U.S. Tax Treaties: Trends, Issues, & Policies in 2006 and Beyond

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I. INTRODUCTION

Tax lawyers regularly spend countless hours trying to parse the often impenetrable language of Subchapter N in the Internal Revenue Code ("I.R.C.") and the accompanying Treasury Regulations, only to find that the problem under analysis can be readily solved through the application of the provisions of a bilateral income tax treaty to which the United States is a party. That experience is often a reminder that, after the U.S. Constitution, an applicable bilateral income tax treaty can have parity with the provisions of the I.R.C. Dependent upon the situation, the provisions of the applicable tax treaty (rather than a relevant statute) might be the "controlling authority." However, having determined that a tax treaty provision might be beneficial to a taxpayer, the advisor might find that a superseding statute must be treated as the controlling authority.

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1. Subchapter N ("Tax Based on Income From Sources Within or Without the United States") of Chapter 1 ("Normal Taxes and Surtaxes") of the I.R.C. provides the statutory rules for the federal income taxation of both "inbound" and "outbound" transactions and persons.

2. I.R.C. § 894(a) (West 2006) provides that "[t]he provisions of this title [that is, the Internal Revenue Code] shall be applied to any taxpayer with due regard to any treaty obligation of the United States which applies to such taxpayer." I.R.C. § 7852(d)(1) provides that "[f]or purposes of determining the relationship between a provision of a treaty and any law of the United States affecting revenue, neither the treaty nor the law shall have preferential status by reason of its being a treaty or law." This latter provision reflects the U.S. rule that the "later in time" of either the treaty or the applicable statute controls. Under the U.S. Constitution, U.S. treaties and federal statutes have equal status as the supreme law of the land. U.S. Const. art. VI, cl. 2. Consequently, when a conflict exists between the treaty and the statute, the later in time prevails. See Restatement (Third) of the Foreign Relations Law of the United States § 115 (1986). This approach is contrary to the rule in most other developed countries, that is, the priority being the relevant country's (1) constitution or other fundamental document, (2) a treaty and, then, (3) an enacted law.

3. As a rule of interpretation, U.S. courts will often seek to interpret and apply U.S. treaties and federal statutes on the basis that a conflict does not exist. See Restatement (Third) of the Foreign Relations Law of the United States § 114 (1986). In some instances, however, when enacting legislation the U.S. Congress will indicate that the applicable legislation supersedes a treaty provision (including those in a tax treaty). Alternatively, the legislative history might indicate that a conflict between the later statute and the earlier treaty provision does not exist, although the lack of such conflict is extremely difficult to discern.
The United States has an extensive network of bilateral income tax treaties, numbering fifty-seven and covering sixty-five countries as of early 2006. The United States also has a limited number of estate, gift, and generation-skipping transfer tax treaties. Other bilateral treaty variants in the tax context include “tax information exchange agreements,” reciprocal shipping and aviation agreements, and Social Security totalization agreements. Even treaties of Friendship, Commerce and Navigation may be sufficiently expansive in certain situations to be applicable to cross-border tax matters.

Some of these U.S. income tax treaties have been in effect for a considerable period; some older treaties have been regularly supplemented with protocols; and some are either quite recent replacements of older treaties or are new treaties particularly with developing countries. Many European countries have much more extensive income tax treaty networks than does the United States, partly because they have been much more interested in their bilateral income tax treaty networks for an extended period and also because many of those treaty partner countries have a more accepting political environment in which to conclude a bilateral tax treaty with smaller European countries (as contrasted to the United

4. This differential between the number of existing treaties and countries is attributable to the old U.S.S.R. treaty remaining applicable to various countries that were members of the Soviet Union. A useful summary of outstanding U.S. tax treaties and ongoing tax treaty negotiations is periodically included in Tax Management International Journal, a monthly publication issued by Tax Management, Inc. The United States is identified as having income tax treaties in force with sixty-five countries (as of December 15, 2005). John Venuti et al., Current Status of U.S. Tax Treaties and International Tax Agreements, 35 TAX MGMT. INT'L J. 38, 39 (2006). Three treaties (or protocols) were identified as signed and awaiting U.S. Senate approval. Id. at 40. The United States is identified as having income tax treaties under negotiation with twenty-eight countries. Id. at 40-41.

5. They come in a variety of options. For example, some only deal with estate tax. This paper does not examine the U.S. treaties dealing with transfer taxes. Note that the expansion of these treaties has been essentially moribund for several decades, although periodically a protocol to an existing estate tax treaty is entered into, often in conjunction with the negotiation of an amendment to the income tax treaty with the same country. Perhaps this ambivalence about transfer tax treaties derives from the larger issue in the United States of the continuation, significant revision, or permanent elimination of the federal estate, and generation skipping transfer taxes.

6. The United States is identified as also having exchange of tax information agreements either in force or signed and awaiting final action or under negotiation. Venuti et al., supra note 4, at 40. Many of the exchange of tax information agreements are with countries in the Caribbean where the United States is interested in receiving information from tax haven jurisdictions, but a U.S. bilateral income tax treaty is of limited value. Id. at 43.

7. The objective of a social security totalization agreement is to ensure that during the contributions phase taxation by two countries is limited, and during the distributions phase credit is provided for contributions to the social security systems of several countries for determining both eligibility and benefit amounts.

8. To reject the potential applicability of these treaties in the tax context, the U.S. Congress may limit the types of international agreements which can provide benefits in a particular tax context. See, e.g., I.R.C. § 884(e)(1) (West 2006) (specifying in the branch profits tax provision that a potential branch profits tax exemption is only available if a treaty “is an income tax treaty.”).
States, the "bull in the China shop"). Consider, in this context for example, the reluctance of many Latin American countries to enter into a bilateral income tax treaty with the "big brother" United States to the north and, also, the traditional perspective of many Arab countries not to enter into economic-based treaties with the United States.

Similarly, the United States Government, that is, the U.S. Department of the Treasury ("Treasury") periodically has been ambivalent about extending its income-tax treaty network. With each new presidential administration, a considerable period of malaise (or antagonism) seems to arise concerning whether the Treasury should pursue a program of revising older tax treaties and expanding the U.S. treaty network. Thereafter, as the particular presidential administration continues, the Treasury representatives recognize the value of a modernized income tax treaty network and pursue negotiations with multiple trading partners. Often smaller countries with developing economies want to enter into a bilateral tax treaty with the United States, but the U.S. tax treaty negotiators, being overwhelmed with the volume of their activities, have been known to present the U.S. Model Income Tax Treaty on a "take it or live it" basis. This is certainly not the most diplomatic approach.

An objective of this article is to emphasize the importance of the immense economic and political value to the United States of its bilateral income tax treaty network and the importance to be paid to regularly modernizing each of these treaties. Hopefully, this objective is accom-
plished by identifying a variety of important issues confronting the current evolution of U.S. tax treaty policy.14 As identified below, during 2005 and continuing into 2006, the Bush Administration has seemed to recognize the importance of having a coherent tax treaty policy and has accelerated efforts to solve outstanding income tax treaty issues through a multiplicity of techniques.

II. THE PURPOSES AND BENEFITS OF BILATERAL INCOME TAX TREATIES

Income tax treaties provide benefits to both taxpayers and governments by establishing clear ground rules that will govern income tax matters relating to trade and investment conducted by residents of the two treaty countries.15 The specific objectives of these tax treaties can include the following:16

1. As an overarching objective to recognize how the tax systems of two countries can work in harmony so that individual taxpayers do not get entangled in the middle between the taxing authorities of two national governments.17

2. To determine whether the activities of particular taxpayers are sufficient to cause those taxpayers to be subjected to taxation in another country by reason of cross-border activities. The inquiry in this context is whether the economic activity in the destination country is of such substance that the destination country should be permitted to exercise taxing jurisdiction over the profits derived in that country from those activities. The tax treaty will identify the circumstances causing tax jurisdiction to exist in the destination country. Otherwise, the sole taxing jurisdiction


15. Brown Testimony, supra note 13, at 1-2. As economic cooperation among multiple jurisdictions advances, the adoption of multilateral income tax treaties can eventually be anticipated. On a quite limited basis, a foundation for such arrangements on the U.S. side might begin to develop through the implementation of multilateral “Advanced Pricing Agreements.” Of course, on the European side, the E.U.-coordinated tax policy endeavors are tending in a similar direction.

