

# THE UNITED STATES MODEL INCOME TAX TREATY

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## Introduction

In May 1976, the United States Treasury Department first released the text of its Model Income Tax Treaty. The current version of the U.S. Model, which differs from the 1976 Model only in minor respects, was released on May 17, 1977.

The U.S. Model is patterned after the Model Income Tax Treaty of the Organization for Economic Cooperation and Development (OECD Model), and closely follows that model both in substance and in form. The United States uses this Model as the basis for conducting negotiations with all countries. Although the United States does not have a model treaty specifically tailored for negotiations with developing countries, it is prepared to vary somewhat from the standard Model provisions in those negotiations.

In describing the U.S. Model, it is perhaps most useful to discuss the principal differences between it and the OECD Model. This paper analyzes the principal differences between the two models on an article by article basis. It should be emphasized that although the primary focus of this paper is on the differences between the two models, the U.S. Model differs from the OECD Model in relatively few instances, and the differences are often minor.

## I. Scope of the Treaty

The first two articles of both the U.S. Model and the OECD Model define the personal scope of the treaty and the taxes covered. The differences in the scope of the two models are discussed below.

1. *Personal scope.* In delimiting the personal scope of the treaty, the most significant departure in the U.S. Model from the OECD Model is the reservation to each Contracting State of the right to tax its own residents and nationals as if the treaty did not come into effect. This provision overrides any other provision that would otherwise limit the authority of a Contracting State to apply its internal tax law to its citizens or residents. The only exceptions to this rule relate to provisions that are

clearly intended to limit the authority of a Contracting State to tax its citizens or residents. The provisions of the treaty relating to the foreign tax credit, non-discrimination and the mutual agreement procedure are examples of those exceptions. The reason for this provision, known as the "saving clause", is that the United States views treaties as affecting a Contracting State's right to tax residents and citizens of the other Contracting State, and not as affecting its right to tax its own residents and citizens.

Under the saving clause, the United States retains its statutory right to tax its citizens and residents on worldwide income. The United States also retains the right to tax a former citizen on U.S. source income for a 10-year period if the former citizen renounced citizenship to avoid U.S. taxes.

In addition to this reservation of the right of each Contracting State to tax its own citizens and residents, the U.S. Model also clarifies that some of the treaty provisions apply to persons that are not residents of either of the Contracting States. The OECD Model makes this clarification in later provisions of the treaty.

2. *Taxes covered.* With respect to taxes covered by the treaty, the U.S. Model contains two differences from the OECD Model. A minor difference is that the U.S. Model focuses on a specific list of taxes covered and does not contain a general discussion of those taxes. A more significant difference is that, except for purposes of the Non-Discrimination Article, income and capital taxes imposed by local subdivisions of the United States are not covered by the treaty. These local U.S. taxes are not covered because it is unlikely that the United States Senate would consent to the ratification of any treaty provision that restricted the rights of the various states to impose their own taxes.

## II. Definitions of Terms

The U.S. Model closely follows the OECD Model in Articles 3, 4 and 5. Those articles define the general terms used in the treaty, such as "person", "company", "enterprise of a Contracting State", "international traffic", "resident of a Contracting State" and "permanent establishment". The few differences between the definitions used in the two models are described below.

1. *Definition of "person".* The U.S. Model includes partnerships, trusts and estates in the definition of a "person". This difference is merely an attempt to clarify that those legal entities are covered by the treaty.

2. *Definition of "international traffic".* The term "international traffic" is defined in the U.S. Model solely in terms of transport. The OECD Model definition of "international traffic" is phrased in terms of transport by a ship or aircraft operated by an enterprise which has its place of effective management in a Contracting State. If the enterprise operating the ship or aircraft has its place of effective management in its State of residence, then the U.S. Model definition of "international traffic", together with the substantive provisions of the Shipping and Air Transport Article, results in the same tax treatment of profits from shipping and air transport as that in the OECD Model.

