable — desirable because of the potential loss of revenue for the fisc and reasonable because foreign businesses have a greater ability than domestic counterparts to escape the U.S. tax system altogether. In short, we should discriminate against foreign investment, but the nondiscrimination article stands in the way.

Forfeiting the ability to discriminate might be a fair trade-off if there were concomitant benefits. But justifications for the article wither under scrutiny. Some claim that the nondiscrimination concept is intended to reduce impediments to cross-border trade and investment — a means of preventing “tax protectionism.”<sup>44</sup> Selective and thoughtful tax discrimination should not, however, adversely affect cross-border trade; the sheer size of the U.S. market and the stable and healthy returns enjoyed by foreign investors should allow a fair and appropriate tax on foreign investment without fear of scaring it away. From an economic perspective, the typical rationale is that source-country nondiscrimination promotes capital import neutrality,<sup>45</sup> an efficiency criterion in which all investments in a given country bear the same marginal rate of taxation regardless of the residence of the investor.<sup>46</sup> But this efficiency norm is not necessarily the most desirable of the available options: Capital *export* neutrality attempts to eliminate tax considerations for investors choosing between do-

mestic and foreign investments. Commentators have observed that without harmonizing global tax rates, it is impossible to achieve capital import and capital export neutrality simultaneously.<sup>47</sup> And there is some suggestion that capital export neutrality is the superior efficiency criterion, because it results in fewer distortions as to the location of international investment.<sup>48</sup>

The nondiscrimination provision does allocate revenue between source and residence countries — it effectively limits the amount of tax the source country will be able to tax and thus the amount of double taxation that the residence country will be called upon to relieve.<sup>49</sup> There is, however, no obvious advantage in allocating taxing rights this way. An alternative norm, reciprocity, governs taxation of portfolio investment — treaty partners typically agree on a mutually acceptable rate of tax at source on royalties, for example, which is not tied to or limited by the taxes levied on purely domestic royalty arrangements.<sup>50</sup> In theory, at least, it is possible to negotiate for reciprocal rates of taxation on PEs in the same manner. First principles do not necessarily determine which norm — reciprocity or nondiscrimination — is fairer. Moreover, if the residence state is concerned with the *rate* of tax in the source country, it seems inapposite to choose a principle so often invoked for allegedly discriminatory taxation methods.<sup>51</sup>

Finally, although the United States would never endorse discrimination as a general principle, Congress often seeks to, and regularly does, enact discriminatory tax legislation. The qualifications in the text of the article’s paragraphs — “similar enterprises,” “same activities,” “under the same conditions,” “in the same circumstances” — reflect the tension between the rhetorical and sentimental appeal of the nondiscrimination principle, on the one hand, and the hard realities of tax enforcement and revenue raising, on the other.<sup>52</sup>

<sup>47</sup>See Graetz and Alvin C. Warren Jr., *Income Tax Discrimination and the Political and Economic Integration of Europe*, 1212-1220 (2006).

<sup>48</sup>See, e.g., Treasury Department, *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study* 25-42 (2000), available at <http://www.treasury.gov/resource-center/tax-policy/Documents/subpartf.pdf>.

<sup>49</sup>Robert A. Green, “The Troubled Rule of Nondiscrimination in Taxing Foreign Direct Investment,” 26 *Law & Pol’y Int’l Bus.* 113, 128-129 (1994).

<sup>50</sup>See generally U.S. model articles 10-12 (specifying reciprocal withholding rates for interest, dividends, and royalties).

<sup>51</sup>For example, a 1990 proposal to extend the typical three-year statute of limitations to six years for foreign corporations was criticized and ultimately shelved as violating the nondiscrimination provision. See Task Force of ABA Comm. on U.S. Activities of Foreigners and Tax Treaties, ABA Comments on Foreign Tax Equity Act of 1990 (H.R. 4308 and S. 2410).

<sup>52</sup>The technical explanation to the U.S. model reflects this tension, at times implying that providing sound reasons for discriminatory policies is enough to render those policies nondiscriminatory. See U.S. model, technical explanation, article 24

(Footnote continued on next page.)

<sup>42</sup>For this reason, payers of passive income are generally required to withhold it at source. See generally section 1441.

<sup>43</sup>This policy rationale underlies, among other provisions, section 367(e), analyzed below.

<sup>44</sup>OECD Thin Capitalisation Report, 27 P 66 (1987); see also Kees van Raad, *Nondiscrimination in International Tax Law* 127 (1986) (“The purpose of the permanent establishment nondiscrimination provision is clear: a State should not offer enterprises operated by residents any competitive advantage over similar enterprises of nonresidents”).

<sup>45</sup>Mason and Knoll, *supra* note 33, 1020 (2012) (“[A] capital export neutrality construction of nondiscrimination would impose nondiscrimination obligations only on residence states, whereas a capital import neutrality construction of nondiscrimination would impose nondiscrimination obligations only on source states”).