16. See id at 2. A review of the structure and provisions of a bilateral tax treaty will confirm that these are separate elements in a tax treaty, including in the various “Articles” of a treaty appropriately designated by specific subject matter. Note that, as specified in the American Jobs Creation Act of 2004, the Treasury was instructed to perform the following:

[C]onduct a study of United States income tax treaties to identify any inappropriate reduction in United States withholding tax to provide opportunities for shifting income out of the United States, and to evaluate whether existing anti-abuse mechanisms are operating properly. The study shall include specific recommendations to address all inappropriate uses of tax treaties. Not later than June 30, 2005, such Secretary or delegate shall submit to the Congress a report of such study.


17. See Brown Testimony, supra note 13, at 2.
for a taxpayer's economic activities should reside in the taxpayer's home country, that is, at the "residence."\textsuperscript{18}

3. When taxing jurisdiction does exist (as determined under the applicable income tax treaty) to protect taxpayers from potential double taxation through the allocation of taxing rights between the two treaty partner countries. The treaty will ordinarily identify where the primary right to tax a specific item of income exists, whether at the situs location where the income arises or in the residence jurisdiction. In this process, the treaty can identify the source location for a particular item of income. Further, particularly with respect to "mobile" income (for example, dividends, interest, and royalties), the treaty might shift the primary (or exclusive) taxing jurisdiction to the residence country and away from the source country.\textsuperscript{19} This is often accomplished by reducing or eliminating the income tax rate applicable at the source. That tax is ordinarily collected through a withholding at source mechanism.\textsuperscript{20}

4. To ensure that disputes concerning taxing jurisdiction can be resolved through administrative procedures with cooperation between the two taxing authorities. This is commonly referred to as the "Competent Authority" mechanism.\textsuperscript{21}

5. To ensure that foreign taxpayers are not discriminated against in favor of host-country taxpayers.\textsuperscript{22} This is ordinarily accomplished under

\textsuperscript{18} See id.


\textsuperscript{20} This reduction of the tax liability at source on mobile income recognizes that these withholding taxes are imposed on a gross basis, and since deductions are not allowable the effective tax rate on this income can be high (and, in some instances, confiscatory). Brown Testimony, \textit{supra} note 13, at 2. In many situations, a more appropriate approach under a conflict of laws approach is to impose taxation at residence rather than at source. When taxed at residence this foreign source income will ordinarily be subject to tax on a comprehensive net income basis.

\textsuperscript{21} On the U.S. side, the responsibility for acting as the "Competent Authority" has been delegated by the U.S. Secretary of the Treasury to the Director, International (LMSB) of the I.R.S. Brown Testimony, \textit{supra} note 13, at 2. This concept of "Competent Authority" contemplates that segment of the I.R.S. that is "duly authorized" by an appropriate Delegation of Authority from the Secretary of the Treasury (rather than the analysis of a disgruntled student/I.R.S. employee in the author's class several years ago who asserted that the I.R.S. could not possibly have any "competent" authority).

\textsuperscript{22} Although the tax treaty provisions do not ordinarily apply to state and local taxation, the non-discrimination provision of an income tax treaty is ordinarily extended to also
a "non-discrimination" provision that provides for "national treatment" of inbound investors. Of course, discrimination and the existence of comparable status in this context is often in the "eye of the beholder" and, consequently, comparability status can be (and often is) treated as not existing.

6. To deal with specialized situations involving individuals where tax jurisdictional conflicts may arise, including the treatment of (a) receipts from Social Security benefits and other government based retirement benefits, (b) private retirement plan benefits, (c) alimony, and (d) child support. Tax jurisdictional issues can arise in this context because, for example, the economic rights may have accrued (as is the case for retirement plan benefits) on a tax deferred basis while a taxpayer was a resident in one country, and, thereafter, that taxpayer receives the payment of these benefits after retirement while residing in another jurisdiction.

7. To enable the exchange of information between taxing authorities so as to monitor the tax reporting of various income items by taxpayers having contacts, business activities, and investments in the two jurisdictions. This can be accomplished through "spontaneous exchanges," specific requests for information, and the exchange of information to resolve an individual tax controversy. For the Treasury, this information exchange encompass state and local taxation, often to the consternation of those local taxing officials.

23. For a discussion of the tax treaty anti-discrimination provision in the context of the federal tax (non)recognition of same-sex marriages, see Arthur C. Infanti, Prying Open the Closet Door: The Defense of Marriage Act and Tax Treaties, 105 Tax Notes 563 (2004), noting that each of the income tax treaties with Belgium, Canada, The Netherlands, and Spain contains a non-discrimination article that prohibits the United States from taxing citizens of the other country in another or more burdensome fashion than it taxes its own citizens in the same circumstances. The heart of this article consists of a discussion of the relationship between the non-discrimination provisions in these treaties and the U.S. "Defense of Marriage Act" ("DOMA"). Professor Infanti concludes that a tenable argument can be made that DOMA should not be given priority over the tax treaty provisions and that, as a result, the I.R.S. (and, in many cases, state and local tax authorities) should be required to recognize for tax purposes the marriages of resident alien same-sex couples who are citizens of Belgium, Canada, The Netherlands, or Spain.

24. See Brown Testimony, supra note 13, at 3, indicating in this context the following: [T]ax treaties clarify the manner in which possible discrimination is to be treated in the tax context. Particular rules are needed here, for example, to reflect the fact that foreign persons that are subject to tax in the host country only on certain income may not be in the same position as domestic taxpayers that may be subject to tax in such country on all their income.

25. For example, this might include the sending of copies of IRS Form 1099 informational returns to the counterpart national taxing authority.

26. The transfer of this tax information is permitted on the U.S. side by I.R.C. § 6103(k)(4) (West 2006), which specifies that a return or return information may be disclosed to a competent authority of a foreign government that has an income tax convention (or gift and estate tax convention) or other convention or bilateral agreement relating to the exchange of tax information with the United States, but only to the extent provided in, and subject to, the terms and conditions of such convention or bilateral agreement. Otherwise, I.R.C. § 6103(a) would be applicable, which specifies that tax returns and tax return information shall be confidential and (except as otherwise authorized) no officer or employee of the United States (or certain other identified individuals) shall disclose any return or tax return information obtained by him in any manner in connection with his service as such as an officer or an employee or otherwise or under the provisions of this
element of a bilateral tax treaty has immense importance.27

In this context, an overarching objective of a presidential administration could be to use bilateral income tax treaties as one of the numerous elements in implementing a cohesive international economic program. The Treasury will often have its own revenue estimates for measuring the impact of various tax treaty provisions (for example, the tax withholding-on-interest provision). Treasury's tax treaty negotiators will know the anticipated cross border impact (for both inbound and outbound directions) of the reduction of an interest or dividend withholding tax rate.28 As Deputy International Tax Counsel Brown indicated: "Because the coverage of our treaty network is already quite comprehensive, it frequently will make more sense, as an economic matter, for the United States to negotiate an update to an existing agreement, rather than to negotiate a full treaty with a new treaty partner."29

This statement reaffirms that the income taxation of most economic transactions in and out of the United States is already within the coverage of a bilateral income tax treaty, with the I.R.C. provisions filling in the gaps at the edges of tax treaty coverage. Ms. Brown also indicated the following in her statement: "Each treaty that we present to the Senate

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27. See Brown Testimony, supra note 13, at 3, specifying the following: [B]ecause access to information from other countries is critically important to the full and fair enforcement of the U.S. laws, information exchange is a priority for the United States in its tax treaty program. If a country has bank secrecy rules that would operate to prevent or seriously inhibit the appropriate exchange of information under a tax treaty, we [the Treasury] will not conclude a treaty with that country. Indeed, the need for appropriate information exchange provisions is one of the treaty matters that we consider non-negotiable.