3. *Undefined terms.* Both the U.S. Model and the OECD Model provide that for purposes of applying the treaty to its own taxes, each Contracting State will look to

its domestic law for the definition of terms not defined in the treaty. The U.S. Model makes the resolution of undefined terms subject to the mutual agreement procedure. This provision may be implicit in the OECD Model.

4. *Definition of “resident of a Contracting State”*. Under both models, treaty benefits are generally conferred only on a resident of a Contracting State, and a person is considered a resident of a Contracting State only to the extent that the person is subject to tax in that State on income from sources both within and without that State. In the interest of clarification, the U.S. Model contains rules for applying this limitation to the income of partnerships, trusts, and estates, and to income taxed in a Contracting State on a remittance basis. In addition, because the United States taxes on the basis of U.S. citizenship and incorporation in the United States, citizenship and place of incorporation are added to the criteria for determining residence. The tie-breaker rules in the U.S. Model for determining a unique residence for individuals generally follow the OECD rules. However, because the United States does not recognize the concept of place of management, the tie-breaker rule for dual resident corporations in the U.S. Model is structured in terms of place of incorporation. The U.S. Model also provides that the competent authorities of the two States are to determine residence in other dual residence situations. Finally, the U.S. Model includes as a “resident of a Contracting State” nationals of that State engaged in the performance of government services for that State, and members of their families, even though they may reside in the other Contracting State or in a third State. This broadened definition of “resident” is intended to extend the benefits of the treaty to government employees and their families who are employees of a Contracting State and are taxed in that State on a worldwide basis.

5. *Definition of “permanent establishment”*. With minor exceptions, the U.S. Model definition of “permanent establishment” is identical to that in the OECD Model. The first exception is that under the U.S. Model, if a place of management in a Contracting State does not have other attributes of a permanent establishment, then it does not constitute a permanent establishment. It is however, difficult to envision the circumstances under which there could be a place of management that does not have other attributes of a permanent establishment. Second, the U.S. Model provides that an installation, drilling rig or ship used for the exploration or development of natural resources constitutes a permanent establishment only if it lasts more than 24 months. The assumption underlying this provision is that the installation, rig or ship is analogous to a construction project and should be treated in the same manner. There is no similar provision in the OECD Model, but the OECD Commentary recognizes the provision in the U.S. Model as one of three acceptable means of dealing with activities of exploration of natural resources. Third, the U.S. Model provides that the maintenance of a fixed place of business solely for any combination of the activities listed in the OECD Model as exceptions to the definition of a permanent establishment will not result in the presence of a permanent establishment. The assumption underlying this provision is that an enterprise of one Contracting State maintaining a place of business in the other Contracting State solely for a combination of these activities is engaging only in activities of a preparatory or auxiliary character.

### III. Rules for Taxation of Specific Categories of Income and Assets

Articles 6 through 22 of the OECD Model set forth rules for the taxation of specific

categories of income and capital. The purpose of these rules is to eliminate double taxation and to provide source rules for applying the general relief from double taxation provisions of Article 23. Under these 17 articles, either the State of source or the State of residence exempts specific types of income or capital from tax or subjects them to reduced rates of taxation. The U.S. Model follows the basic structure and substance of the OECD Model in these 17 articles. The principal differences between the two models as they relate to each category of income or capital are discussed below.

1. *Income from immovable property.* In the U.S. and OECD Models, the primary right to tax income from immovable property is vested in the State in which the property is situated. The U.S. Model further provides for an election to be taxed on the income from immovable property on a net basis. U.S. tax law unilaterally provides that residents of other countries may elect to be taxed in the United States on income from real property on a net basis.

2. *Business profits.* The U.S. Model closely follows the OECD Model in the treatment of business profits. In both models, business profits of a resident of one Contracting State are not taxable in the other Contracting State unless the resident has a permanent establishment in that other Contracting State. There are, however, some minor differences between the two models.