<sup>46</sup>See Charles H. Gustafson, Peroni, and Richard Crawford Pugh, *Taxation of International Transactions*, 17 (2d ed. 2001).

For at least several decades, Congress has leaned on these phrases in enacting laws that draw distinctions between domestic and foreign taxpayers. What has become clear is that the qualifying words are accommodating enough to justify increasingly distant deviations from the spirit, if not the letter, of nondiscrimination. By manipulating the level of generality at which the “conditions,” “circumstances,” or whatever else are described, it has been possible to discriminate in substance while professing nonviolation of U.S. treaty commitments.

For example, the earnings stripping provisions of section 163(j) deny or defer deductions for “disqualified interest” paid by thinly capitalized companies to related persons not fully subject to U.S. tax.<sup>53</sup> Upon enactment, critics pointed out that this provision might violate the deductibility paragraph of the nondiscrimination article since the overwhelming majority of denied deductions would be for payments to foreign lenders.<sup>54</sup> Congress defended the provision because it also applied, in theory, to domestic tax-exempt organizations (which are not ordinarily in the business of lending money).<sup>55</sup> The logic, apparently, was that taxable domestic lenders and treaty-eligible foreign lenders were not receiving interest payments under the “same conditions” of being fully subject to U.S. tax.

Legislators have made similar rhetorical moves elsewhere. Section 367(e)(2) taxes the built-in gain on assets distributed in liquidation by a U.S. subsidiary to its foreign parent, when the same tax would not apply in a purely domestic context. The Treasury technical explanation to the U.S. model considers and dismisses the possibility that this provision violates the capital ownership nondiscrimination paragraph.<sup>56</sup> According to the corresponding 1996 explanation, the two situations are insufficiently “similar” since the subsequent disposition of the asset would be outside the U.S. taxing jurisdiction and therefore would escape U.S. tax.<sup>57</sup>

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(“[T]he common underlying premise [of the qualifying phrases] is that if the difference in treatment is directly related to a tax-relevant difference in the situations of the domestic and foreign persons being compared, that difference is not to be treated as discriminatory”).

<sup>53</sup> See section 163(j)(1)(A).

<sup>54</sup> See, e.g., American Law Institute, *Federal Income Tax Project: International Aspects of United States Income Taxation II*, “Proposals on United States Income Tax Treaties,” 258-259 (1992).

<sup>55</sup> See H.R. Rep. 101-386, at 568 (1989) (Conf. Rep.).

<sup>56</sup> See U.S. model, technical explanation, article 24(5) (“The taxation of a distributing corporation under section 367(e) on an applicable distribution to foreign shareholders does not violate paragraph 5 of the Article because a foreign-owned corporation is not similar to a domestically owned corporation that is accorded non-recognition treatment under sections 337 and 355”). If this statement is true, as it appears to be, one may question what it leaves intact in the nondiscrimination principle.

<sup>57</sup> U.S. model, technical explanation, article 24(1); see also Notice 87-66, 1987-2 C.B. 376 (1987).

In still other instances, lawmakers and treaty negotiators have enacted questionable statutory fixes to address nondiscrimination concerns. The branch profits regime, for example, subjects unincorporated U.S. businesses of foreign corporations to a second level of U.S. taxation intended to mimic a withholding tax on dividend distributions.<sup>58</sup> The tax is imposed annually and may apply regardless of whether funds are actually remitted to the foreign head office. As the American Law Institute has pointed out, this scheme likely violates the nondiscrimination principle by virtue of subjecting foreign-owned U.S. businesses to more onerous taxation than similarly situated U.S. corporations.<sup>59</sup> In cognizance of this argument, Congress expressly requested that the Treasury Department renegotiate outstanding treaties to permit application of the tax; however, it also declined to concede that the tax violated the nondiscrimination article in the first place.<sup>60</sup>

Similarly, section 897(i) allows a foreign corporation to elect to be treated as a domestic corporation for purposes of the 1980 Foreign Investment in Real Property Tax Act.<sup>61</sup> This provision was enacted out of concern that FIRPTA discriminated against foreign corporations by imposing withholding requirements and denying nonrecognition treatment afforded to domestic corporations under the same circumstances.<sup>62</sup> Although section 897(i) is a creative bit of statutory drafting, the treaty nondiscrimination rule is expressed in mandatory, unequivocal terms.<sup>63</sup> Allowing a corporation to choose to be treated as a domestic entity is not the same thing as refraining from discriminating against it. Like the other examples above, the provision illustrates a hypocritical proclivity to discriminate against foreign investment while denying that discrimination is taking place. Even if there were some merit to the nondiscrimination principle, the frequency of its defiance by U.S. lawmakers would seem to limit its real-world efficacy.