28. For example, rumors abounded that the United States was reluctant for a considerable period to renegotiate the Japan-U.S. income tax treaty because of the withholding tax being collected on outbound interest payments and because Japanese lenders were receiving considerably more interest income from the United States than the interest flowing inbound into the United States from Japan. See, e.g., J. Comm. on Taxation, JTC Explains Proposed Protocol to Netherlands-U.S. Income Tax Treaty (JCX-54-04), TAX NOTES TODAY, Sept. 16, 2004, LEXIS, 2004 TNT 181-5.

29. Brown Testimony, supra note 13, at 3 (emphasis added). This statement further notes the following: [S]uch a full agreement will require the potential treaty partner to grapple with many of the complexities of U.S. domestic and international tax rules and U.S. tax treaty policy, and how it interacts with its own domestic law and policies. Thus, the primary constraint on the size of our tax treaty network may be the complexity of the negotiations themselves.

Id. at 3. The various functions performed by tax treaties, and most particularly the need to mesh the particular tax systems of the two treaty partners, make the negotiation process exacting and time-consuming for the government representatives on both sides. Id. Periodically Treasury representatives have informally indicated that those (smaller) countries who want a tax treaty with the United States can adopt the U.S. Model Income Tax Treaty on a "take it or leave it" basis. The problem with that approach now is that the Treasury Model dated 1996 is significantly outdated and, consequently, no real "model" exists to "take or leave." See United States Model Income Tax Convention, Sept. 20, 1996, available at http://www.treasury.gov/offices/tax-policy/library/made/1996.pdf [hereinafter Model Treaty].
represents not only the best deal that we believe we can achieve with the particular country but also constitutes an agreement that we believe is in the best interests of the United States."  

Although these are designated as "treaties," taxpayers and their representatives must also be aware that these arrangements are bilateral "contracts" entered into between the United States and one other national state after serious negotiations. Consequently, each side will want to ensure that its own special interests are protected as part of the bilateral trade and investment arrangements between the two countries. Tax treaty partners to the United States are often quite careful (often with the advice of Washington, D.C.-based international tax counsel) to make certain that any subsequent fundamental tax treaty policy changes implemented by the United States will also inure to the benefit of the nation state currently entering into a treaty contract with the United States.

Further, the United States is careful to ensure that the tax treaty's beneficiary will be taxable in the other treaty country, thereby preventing the tax treaty's exploitation by persons in a third country. The use of a U.S. income tax treaty by third country residents is not perceived as being consistent with the "treaty deal." Further, preventing this exploitation of the provisions of a bilateral treaty by a third country party "is critical to ensuring that the third country will sit down at the table with us to negotiate on a reciprocal basis, so that we can secure for U.S. persons the benefits of reductions in source country tax on their investments in that country."  

III. THE UNITED STATES AND THE OECD MODEL INCOME TAX TREATIES

The United States has traditionally issued its own model income tax treaty which has ordinarily constituted the initial position of the Treasury

31. An example of this is in the Bangladesh-U.S. income tax treaty being considered by the U.S. Senate for ratification during 2006. This proposed treaty specifies that double taxation relief will be provided through the foreign tax credit mechanism. Id. at 10. However, this convention does not include a "tax sparing credit" since such credits are contrary to current U.S. tax treaty policy. Id. The "tax sparing credit" is a mechanism sometimes used by other developed countries to provide a hypothetical credit to offset the income tax liability otherwise incurred in the home country when the destination country (often a developing country) imposes little or no tax so as to encourage economic development within that country. With no tax sparing the income tax burden would merely be shifted to the residence jurisdiction (as is the result of current U.S. tax policy, but is usually avoided through the imposition for a foreign country subsidiary). At Bangladesh's request, the exchange of diplomatic notes accompanying the proposed treaty provides that if the United States alters its policy regarding the granting of tax sparing credits or provides for such credits in another treaty, U.S.-Bangladesh negotiations will be reopened with a view to concluding a protocol that would offer similar benefits to Bangladesh. Id. Although this change in policy is only a remote possibility, the future U.S. adoption of a territorial approach to U.S. cross-border income taxation would essentially achieve the objective of immunizing this income (and might trigger a review in this context).
32. See discussion of the "limitations on benefits" provisions infra Part VIII.B.
33. Brown Testimony, supra note 13, at 5.
in commencing bilateral tax treaty negotiations with a particular country. The Treasury issued the Model Treaty in 1996 and also issued an accompanying Technical Explanation.\(^{34}\) Rumors circulated, particularly during 2005, that a revised Model Treaty would be released during the year 2005, but that has not occurred as of mid 2006.\(^{35}\) Perhaps the latter part of the year 2006 will see an updated version of the Model Treaty (and an accompanying Technical Explanation).\(^{36}\) Since its release, the 1996 Model Treaty has become significantly outmoded, particularly when contrasted with recently implemented bilateral income tax treaties.\(^{37}\) Treaty negotiators from treaty partner countries are quite aware of this evolution as to many provisions in the U.S. Model Treaty. These countries (if alert) also often find informed advice useful (often from Washington, D.C.-based international tax advisors) concerning these items and the significance of these matters in the context of the particular tax treaty negotiation. The international tax advisor must, therefore, piece together the changes implemented in the most recently negotiated U.S. income tax treaties to discern the current possible negotiating position of the United States on a particular treaty issue. The Treasury may also indirectly indicate that its tax treaty negotiating position has fundamentally changed (at least as to countries in basically the same economic situation). For example, in the Treasury's Technical Explanation to the income tax treaty between the United Kingdom and the United States, the Treasury indicated that, in the negotiations, the parties took into account recent income tax treaties negotiated by both parties, signaling that in some areas its fundamental positions have changed.\(^{38}\)


\(^{35}\) Perhaps the concern is that either the Senate Foreign Relations Committee (the relevant committee for approving treaties, including tax treaties) or the Senate Finance Committee (not having jurisdiction over tax treaty ratification, but being concerned about the direction of international taxation and, therefore, tax treaty policy) would hold a public hearing to address the important elements of the revised Model Treaty. During the normal tax treaty ratification process the Staff of the Joint Committee on Taxation prepares a summary of the particular treaty under review and often makes a comparison to the Model Treaty, but a review of fundamental tax treaty policy could be a much larger inquiry which many would prefer to avoid.

\(^{36}\) See Brown Testimony, supra note 13, at 10, indicating the following as of February 2, 2006: Work on the U.S. Model was well advanced last year [2005] but was delayed due to other commitments. However, we expect to forward a draft text to the staffs of the Senate Foreign Relations Committee and Joint Committee on Taxation within the next month. We look forward to working with them on this project.

\(^{37}\) For example, in revised treaties with Japan, the United Kingdom, The Netherlands, Mexico, and Sweden, the withholding tax at source on dividends paid by an affiliate to its foreign parent corporation was eliminated. The Model Treaty provides for a minimum five percent on such dividends. See Model Treaty, supra note 29, at 10.