First, the U.S. Model refers to "business profits", rather than to "profits". The reference to "business profits" merely clarifies that the OECD term "profits" includes only income from business and not any other income. If this interpretation is not used, Article 22, dealing with other income, would have no significance.

Second, for the purpose of determining which profits are attributable to a permanent establishment, the U.S. Model requires arm's length dealings between all related entities, not just between the permanent establishment and its home office. Third, the U.S. Model specifies that in determining the profits of a permanent establishment, a deduction is allowable for a reasonable allocation of research and development expenses, interest and other expenses incurred for the enterprise of which the permanent establishment is a part. This change generally puts into the text of the treaty the apparent intent reflected in the OECD Commentary.

Fourth, because the United States does not determine profits attributable to a permanent establishment through an apportionment method, the apportionment provision of the OECD Model is deleted.

Finally, the U.S. Model contains a definition of the term "business profits", and specifically includes in that definition income derived from the rental of tangible personal property and motion picture, television and radio tapes and films. This definition is provided to delineate more precisely the types of income subject to the permanent establishment rules and to taxation on a net, rather than gross, basis.

3. *Income from shipping and air transport.* There are three differences between the U.S. Model and the OECD Model with respect to the taxation of income from shipping and air transport.

First, in the U.S. Model, profits from the operation of ships or aircraft in international traffic are subject to tax only in the country of residence of the operator of the ship or aircraft. Under the OECD Model, the State in which the place of effective management of the operator is located has the exclusive right to tax. The difference between the two models exists because U.S. tax laws do not contain a concept of place of effective management. However, there is no substantive difference be-

tween the OECD rule and the U.S. rule in cases in which the enterprise operating the ships or aircraft has its place of effective management in the State of its residence. Second, the U.S. Model deletes the OECD Model provision relating to shipping on inland waterways because foreign ships do not operate on U.S. inland waterways and it is unlikely that U.S. ships will operate on inland waterways of foreign countries. Third, the United States Model clarifies that profits from the rental of ships or aircraft operated in international traffic, profits that are incidental to international transport, and profits from the rental of containers used for transport in international traffic are exempt from taxation in the State of source. The applicability of these rules is generally acknowledged in the OECD Commentary.

4. *Profits of associated enterprises.* The scope of the provision in the U.S. Model for allocating profits between related enterprises is broader than the scope of the OECD provision in that it extends the right of the Contracting States to distribute, apportion or allocate income, deductions, credits or allowances between related parties that are residents of the Contracting States and of third States.

5. *Dividends.* In addition to minor drafting differences, there are two substantive differences between the U.S. Model treatment of dividends and that of the OECD Model. First, the U.S. Model provides that a recipient of a dividend that owns 10 percent of the stock of the company paying the dividends qualifies for the 5 percent rate of withholding. The U.S. Model applies the 10 percent ownership rule, rather than the 25 percent ownership rule of the OECD Model, because U.S. tax laws distinguish between direct investment and portfolio investment for foreign tax credit purposes at the 10 percent level of stock ownership. Second, the U.S. Model embodies in the treaty a basic concept of U.S. tax law that one Contracting State may tax dividends paid by a resident of the other Contracting State to the extent attributable to the profits of a permanent establishment in the taxing State, but only if those profits account for at least 50 percent of the gross income of the corporation paying the dividends.

6. *Interest.* The principal difference between the U.S. Model and the OECD Model in the treatment of interest income is that the U.S. Model exempts interest payments from withholding at source, while the OECD Model provides for a 10 percent rate of tax withholding. In the U.S. view, a 10 percent rate of tax withholding at source fails to adequately recognize that there are often substantial expenses associated with interest income. Thus, even a relatively low rate of tax withholding on gross interest may translate into a very high rate of tax on net interest income.