Unshackling ourselves from the nondiscrimination article would be no easy task. Despite its flaws, the rule commands significant support among legislators,

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<sup>58</sup> See section 884.

<sup>59</sup> American Law Institute, *Federal Income Tax Project: International Aspects of United States Income Taxation* 144-145 (1987).

<sup>60</sup> See H.R. Rep. No. 99-426, 433 (1985), reprinted in 1986-3 C.B. (Vol. 2).

<sup>61</sup> P.L. No. 96-499 sections 1121-1125, 94 Stat. 2682 (codified in scattered sections of 26 U.S.C.).

<sup>62</sup> See Boris Bittker and Lawrence Lokken, *Federal Taxation of Income, Estates, and Gifts* (2015), section 67.7.6 (explaining that although the pre-1986 corporate nonrecognition rules regarding distributions by corporations to shareholders provided the primary impetus for the enactment of the section 897(i) election, the election remains available after repeal of those rules).

<sup>63</sup> See, e.g., U.S. model article 24(1) (“Nationals of a Contracting State shall not be subjected”) (emphasis added).

treaty negotiators, and international tax planners.<sup>64</sup> At present, we may only be able to confine the scope of the article rather than eliminate it. There is, however, relevant precedent. Unique among tax treaties currently in force, the 1982 Australia-U.S. tax treaty contains an especially source-friendly version of the nondiscrimination article. In contrast to the U.S. model's private right of action, the nondiscrimination provision in that convention creates only a government-to-government remedy. The article begins, uniquely, with the words "Each Contracting State in enacting tax measures, shall ensure that. . . ." And paragraph (4) provides:

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.<sup>65</sup>

A substantial net capital importer at the time of negotiation, Australia was adamantly opposed to the nondiscrimination article, fearing it would limit its ability to impose a branch profits tax, reallocate cross-border profits, implement thin capitalization rules, and regulate foreign firms for non-revenue-raising reasons.<sup>66</sup> U.S. negotiators insisted on retaining some form of nondiscrimination article in the text of the treaty. The result was a compromise between those two positions.

U.S. treaty negotiators might consider the parallels between Australia's 1982 stance on nondiscrimination and the U.S.'s current position. Given these parallels, paragraph (4) provides a rough-and-ready blueprint for negotiations with countries insistent upon the nondiscrimination principle. Even if the nondiscrimination article stubbornly persists, casting it in the form of a public rather than private remedy removes much of its bite.

Such a move would clear away one impediment to more effective taxation of inbound investment, but there are other targets in the U.S. model. In recent decades, earnings stripping has significantly eroded the tax base of the United States and many other coun-

tries.<sup>67</sup> Section 163(j) purports to address the problem,<sup>68</sup> but it is largely ineffective and, of course, it has the specter of the nondiscrimination article hanging over it. Article 11(1) of the U.S. model exempts most types of interest from source-country taxation. The subsequent paragraph provides an exception for interest "determined with reference to receipts, sales, income, profits, or other cash flow of the debtor," which may be taxed at the maximum rate of 15 percent.<sup>69</sup> To support a more rigorous source-based tax regime, the United States might consider broadening the exception to include some of the base-eroding hybrid mismatch arrangements currently in the OECD's cross hairs — for example, by allowing withholding on interest when the payer is a disregarded entity from the point of view of the recipient's domestic law.<sup>70</sup>

Interest is probably the most important of the investment categories, owing both to the volume of cross-border interest flows and the arbitrage opportunities arising from the fungibility and tax-deductibility of debt financing. But the treatment of other kinds of investment may also merit rethinking. On dividends, the U.S. model generally provides preferential withholding rates of 5 percent (if the recipient is a corporation owning at least 10 percent of the voting stock of the corporation paying the dividend) or 15 percent in most other cases.<sup>71</sup> Some categories of dividends, however, such as those paid by real estate investment trusts, are sometimes not entitled even to the higher 15 percent preferential rate.<sup>72</sup> As with interest, the exceptions might be broadened to include other categories of objectionable distributions. And U.S. model rules on royalties should receive similar scrutiny, since royalties are only taxable in the residence country under those rules.<sup>73</sup> This exemption dates from the era when the United States was a major net exporter of intellectual property. In light of its current status as a net IP importer, the United States might revisit the general zero withholding rate as well.

Perhaps the most direct impediment to robust inbound taxation is the flinty definition of the term "permanent establishment" in the U.S. model. Under article 5, foreign companies may conduct significant

<sup>64</sup>Mason and Knoll, *supra* note 33, at 1018 ("Lack of a clear definition has not prevented prohibitions of tax discrimination from appearing in (or being read into) statutes, constitutions, and international treaties").