The Organization of Economic Cooperation and Development ("OECD"), consisting primarily of the developed countries, also has promulgated its own model income tax treaty ("OECD Model Treaty"). Unlike the U.S. Model income tax treaty, the OECD Model Treaty is under regular review and analysis, therefore incorporating current tax treaty positions from the perspectives of multiple countries. The OECD has working parties (Technical Advisory Groups or "TAGs") regularly examining income tax treaty positions and the OECD periodically issues updates to incorporate changes or refinements in positions, incorporated into its model treaty. Although the United States is an active participant in the OECD, including the regular examination of possible changes in the OECD Model Treaty, this is truly an international effort (ordinarily European dominated). Because the OECD Model Treaty is under regular review, this model treaty has become the real "yardstick" for constructing and revising bilateral income tax treaties around the world. The OECD Model Treaty significantly influences any potential treaty partners with the United States. Consequently, even the Treasury representatives may also often be influenced by the OECD Model Treaty, more than the traditional perspective of starting negotiations from the U.S. Model Treaty, as including recent specific country treaty negotiation provisions.

IV. THE U.S. TAX TREATY RATIFICATION PROCESS

The U.S. tax treaty ratification process has interesting political components that influence attitudes towards U.S. tax treaty policy. Under the United States Constitution, a treaty (including a tax treaty) must have the
"advice and consent" of the U.S. Senate to achieve effectiveness.\textsuperscript{43} Under international protocol, a U.S. tax treaty does not technically become effective until both approval by the U.S. Senate and, thereafter, an exchange between the two governments of ratification instruments.\textsuperscript{44} Under the rules of the United States Senate, the matter of the ratification of treaties (including tax treaties) is within the jurisdiction of the Senate Committee on Foreign Relations.\textsuperscript{45} Jurisdiction over tax treaties does not reside with the Senate Finance Committee, which does have general jurisdiction over federal taxation matters. This generates some feelings of resentment from members of the Senate Finance Committee, who view the subject of taxation as within their particular domain.\textsuperscript{46} This problem was (unsuccessfully) sought to be resolved by a change in the rules of the U.S. Senate.\textsuperscript{47}

\textsuperscript{43} U.S. Const. art. II, § 2, cl. 2.
\textsuperscript{44} See, for example, the Treasury Technical Explanation of the Sweden-U.S. Income Tax Treaty Protocol, which notes that Article VIII of the Protocol contains the rules for bringing the Protocol into force and giving effect to its provisions. Dept. of the Treasury, Technical Explanation of the Protocol Signed at Washington on September 30, 2005 Amending the Convention Between the United States of America and the Government of Sweden for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Signed at Washington on September 1, 1994, art. VIII (2006). Paragraph 1 provides for the ratification of the Convention by both Contracting States according to their applicable procedures. Id. para. 1. Each State must notify the other as soon as its requirements for ratification have been complied with. Id. The convention is to enter into force on the thirtieth day after the later of such notification accompanied by an instrument of ratification. Id. This Explanation indicates that, in the United States, the process leading to ratification and entry into force is as follows: Once a protocol or treaty has been signed by authorized representatives of the two Contracting States, the Department of State sends the protocol or treaty to the President who formally transmits it to the Senate for its advice and consent to ratification, which requires approval by two-thirds of the Senators present and voting. Id. Prior to the vote, however, it generally has been the practice of the Senate Committee on Foreign Relations to hold hearings on the protocol or treaty and make a recommendation regarding its approval to the full Senate. Id. Both Government and private sector witnesses may testify at these hearings. Id. After receiving the Senate's advice and consent to ratification, the protocol or treaty is returned to the President for his signature on the ratification document. Id. The President's signature on the document completes the process in the United States. Id. Similarly, see OECD Model Treaty Article 30(1) which indicates that a convention shall be ratified "and the instruments of ratification" shall be exchanged as soon as possible. OECD Model Treaty, supra note 40. Article 30(2) of the OECD Model Treaty indicates that the convention shall enter into force "upon exchange of instruments of ratification." Id. art. 30(2).


\textsuperscript{46} See Standing R. of the S. xxv(i)(j)(17) (specifying that the Senate Foreign Relations Committee has jurisdiction over treaties and executive agreements, except reciprocal trade agreements); Standing R. of the S. xxv(i)(i)(7) (indicating that the Senate Finance Committee has jurisdiction over reciprocal trade agreements).

\textsuperscript{47} An interesting proposal concerning this tax treaty review jurisdiction was included in the Senate version of "Jumpstart Our Business Strength Act," ("JOBS"), as Act Section 236 in the modification of the Chairman's Mark. Staff of the J. Comm. on Taxation, Modification of the Chairman's Mark on the "Jumpstart Our Business Strength (JOBS) Act," Jcx-85-03 (2003). The Senate Committee on Foreign Relations...
As required by the U.S. Constitution, tax legislation starts in the House of Representatives.\textsuperscript{48} Treaties do not constitute legislation for this purpose. Since treaties are subject to the "advice and consent" of the U.S. Senate (and not the U.S. House of Representatives), the tax writers in the House of Representatives are also not very interested in the tax treaty process. For this reason, these tax writers are more inclined to adopt legislation which may even be contrary to (that is, "override") a tax treaty provision, since they have little political capital invested in the tax treaty process and are often somewhat inimical to tax treaties as being part of the U.S. international tax structure. A delicate balance exists in this context. Consequently, one result of the constitutional requirement that tax bills originate in the House of Representatives is that a U.S. tax treaty can only reduce potential U.S. tax liabilities, that is, it can not be used to impose any greater tax liabilities.

**V. U.S. LEGISLATION MAKING EXISTING TREATY PROVISIONS OBSOLETE**

As noted, since under the U.S. Constitution tax treaties are only ratified by the U.S. Senate, the U.S. House of Representatives is (at best) ambivalent about tax treaties and is sometimes inclined to adopt tax legislation overriding existing tax treaty provisions. However, even without this specific objective in mind, the comprehensive restructuring of tax legislation impacting cross border transactions can result in requiring the Treasury to renegotiate many of its tax treaties. Thus, on occasion a significant change in internal tax laws can make certain provisions of applicable income tax treaties irrelevant.

For example, a significant change has been suggested for the taxation of foreign earnings of branches and foreign corporations controlled by U.S. corporations by a proposal where dividend exemption would be provided for that portion of dividends received by a U.S. corporation from a

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\textsuperscript{48} All bills for raising revenue shall originate in the House of Representatives, but the Senate may propose or concur with amendments as on other bills. U.S. Const., art. 1, § 7, cl. 1.
controlled foreign corporation attributable to active business earnings.\(^4\)

Since the classical system of corporation/shareholder income taxation would be significantly modified by any such legislation, the fundamental premises of most U.S. income tax treaties would be undermined by any such changes. For this reason the proposal indicates the following:

The proposed system would require the renegotiation of existing income tax treaties, which are premised on the assumption that the United States will continue to operate a worldwide tax system. For example, existing treaties generally require the United States to allow foreign tax credits for foreign corporate income taxes and dividend withholding taxes under certain circumstances. These treaties would have to be revised to reflect the conversion from a credit mechanism to an exemption mechanism.\(^5\)

The modification of all tax treaties to accommodate such a change would present a serious challenge to the Treasury's tax treaty representatives who negotiate tax treaties.

VI. THE PROCESS OF INTERPRETATION FOR TAX TREATIES

A. BASIC APPROACHES TO TAX TREATY ANALYSIS

In considering tax treaty applicability, the tax advisor must be continually aware of the wide variety of techniques (some unique to the treaty context) used to amplify and interpret tax treaty provisions. In researching a narrow issue in the domestic statutory context, a tax planner will examine the potential existence of a solution in Treasury Regulations, published Revenue Rulings, Revenue Procedures, private letter rulings, and other IRS pronouncements. This universe of interpretive material is similarly applicable and available in the tax treaty context, but the possibilities of significant additional sources must be considered. The identification of these additional sources reinforces the premise of this article, that is, that tax treaties are of a unique character in considering tax planning.