7. *Royalties.* The U.S. Model treatment of royalties is essentially the same as that in the OECD Model. However because income from the rental of motion picture films, films and tapes for use in television and radio broadcasting and industrial, commercial and scientific equipment is taxed as business profits in the U.S. Model, that income is excluded from the definition of the term "royalties". In cases where an enterprise of one Contracting State has no permanent establishment in the State of source of the royalties, there is no substantive difference between the U.S. Model and the OECD Model; in both cases, those royalties are not subject to tax in the source State. Also, under the U.S. Model, gains from the alienation of industrial property are taxed as royalties to the extent contingent on productivity or sales, because contingent payments more closely resemble royalties than gain.

8. *Capital gains.* The U.S. Model treatment of capital gains differs from that in the OECD Model only in that gains derived by an enterprise from the alienation of ships, aircraft or containers operated by that enterprise in international traffic are taxable only in the State of residence of the operator rather than in the State in which the enterprise has its place of effective management. This difference results from the absence in U.S. tax laws of a concept of place of effective management of an enterprise. If the enterprise conducting the international transport operations has its place of effective management in the State of which it is a resident, there is no substantive difference between the two models in the taxation of those gains.

9. *Income from the performance of independent personal services.* The principal difference between the two models in the treatment of income from the performance of independent personal services is that the U.S. Model permits a Contracting State to tax a resident of the other Contracting State on that income if the person performing the services is present in that State for more than 183 days during the year. Under the OECD Model, if the person performing the services does not have a fixed base in the taxing State, he would not be subject to taxation in that State irrespective of the length of his presence in that State. In the U.S. view, residents of the taxing State find it objectionable that a resident of the other Contracting State can be present in the taxing State for more than half the year and not be subject to tax on earnings from personal services performed there. The 183-day rule of the U.S. Model is consistent with the 183-day rule in the Dependent Personal Services Articles in both the OECD and the U.S. Models and is also consistent with the laws of many countries that use a six-months presence test for determining residence.

The U.S. Model also makes two clarifications to the OECD Model. First, the U.S. Model clarifies that the independent personal services provisions apply only to individuals. Second, the U.S. Model uses the term "personal services", rather than the OECD term "professional services", to clarify that all independent personal services are covered by Independent Personal Services Article.

10. *Income from the performance of dependent personal services.* With respect to the taxation of income from the performance of dependent personal services, the U.S. Model differs from the OECD Model only in that the taxation of remuneration derived in respect of an employment as a member of a regular complement of a ship or an aircraft operated in international traffic is reserved to the State of residence of the operator of the ship or aircraft rather than to the State in which the place of effective management of the operator is situated. The results reached in the two models are the same if the enterprise engaging in the international transport has its place of effective management in the State of its residence.

11. *Directors fees.* Unlike the OECD Model, the U.S. Model contains no provision specifically addressing the taxation of directors' fees. The position in the U.S. Model is that directors' fees should be taxable as income from the performance of dependent personal services if the director is an employee of the company paying the directors' fees, and as income from the performance of independent personal services if the director is not an employee of that company.

12. *Investment or Holding Companies.* The U.S. Model contains a separate article designed to limit the opportunity for third country residents to take advantage of the treaty benefits by organizing a holding or investment company in one of the Contracting States. There is no comparable provision in the OECD Model. However, the

Commentary to the OECD Model indicates that it may be appropriate to provide for special treatment of investment or holding companies in bilateral treaties.

13. *Artistes and Athletes.* The only principal difference between the U.S. Model and the OECD Model in the treatment of income of artistes and athletes is that under the U.S. Model, income earned in one Contracting State by artistes and athletes resident in the other Contracting State is treated the same as income earned from the performance of independent or dependent personal services unless it exceeds \$15,000 during the taxable year. Under the OECD Model, all the income is taxable in the State where the artistes or athletes performed. The rule in the U.S. Model reflects the view that cultural exchanges should be encouraged, and that in the absence of international tax avoidance, entertainers and athletes should not be singled out for special adverse tax treatment. The U.S. Model does recognize, however, the ability of those performers to earn very high remuneration in very short periods, and, for that reason, includes the \$15,000 threshold. The U.S. Model also contains additional clarification in the provisions designed to counter tax avoidance schemes employed by entertainers and athletes.