<sup>65</sup>See Convention Between the United States of America and the Government of Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Aug. 6, 1982, article 23, para. 4, 1 *Tax Treaties* (CCH) P 520.

<sup>66</sup>See Goldberg and Glicklich, *supra* note 41, at 58 ("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").

<sup>67</sup>See generally Ilan Benshalom, "The Quest to Tax Interest Income in a Global Economy: Stages in the Development of International Income Taxation," 27 *Va. Tax Rev.* 631 (2008).

<sup>68</sup>See Treasury Department, "Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Tax Treaties," 23 (Nov. 2007), available at <http://www.treasury.gov/resource-center/tax-policy/Documents/ajca2007.pdf>.

<sup>69</sup>See U.S. model article 11(2).

<sup>70</sup>See OECD, "BEPS Action 2: Hybrid Mismatch Arrangements" (Sept. 2014).

<sup>71</sup>See U.S. model article 10(2). Several U.S. treaties now reduce the rate on some direct investment dividends to zero.

<sup>72</sup>U.S. model article 10(4).

<sup>73</sup>U.S. model article 12(1).

business in the United States without fear of triggering U.S. tax. The enumerated list of activities that do not constitute a PE is long. Articles 5(4)(a) and (b), for example and in relevant part, exempt the “use of facilities” and the “maintenance of a stock of goods” for the purpose of delivering goods to customers.

These exceptions are passing into obsolescence. Modern technology makes it possible to negotiate and conclude sales contracts without a physical presence in the market nation. As a result, businesses that operate predominantly online have found it increasingly easy to shoehorn their activities into once-narrow carveouts. Online sellers of physical products, whose business models often depend on proximity to customers and fast delivery times, are major beneficiaries.<sup>74</sup>

Several BEPS reports propose updates to the definition of PE, with the goal of fixing the incongruity between the enumerated carveouts and the modern economy. Those recommendations include specifying that all of the activities described in the OECD model’s article 5(4) must be of an “auxiliary or preparatory nature” as well as removing the word “delivery” from paragraphs (a) and (b) of that article (which exempt “the use of facilities” and “the maintenance of goods,” respectively, when undertaken “solely for the purpose of storage, display or *delivery* of goods or merchandise belonging to the enterprise”) (emphasis added).<sup>75</sup> Other recommended changes include tamping down on so-called commissionaire arrangements by imputing a PE when firms regularly hire ostensibly independent intermediaries to act on their behalf.<sup>76</sup> Although U.S. policymakers should not blindly adopt these recommendations, they are useful for spurring discussion on changes to the analogous article in the U.S. model.

More ambitiously, the OECD has suggested supplementing the brick-and-mortar PE concept with a new “digital presence” threshold.<sup>77</sup> This test would target

companies whose products are largely dematerialized and intangible, such as Facebook and Google. Factors to be potentially included in such a test are the volume of sales transactions conducted with customers in the source country, the number of active website accounts, and the use of source-country banking or logistics services.<sup>78</sup> The prospects for implementing the concept are meager at best; such a project would involve upending a long-standing and obdurate global consensus that PEs are based on physical presence alone. But U.S. negotiators should at least begin rethinking this consensus. In the coming decades, the treaty system will need to reckon with the fact that corporeality is no longer a good proxy for permanence.

Finally, the LOB article needs a thorough reevaluation. Whether the United States continues to see itself as primarily a residence-basis country — and there is little doubt that will be the case — or adopts a more neutral position, the inconsistencies and discontinuities in article 22 of the U.S. model must be addressed. One option would be a much shorter and less objective set of tests, as is found in the LOB article in the Cyprus-U.S. treaty.<sup>79</sup> If this proves to be too subjective, something of this nature should at least serve as a supplement to objective rules that can provide a roadmap for treaty shopping.

## VI. Conclusion

The U.S. Treasury is working on a new version of the U.S. model. It has let it be known, informally, that all aspects of the 2006 model are candidates for review and revision. In the process of that review, Treasury should pause to consider whether policies that have animated the U.S. treaty negotiating position for decades are themselves worthy of a fresh look. If the concepts advanced in this article are correct, the process could produce dramatic changes to the model in the future. ◆

<sup>74</sup>See OECD, “BEPS Action 1: The Digital Economy” (Sept. 2014), at 127-129.

<sup>75</sup>OECD, “BEPS Action 7: Artificial Avoidance of PE Status” (discussion draft) (Oct. 31, 2014), at 15-16.

<sup>76</sup>*Id.* at 12-14.

<sup>77</sup>OECD, “BEPS Action 1: The Digital Economy” (Sept. 2014), at 143-145.

<sup>78</sup>*Id.*

<sup>79</sup>Convention Between the Government of the United States and the Government of the Republic of Cyprus for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income, with Related Notes, Mar. 19, 1984, article 26, 35 U.S.T. 4737.