The Technical Explanation of the Model Treaty is often a good place to start, but this is only the beginning. Reference to this Technical Explanation reminds us that (1) the bilateral income tax treaty is a two-party agreement, but (2) the Technical Explanation is ordinarily only a one-party document (that is, a unilateral pronouncement by the Treasury). The Technical Explanation provides the perspective of the U.S. side concerning a particular treaty provision, but in the interpretation of a particular provision, the treaty partner country may not be in agreement. If considered in advance of particular bilateral tax treaty negotiations, a specific issue might be considered and addressed in any accompanying

\(^{49}\) See Staff of the J. Comm. on Taxation, Options to Improve Tax Compliance and Reform Tax Expenditures, JCS-02-05, at 186-97 (2005).

\(^{50}\) Id. at 192-93.
exchange of diplomatic "notes," but often these issues are not adequately addressed until identified after the treaty becomes effective. The issue may be addressed in a Technical Explanation of the particular bilateral income tax treaty, often released shortly after the conclusion of a new (or revised) treaty, but again, this is ordinarily only the Treasury’s perspective. The Treasury representatives may have given their counterparts from the treaty partner country an advance opportunity to comment on the draft Technical Explanation, but the Treasury representatives may not have included any objections or adverse comments when releasing that specific Technical Explanation. Ordinarily, the treaty partner does not release its own Technical Explanation (or other interpretive guidance) or release a statement of objection, so tax advisors may not necessarily be able to identify where the conflicts exist.

B. THE "MEMORANDUM OF UNDERSTANDING" APPROACH

When significant technical issues subsequently do arise concerning tax treaty interpretation, the question often presents itself concerning whether the treaty should be amended by protocol or whether that process can be circumvented through the issuance by the Internal Revenue Service ("Service") of either (1) a unilateral interpretation or (2) some agreement with a representative of the other government, such as a Memorandum of Understanding ("MOU"). The MOU is treated as not necessitating U.S. Senate "advice and consent." The position of the Service in implementing an MOU is that it is merely an interpretation of provisions within the treaty and, therefore, is permitted within the already existing jurisdiction of the Competent Authority. 51 A protocol constitutes an amendment to the original treaty, thereby necessitating further "advice and consent" from the U.S. Senate before it can become effective. 52 Whether a protocol is required (rather than merely a unilateral interpretation) can be a close issue, and of course, the U.S. government representatives would often like, if possible, to avoid the necessity of being forced to clear the hurdle of obtaining Senate approval. This ratification process both takes time and requires a serious, rational explanation before the Senate Foreign Relations Committee by both Treasury representatives and members of the Staff of the Joint Committee on Taxation.

During 2005 and early 2006, the Service and Treasury have been active in the implementation of MOUs. MOUs are signed on behalf of the United States Government by the Director, International ("LMSB"), as the IRS Competent Authority, thereby representing that these are merely administrative decisions (and do not necessitate U.S. Senate approval). For example, the United States and Japan have entered into a MOU on the meaning of "investment bank" under the United States-Japan income

51. In most of the MOUs, the parties merely state the particular treaty article they are interpreting without identifying their authority to enter into a specific agreement.
52. The protocol is treated as a modification of the treaty and, therefore, necessitates similar treatment as a treaty.
tax treaty. The United States and Canada have entered into a MOU on resolving factual disputes under the mutual agreement procedure ("MAP") specified in the Canada-United States income tax treaty, and the United States and Mexico have entered into a MOU concerning limited liability companies and the treatment of fiscally transparent entities under the Mexico-United States income tax treaty. Other examples include the Agreement on Treaty Benefits between the U.S. and Swiss competent authorities regarding the Limitation of Benefits Article of the income tax treaty and an accompanying Revised Memorandum of Understanding between the United States and the Swiss Confederation. The Service seems willing to use the MOU technique in a variety of areas, premised upon the assumption that the basic matter is included within the fundamental scope of the income tax treaty itself (and therefore, authority exists to interpret and apply the terms of the existing treaty).

C. REFERENCE TO FOREIGN LAW AND FOREIGN COURTS

Many provisions in income tax treaties are quite uniform (including the OECD Model Treaty, which has provisions similar to those in specific U.S. income tax treaties). The primary source of guidance in this context for the resolution of tax treaty controversies arising in foreign courts is often the Commentary to the OECD Model Treaty ("OECD Commentary"). This is provided by the OECD Secretariat as a detailed explana-


54. I.R.S., I.R.S. Announces U.S.-Canada Memorandum of Understanding on Mutual Agreement Procedure, TAX NOTES TODAY, June 23, 2006, LEXIS, 2006 TNT 14-8. The purpose of this MOU is to establish an independent review process for resolving disagreements regarding the underlying facts and circumstances ("factual disagreement") of a specific mutual agreement procedure case for further negotiations by the Competent Authorities. Id. A factual disagreement is identified as a disagreement concerning any of (i) the existence of a fact (for example, whether a party made a payment or not), (ii) the relevance of a fact agreed to exist (for example, if the payment was made, is that fact relevant to determining the transfer price for transactions covered by the MAP case), or (iii) the significance to be accorded a fact agreed to exist (for example, what significance should be given to the fact that a payment was made). Id.

55. I.R.S., I.R.S. Announces Mexico LLC MAP Agreement, TAX NOTES TODAY, Jan. 23, 2006, LEXIS, 2006 TNT 14-9 (indicating that it is understood that income from sources within one of the Contracting States received by an entity that is organized in either of the Contracting States, or a third state with which Mexico has in force a comprehensive exchange of information agreement, and that is treated as fiscally transparent under the laws of either Contracting State will be treated as income derived by a resident of the other Contracting State to the extent that such income is subject to tax as the income of a resident of the other Contracting State). See also I.R.S. Announcement 2005-72, 2005-41 I.R.B. 692 (providing Press Release IR-2005-107, Director, International, U.S. Competent Authority, United States Mexico Reach Mutual Agreement Regarding Eligibility of Fiscally Transparent Entities to Benefits (Sept. 19, 2005), which announced that the United States and Mexico had reached a mutual agreement regarding the eligibility of entities that are treated as fiscally transparent under the laws of either country for the benefits of the 1992 U.S.-Mexico Income Tax Treaty).


tion of the various articles of the OECD Model Treaty. The question often arises in the United States concerning whether a foreign legal authority, such as a court decision in a foreign jurisdiction or analysis such as the OECD Commentary, is relevant and, perhaps persuasive, in resolving a controversy in a U.S. court involving a similar income tax treaty provision. For example, in *Taisei Fire and Marine Insurance Co. v. Commissioner*, Judge Tannenwald relied on the 1963 OECD Commentary in examining whether a "permanent establishment" existed when Japanese property and casualty insurance companies were enabled to write reinsurance through a U.S. corporation operating in the United States. Further, in this case, a decision of the Federal Republic of Germany Tax Court (at Bremen) was found relevant by the Tax Court. Although noting that this case had clearly distinguishable facts, the implication is that the foreign court authority, here a German case, could certainly be exceedingly useful in the Tax Court's decision making if the case is relevant.

Similarly, in a supplemental memorandum opinion to *Podd v. Commissioner*, the court noted that Paragraph 2 of Article IV of the U.S.-Canada treaty,

would require a decision as to whether petitioner had a permanent home available to him in either the United States or Canada . . . during 1990. Art. 4, par. 2 [of the OECD Model Treaty (1977)] contains substantially the same language as the above-quoted Art. IV., par. 2, of the Canada Convention. The commentary to the [OECD] Model Treaty . . . further explains the requirements of Model Treaty Art. 4. Because both the United States and Canada were OECD members when the Model Treaty and the commentary were drafted, courts have used the commentary to interpret income tax treaties between the United States and Canada. See *United States v. A.L. Burbank & Co.*, 525 F.2d 9, 15 (2d Cir. 1975); *Birth W. Life Assurance Co. of Canada v. Commissioner*; see also *Taisei Fire & Marine Ins. Co. v. Commissioner* . . . (which construed the [United States-Japan treaty] with reference to the Model Treaty and its commentary).