14. *Pensions, annuities, alimony and child support.* The OECD and U.S. Models contain virtually identical provisions for the taxation of pensions. The U.S. Model goes beyond the OECD Model in that it also sets out provisions regarding the tax treatment of social security payments and other public pensions, annuities, alimony, and child support. Under the U.S. Model, social security payments and other public pensions are taxable only by the paying state. In the United States, employee social security contributions are made with after-tax dollars and social security benefits paid by the United States are not taxed. Social security benefits paid by foreign governments to U.S. citizens and residents are normally taxed by the United States. However, in the U.S. Model, the United States gives up this tax on foreign social security payments in exchange for the agreement of the other Contracting State not to tax social security benefits paid by the United States to a resident of that other Contracting State. The other Contracting State is, however, permitted to tax the social security benefits that it pays to a resident of the United States.

The U.S. Model also provides that annuities may be taxed only by the State of residence of the person receiving the annuity, that alimony may be taxed only by the State of residence of the person receiving the alimony, and that child support payments are exempt from tax in both Contracting States. Pursuant to the Other Income Article of the OECD Model, annuities and alimony are taxed only by the State of the recipient's residence. Thus, the tax treatment of annuities and alimony is the same in both Models.

15. *Government service.* The government service provisions of the two models are essentially the same. The U.S. Model does, however, contain a special provision to the effect that the motive of a spouse or a dependent child of an employee of the government of one Contracting State in becoming a resident of the other Contracting State will not affect the tax exempt status of that spouse or child in that other Contracting State if that spouse or child later becomes an employee of the government of the first Contracting State.

16. *Students and trainees.* The only substantive difference between the U.S. Model and the OECD Model in the treatment of income of students, apprentices or business trainees is that the U.S. Model provides that the student, apprentice or trainee from

one Contracting State temporarily present in the other Contracting State may elect to be taxed as a resident of the other Contracting State. By electing to be treated as a resident of the United States, a non-resident alien is permitted to take certain statutory deductions, allowances and exemptions that would not otherwise be available, and to file a joint income tax return. However, the person making the election must give up the benefits otherwise provided by the treaty for residents of his home State and will be taxed by the United States on worldwide income.

17. *Other income.* The U.S. Model provides for essentially the same treatment of income not otherwise dealt with in the treaty as is provided in the OECD Model. A minor difference between the two models is that the U.S. Model clarifies that the Artistes and Athletes Article, as well as the Business Profits and the Independent Personal Service Articles, will override the Other Income Article if income not otherwise dealt with in the treaty is effectively connected with a permanent establishment or fixed base maintained in the taxing State by a resident of the other State.

18. *Capital.* Although the United States does not currently impose taxes on capital, the U.S. Model contains substantially the same provisions as the OECD Model. The only principal difference between the two models is that the U.S. Model reserves the right to tax capital represented by ships or aircraft operated in international traffic and related movable property to the State of residence of the operator of the ship or aircraft, rather than to the State in which the effective management of the operator is situated. However, there is no difference between the two models in this respect if the enterprise operating the ships or aircraft has its place of effective management in its State of residence.

### III. Relief from Double Taxation

Article 23 of both the U.S. and OECD Models contains detailed rules for the elimination of double taxation in cases in which double taxation is not otherwise accomplished in the treaty by the relinquishment of the right of the State of source or the State of residence to tax specific types of income or capital. This article is one of the few articles in which the U.S. Model does not follow the style of the OECD Model. The U.S. Model does not follow the OECD Model because traditionally most countries have devised their own provisions for relief from double taxation, and it is generally expected that this article of the OECD Model will be modified in bilateral treaties.

Consistent with U.S. tax laws, the U.S. Model employs a credit method of relief from double taxation for the United States. Essentially, the United States guarantees to its residents and citizens that they will be entitled to a credit against U.S. tax liability for foreign taxes paid on foreign source income. The guarantee embodies the U.S. statutory foreign tax credit both for taxes paid directly to the other Contracting States by the U.S. citizen or resident and for those foreign taxes paid by foreign corporations more than 10 percent owned by a U.S. corporation.