The United States Tax Court does not seem reluctant to refer to foreign law or international understandings (for example, the Commentary to the OECD Model Tax Treaty) when seeking to determine results in particular situations involving the application of U.S. tax treaty concepts. More generally, however, reliance on foreign law seems to have become a highly volatile issue in the United States and, consequently, litigants, planners, and particularly judges should take note of these developments outside the tax context. For example, during the 109th Congress, the

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59. *Id.* at 549-50.
60. *Id.* at 556. This was a proceeding involving the application to a German insurance agent of the "independent agent" provision of the Germany-Netherlands Treaty.
61. 76 T.C.M. (CCH) 906 (1998).
62. *Id.*
Constitution Restoration Act was introduced by Rep. Aderholt (R-Ala.) and Sen. Shelby (R-Ala.). This legislation would provide the following:

In interpreting and applying the Constitution of the United States, a court of the United States may not rely upon any constitution, law, administrative rule, Executive order, directive, policy, judicial decision, or any other action of any foreign state or international organization or agency, other than English constitutional and common law up to the time of the adoption of the Constitution of the United States.

Although prospects for its enactment might be limited, and even though most tax decisions involving tax treaties do not involve "constitutional issues" from these developments, a "chilling effect" on court opinion writing (including in the United States Tax Court) might be observed.

Whether this "chilling effect" will eventually spill over more substantially into the tax adjudication context in the United States is difficult to predict. Perhaps, however, these judges in U.S. tax cases are becoming aware of the (probably political) risks in relying on foreign (including international organization) laws and model rules.

VII. TAX-TREATY AUTHORIZED WITHHOLDING ON INTERCOMPANY DIVIDENDS

In addition to the many procedural elements of income tax treaties (as discussed above), the imposition of withholding taxes on corporate dividends paid continues to evolve. Under the U.S. domestic tax structure, dividends paid to the foreign shareholder are subject to withholding at

64. Id. § 201. Note that in an October 28, 2003 speech, (former) Justice Sandra Day O'Connor indicated (commenting on the Texas sodomy case, Lawrence v. Texas, 539 U.S. 558 (2003)) that she and her colleagues on the Supreme Court had looked to international norms in the Lawrence case and another recent case involving the execution of the mentally retarded. She noted that over time "we will rely increasingly on international and foreign law in resolving, what now appear to be domestic issues." Sandra Day O'Connor, former Assoc. Justice, Supreme Court of the United States, Remarks to Southern Center for International Studies (Oct. 28, 2003) (receiving the World Justice Award). In the November 1, 2003 issue of the Christian Coalition's weekly report, the Christian Coalition suggested that this comment meant that Justice O'Connor would ignore the U.S. Constitution, adding that such a move "seems to be an impeachable offense." See Supreme Court Justice Sandra Day O'Connor Aborts the U.S. Constitution: Impeachable Offense?, BNA DAILY REP. FOR EXECUTIVES, Nov. 4, 2003, at A17. What does this imply for (lower level) U.S. judges in U.S. tax cases who have the audacity to rely on foreign (including international organization) laws and model rules. Perhaps tax cases will be "under the radar" on this issue.
65. Similarly, on January 13, 2005, at a forum at American University Law School, U.S. Supreme Court Justices Scalia and Breyer debated this precise issue. See Stephen Breyer, Assoc. Justice, Supreme Court of the United States, and Antonin Scalia, Assoc. Justice, Supreme Court of the United States, Foreign Courts and U.S. Constitutional Law, Debate of American University Law School (Jan. 13, 2005). Justice Breyer stated that reference to foreign law was appropriate, noting "I may learn something" and "[f]oreign law doesn't determine the result, but it shows what other people have done." Id. But, Justice Scalia indicated that it is "arrogant" to rely on foreign law to determine issues in the United States, noting that "if we don't want [foreign law] to be authoritative, then what is the criteria for using it?" Id. See also BNA DAILY REP. FOR EXECUTIVES, Jan. 14, 2005, at A32.
source on the gross amount at the rate of thirty percent. The rate of this withholding is ordinarily reduced under an applicable tax treaty: The U.S. Model Treaty suggests that withholding at source should be imposed at the rate of fifteen percent, but at the reduced rate of five percent of the gross amount of the dividends if the beneficial owner of the dividends being received is a company that owns directly at least ten percent of the voting stock of the company paying the dividends. The OECD Model Treaty is the same except for the percentage of ownership required to obtain the reduced five percent withholding rate.

Starting in 2001 with the renegotiation of the U.K.-U.S. income tax treaty, some U.S. income tax treaties have been adopted to significantly modify this position so that the withholding tax on intercompany dividends (under the conditions specified in each treaty) is eliminated, with all the taxation assumed therefore to be imposed at residence. This has occurred in the following treaties between the United States and the following countries: (a) The United Kingdom; (b) Australia; (c) Mexico.

66. Under the statutory approach that withholding is at the rate of thirty percent of the gross payment. I.R.C. §§ 871(a)(1), 881(a)(1) (West 2006).
67. Model Treaty, supra note 29, art. 10(2).
68. OECD Model Treaty, supra note 40, art. 10(2). The five percent rate would be available if the beneficial owner of the dividends is a company other than a partnership which holds directly at least twenty-five percent of the capital of the company paying the dividends. OECD Model Treaty Comment 10 to Article 10 provides that if a company of one of the States directly owns a holding of at least twenty-five percent in a company of the other State, it is reasonable that payments of profits by the subsidiary to the foreign parent company should be taxed less heavily to avoid recurrent taxation and to facilitate international investment. Id. cmt. 10. Comment 13 to Article 10 specifies that the tax rates fixed by the Article for the tax in the State of source are maximum rates. Id. cmt. 13. The States may agree, in bilateral negotiations, on lower rates or even on taxation exclusively in the State of the beneficiary’s residence. As noted in the text, this advice has been implemented by the United States in various recent treaties (limited as to an increased percentage of ownership).
70. A protocol to the Australia-U.S. income tax treaty entered into force on May 12, 2003. See generally Protocol Amending the Convention Between the Government of 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, U.S.-Austl., Sept. 27, 2001, S. TREATY DOC. No. 107-20. This protocol also provides for a zero-rate withholding tax on certain intercompany dividends and for the elimination of source country withholding taxes on several important types of interest, particularly interest derived by a financial institution (if dealing independently with the payor, in other words, is not related) and interest paid to governmental entities. Id. § 6, para. 3, § 7, para. 3. However, other types of interest (including interest received by financial institutions in back-to-back loans or their economic equivalent) continue to be subject to source-country withholding tax at the maximum rate of ten percent. Id. § 7, para. 4. See, generally, Linda L. Ng, Asia-Pacific Tax Review: Australia-U.S. Treaty Protocol an Example of New U.S. Treaty "Gold Standard," 31 TAX NOTES INT’L 869, 887 (2003).
71. A protocol to the Mexico-U.S. income tax treaty was signed on November 26, 2002 and entered into force on July 3, 2003. See, generally, DEPT OF THE TREASURY, TECHNICAL EXPLANATION OF THE PROTOCOL BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE UNITED MEXICAN STATES (2003). This also contained zero dividend withholding tax provisions. U.S. Senate Foreign Relations Committee, Senate Panel Releases Report on Proposed Mexico-U.S. Protocol, TAX NOTES TODAY, Mar. 20, 2003, LEXIS 2003 TNT 55-17. This revision further provides Mexico with tax treaty treatment equivalent to the best treatment negotiated by the United States with any other tax treaty partner (that is, a “most favored nation” clause). Id. at 23. The Senate Foreign Relations Committee noted its displeasure with such a provision, indicating the following: “The Committee notes its continuing concern regarding the effect of such provisions [the self-executing MFN provision] and expects that the Treasury Department will not include such provision in future treaties.” Id. at 27.

72. This treaty, initialed during June 2003, was signed on November 6, 2003. Protocol for the Convention Between the Government of the United States of America and the Government of Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-Japan, Nov. 6, 2003 S. TREATY DOC. No. 108-14 [hereinafter 2003 U.S.-Japan Treaty]. See also BNA DAILY REP. FOR EXECUTIVES, supra note 65, at L5. This treaty constitutes a modernization of the 1971 Japan-U.S. income tax treaty, one of the oldest U.S. income tax treaties. This treaty accomplishes significant reduction in cross-border withholding taxes; all source-country withholding tax on royalty income is eliminated, an item particularly significant because of the large inflow of royalties into the United States from Japan; the treaty eliminates withholding tax on interest earned by financial institutions and reduces presently higher withholding rates to lower rates of the preferred U.S. model. Also eliminated is the withholding tax on dividend payments to a controlling parent corporation. The withholding tax is eliminated on dividends paid by a U.S. subsidiary to the Japanese parent company that owns more than a fifty-percent interest and, similarly in the reverse situation, if the parent company owns a fifty-percent interest or less in a subsidiary, the dividends would remain subject to withholding under the revised treaty. See generally U.S.-Japan Treaty, supra. Of course, in situations like this, planning devices (such as minimal preferred shares) will probably be implemented to enable surpassing the fifty percent hurdle imposed by this provision.

73. See Protocol Amending the Convention Between the United States of America and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-Neth., art. III March 8, 2004, S. TREATY DOC. No. 108-25 (amending Article 10 of the treaty to provide for no withholding on dividends from an eighty percent or greater owned subsidiary). See also STAFF OF THE J. COMM. ON TAXATION, EXPLANATION OF PROPOSED PROTOCOL TO THE INCOME TAX TREATY BETWEEN THE UNITED STATES AND THE NETHERLANDS, JCX-54-04 (2004).

74. Protocol Amending the Convention Between the Government of the United States of America and the Government of Sweden for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Sept. 30, 2005, S. TREATY DOC. No. 109-8 art. IV (providing for a complete replacement of Article 10, the current dividends article); see also Protocol to Sweden-United States Income Tax Convention, Signed September 30, 2005, TAX NOTES TODAY, LEXIS, 2005 TNT 191-24. See also Brown Testimony, supra note 13, at 6 (indicating that the provision dealing with intercompany dividends was very important to Sweden because it had unilaterally eliminated its withholding tax on inter-company dividends).

The legislative history to that domestic law change makes it clear that the main beneficiaries of that change were expected to be U.S. companies. In fact, it refers specifically to assurances given to the Swedish negotiators that the United States would not agree to eliminate the withholding tax on intercompany dividends in any bilateral agreement with any country. Now that U.S. policy has changed, failure to provide a reciprocal benefit for Swedish companies would have jeopardized the exemption from Swedish withholding tax that currently benefits U.S. companies. We believe that securing that protection, as well as eliminating the withholding tax on dividends paid to pension funds, is a sufficient quid pro quo.
In 2006 testimony before the Senate Foreign Relations Committee, the U.S. Treasury stated that the decision to eliminate the source country withholding on intercompany dividends “is made independently with respect to every treaty negotiation.” The indication from Treasury is that, upon the adoption of the U.S. Treasury position to possibly eliminate the source country withholding tax on intercompany dividends, “a number of treaty relationships that had been at best stagnant and at worst problematic have changed for the better.” A further observation made was that bilateral tax treaty relationships between other countries (that is, non-U.S. relationships) have resulted in similar exemptions on intercompany dividends, and that this could be beneficial upon the transfer of profits from one foreign country subsidiary upstream to another foreign country subsidiary, where both of these countries have implemented withholding exemptions under their treaty.

As evidence that this intercompany dividend exemption has not been adopted as an absolute policy, one can observe the Bangladesh-U.S. income tax treaty also subject to review at the February 2006 hearings. This proposed U.S. income tax treaty was signed in September 2004 and provides for a maximum source country withholding tax rate on dividends of fifteen percent and a ten percent rate applicable to direct investment dividends. Similar to the Model Treaty, this treaty requires a ten percent ownership threshold for the application of the ten percent withholding tax rate. An explanation for not including a zero intercompany

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75. Brown Testimony, supra note 13, at 5. The statement is made that “[t]he United States will agree to the provision only if the agreement includes limitation on benefits and information exchange provisions that meet the highest standards, and if the overall balance of the agreement is appropriate.” Id. Earlier, when reviewing the Mexico-U.S. Income Tax Treaty, the Senate Foreign Relations Committee noted with approval the Department of Treasury’s statement that “[i]n light of the range of facts that should be considered, the Treasury Department does not view [the elimination of the withholding tax on inter-company dividends] as a blanket change in the United States’ tax treaty practice.” See U.S. Senate Foreign Relations Committee, Senate Panel Releases Report on Proposed Mexico-U.S. Protocol, TAX NOTES TODAY, March 20, 2003, LEXIS, 2003 TNT 55-17.

76. Brown Testimony, supra note 13, at 5, specifying that this changed policy has enabled the Treasury to achieve the following objectives: (a) strengthen treaty shopping provisions, including the introduction of rules that prevent the use of tax treaties after a corporate inversion transaction; (b) significantly improving information exchange provisions, allowing access to information even when the treaty partner does not need the information for its own tax purposes; (c) reducing withholding taxes on interest and royalties to levels lower than those to which the treaty partners had previously agreed; (d) eliminating withholding taxes on dividends paid to pension funds (thereby eliminating eventual double taxation); and (e) protecting U.S. companies against the retaliatory re-imposition of withholding taxes on inter-company dividends.

77. Id.


80. Id.
dividends rate is that this is a treaty with a developing country.\textsuperscript{81} Future
tax treaties with developing countries will presumably implement a simi-
lar approach. The objective, one must assume, is that the dividend flows
are predominantly sourced from the developing country and, therefore,
the economic objective of maintaining a withholding tax would be to en-
able the source (developing) country to capture some of that tax benefit,
even though profits taxes on the distributed dividend may have previ-
ously been imposed on the distributing corporation (perhaps at a level
even higher than the thirty-five percent U.S. maximum corporate tax
rate).

\section*{VIII. EXPLOITATION OF GAPS IN BILATERAL INCOME
TAX TREATIES}

\subsection*{A. Double Non-Taxation}

The bilateral income tax treaty may enable reference to local law for
making certain determinations concerning treaty applicability. Alterna-
tively, a void may exist, and each party can interpret the provisions in a
manner not inconsistent with the treaty provisions. This can present
anomalous situations, including (1) potential double taxation and (2) po-
tential zero taxation.

If potential economic double taxation does arise, the taxpayer (often
multiple taxpayers, for example, parent and subsidiary corporations) can
often obtain relief under the Competent Authority provisions of the ap-
licable bilateral tax treaty. Tax treaties do not ordinarily explicitly pre-
clude economic double taxation. The article providing for profits
adjustments between related entities will often require a mutual adjust-
ment, however.\textsuperscript{82} Article 23 of the Model Treaty specifically provides for
relief from double taxation and ordinarily indicates that a tax credit shall
be allowed so as to avoid double taxation occurring.\textsuperscript{83} If necessary, the
parties might seek assistance from the "competent authorities" of each
taxing authority so as to eliminate or reduce the impact of potential eco-
nomic double taxation.\textsuperscript{84}

\textsuperscript{81} Id.

\textsuperscript{82} See Model Treaty, supra note 29, art. 9(1) (providing for the appropriate allocation of profits between related entities), but see id. art. 9(2) (specifying that the competent authorities shall consult to avoid double taxation in these contexts).

\textsuperscript{83} Id. art. 23.