The U.S. Model permits the other Contracting State to set out its own method for avoiding double taxation. However, if the treaty partner uses a credit method, the United States requests that the credit cover the direct and indirect U.S. taxes paid on the business profits and also the withholding tax imposed by the United States on the dividends paid.

#### IV. Administrative Provisions

The remaining six articles of both the U.S. Model and the OECD Model contain provisions relating to the administration of the treaty. Those articles relate to non-discrimination, the mutual agreement procedure, exchange of information and administrative assistance, the effect of the treaty on diplomatic agents and consular officials, entry into force and termination.

1. *Non-discrimination.* The non-discrimination provision in the U.S. Model differs from that in the OECD Model in several respects. First, the U.S. Model clarifies that nationals who are subject to tax by a Contracting State on worldwide income are not in the same circumstances as nationals who are not so subject. This provision enables the United States to continue its statutory scheme of taxing its citizens and corporations on their worldwide income, and of taxing non-resident aliens and foreign corporations only on investment income from U.S. sources and on income effectively connected with a U.S. trade or business. Second, the U.S. Model does not guarantee non-discriminatory treatment to stateless persons because it is felt that the coverage of stateless persons is inappropriate in a bilateral treaty. Finally, in the interest of clarity, the U.S. Model specifies in greater detail than the OECD Model the types of disbursements for which an enterprise of one Contracting State must be allowed a deduction by the other Contracting State on a non-discriminatory basis.

2. *Mutual agreement procedure.* There are two minor differences between the Mutual Agreement Procedure Articles of the two models. First, the OECD Model generally requires a person to invoke the mutual agreement procedure in the State of which that person is a resident. The U.S. Model provides that a person may invoke that procedure in either the State of residence or the State of which he is a citizen. Second, the U.S. Model contains no limitation on the time period within which the mutual agreement procedure must be invoked, while the OECD Model requires that the procedure be invoked within a three year period.

3. *Exchange of information and administrative assistance.* There are two differences between the exchange of information provisions in the U.S. and OECD Models. First, the U.S. Model provides for the exchange of information with respect to all national taxes, while the OECD Model applies only to the taxes covered in the treaty. Second, the U.S. Model contains an additional provision detailing the procedures relating to the collection of information and the form in which the information is to be provided to the requesting State.

The U.S. Model also contains a provision under which the Contracting States agree to render limited assistance to each other in the collection of taxes. This provision does not provide for general assistance in collection, but only for the limited assistance necessary to prevent misuse of the treaty. The United States requests limited assistance in collection to prevent abuse of the address system (as opposed to a certification system or a refund system) which the United States uses in applying the treaty exemption or reduced withholding for dividends paid by U.S. corporations to residents of foreign countries.

4. *Effect of convention on diplomatic agents and consular officials, domestic laws and other treaties.* The U.S. Model goes beyond the OECD Model provision concerning the fiscal privileges of diplomatic agents and consular officials in that it clarifies that the treaty does not limit any of the fiscal privileges otherwise provided

under the laws of either Contracting State or under any other treaty or agreement between the Contracting States.

5. *Entry into force.* In the entry into force provisions, the U.S. Model differs from the OECD Model in two very minor respects. First, the U.S. Model clarifies that the treaty has no effect until it has been ratified or approved in accordance with the constitutional procedures of each Contracting State. Second, the U.S. Model specifies in detail the effective dates for the application of the treaty.

6. *Termination.* The U.S. Model provision relating to termination of the treaty differs from that in the OECD Model in that it provides for a five year minimum period during which the treaty is to remain in force. The OECD Model leaves the minimum period up to the Contracting States. As in the provision concerning entry into force, the U.S. Model also specifies in detail the effective dates for the termination of the treaty.