\textsuperscript{84} For example, the U.S. Model Treaty, Article 25(1), entitled "Mutual Agreement Procedure", specifies the following:

\begin{quote}
Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, and the time limits prescribed in such laws for presenting claims for refund, present his case to the competent authority of either Contracting State.
\end{quote}

Id. art. 25(1). Further, the Technical Explanation specifies that this article provides the mechanism for taxpayers to bring to the attention of competent authorities those issues and problems that may arise under the Convention. Technical Explanation, supra note 34, at 117. It also provides a mechanism for cooperation between the competent
From the taxpayer's (and tax planner's) perspective, the objective, of course, is (1) to not only avoid economic double taxation but also (2) to achieve "double non-taxation." This means incurring no tax on the income derived from a particular cross-border transaction, achieved through exploiting gaps between the tax structures in the two countries which are the parties to the tax treaty. Thus, in some situations no tax is actually imposed on certain types of income by either the source country or the residence country. For investors coming into the United States this can be possibly achieved when the foreign investor importing the capital into the United States operates through a reverse hybrid structure (that is, a corporation in the United States and a passthrough in the country of residence). For government tax policy specialists, the inquiry must be whether "double non-taxation" should be indirectly authorized through gaps in an income tax treaty.

This is an issue that will percolate for a considerable period because taxpayers have become particularly sophisticated in achieving double non-taxation, often through gaps in entity-characterization rule differences between treaty partner countries. Many treaties (including, particularly, U.S. income tax treaties) do not directly address this issue. To prevent U.S. income tax avoidance, I.R.C. § 894(c) was enacted to limit a taxpayer's right to a reduced withholding rate under a tax treaty in certain situations involving fiscally transparent entities. The issue of whether actual taxation should be a prerequisite to obtaining treaty relief is a subject which is now beginning to mature. Treaty policy deliberations must address how to confront this important issue.

B. THE LIMITATION ON BENEFITS

For several decades the Treasury has been pursuing the inclusion of a "limitation on benefits" provision in new and renegotiated tax treaties. The objective of the Treasury in this context is to not enter into or maintain in existence an income tax treaty which, practically, can be transformed through adroit tax planning, into a "treaty with the world."
tax planner's objective sought to be achieved would be to enable use of
an entity in the treaty partner country, which, however, facilitates conduit
tax treatment in that country. The important objective of income tax
treaty provisions reducing source country taxation is to cause a shifting of
a taxpayer's tax burden to the residence state, but only if the beneficiary
is actually a tax resident of the other state. "Those reductions and bene-
fits are not intended to flow to residents of a third country." For exam-
ple, if (a) a resident (including a corporation) in a Middle Eastern or
South American country not having an income tax treaty with the United
States could organize a controlled entity in a third jurisdiction (such as
The Netherlands), (b) that Netherlands entity would have the benefits of
the U.S. income tax treaty upon the receipt of profits from U.S. corporate
investments, and (c) under the applicable internal Dutch tax law (that is,
the “participation exemption” provisions) the taxation on that income in
The Netherlands could be eliminated or significantly moderated, the pro-
visions of this tax treaty would be frustrated. Every new U.S. income tax
treaty (particularly every revision of previously existing U.S. income tax
treaties with large trading partner countries) produces a strengthening of
the limitations imposed in this context. The nuances in this context are
many, with the variables depending upon business investment conditions
and tax structures in the treaty partner country. The objective of the
Treasury is quite clear, and the continuing evolution of the Treasury's
perspective in this context is quite interesting to examine.

IX. DISPUTE RESOLUTION UNDER INCOME TAX TREATIES

Because of national pride (or unilaterist perspectives), the United
States (under the watchful eye of the U.S. Senate) has been quite careful
about agreeing that disputes over appropriate taxing jurisdiction between
the United States and a foreign country be referred to binding, indepen-
dent arbitration.90 Several U.S. tax treaties do include provisions con-
cerning utilizing binding arbitration to resolve tax treaty disputes where
the competent authorities have been unsuccessful in their efforts.91 Ex-

(2002).
91. See, e.g., Convention Between the Government of the United States of America
and the Government of the Federal Republic of Germany for the Avoidance of Double
Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Cap-
Treaty 1400, introducing an arbitration procedure not found in other U.S. income tax trea-
tries. It provides that where the competent authorities have been unable to resolve a disa-
greement regarding the application or interpretation of the Convention, the disagreement
may, by mutual consent of the competent authorities, be submitted for arbitration. Noth-
ing in the provision requires that any case be submitted for arbitration. Detailed rules are
provided for implementation of the arbitration procedure. See also Convention Between
the Government of the United States of America and the Government of the United Mexi-
can States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with
WL 841568, specifying the potential for an arbitration procedure. The competent authori-
ties are to consult after this treaty has been in force for three years to decide whether it is
treme reluctance exists on the U.S. side to make the leap of faith that the arbitrators actually will be independent (particularly tempered by the perspective of many U.S. politicians that tax controversy adjudication concerning U.S. taxation cannot be delegated to an international body). This perspective is somewhat myopic since another nation-state is also involved in these controversies over the appropriate exercise of tax jurisdiction. Gradually, cross-border tax dispute resolution is occurring among other countries, and eventually these “alternative dispute resolution” mechanisms must be seriously recognized by the United States. This will particularly be the situation forced on the United States if it must deal with tax controversies in a multilateral context, for example, in a North American Free Trade Agreement (“NAFTA”) environment where both Mexico and Canada are also involved, or in arrangements with the European Union (“EU”) where many of the EU Member States jointly have positions concerning the exercise of taxing rights antagonistic to the perspective of the Treasury.

X. CONSIDERING THE FUTURE

The speed of progress for the expansion and improvement of the U.S. income tax treaty regime structure has increased significantly during 2005 and early 2006, and that expansion can reasonably be anticipated to continue during late 2006. The challenge to the U.S. tax treaty negotiators is not only to respond expeditiously to current, significant issues arising under existing U.S. income tax treaties with major trading partners. A further obligation will be to expeditiously confront some of the fundamental challenges presented to tax treaty policies if substantial revision of the business tax structure should occur in the United States.

Consequently, a large imponderable in this process is the potential impact on the entire U.S. income tax structure if significant corporate-shareholder taxation revision were to be adopted or if other substantial changes were to be implemented. For example, in the Joint Committee on Taxation’s 2005 Option Paper, a proposal is included to amend the rules for determining corporate residency. Under this proposal, a publicly traded foreign incorporate entity would be treated as a resident in the United States if it is managed and controlled in the United States. This would be similar to the “substantial presence” test included in the

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93. See Staff of the J. Comm. on Taxation, Options to Improve Tax Compliance and Reform Tax Expenditures, JCS-02-05 178 (2005).
94. Id.
2004 protocol to the Netherlands-U.S. Income Tax Treaty. This proposal concerning corporate residence is reaffirmed in the Report of the President's Advisory Panel on Federal Tax Reform. This proposal, as enunciated in the report of the President's Advisory Panel, would also appear to necessitate revision of that article in U.S. income tax treaties defining corporate residence.

Similarly, multiple proposals were made during 2005 in these several studies to adopt a dividend exemption system for the taxation to U.S. taxpayers of foreign business income. Changes made to implement these changes could likewise necessitate quite significant revisions of all the treaties in the U.S. income tax treaty network. All these developments evidence that the impact of income tax treaties on cross border transactions is becoming even more complicated. Traditionally, the resolution of disputes involving treaty issues appeared easier than resolving interpretations of complicated provisions of the I.R.C. Even though the language in an applicable U.S. income tax treaty may still seem considerably less complicated than the I.R.C. provisions, the


96. The JCT Staff report implies that this may not be necessary, noting on page 181 that the JCT Staff proposal concerning corporate situs "does not adopt all aspects of the substantial presence test used in the Dutch protocol because some aspects lack relevance outside the treaty context." STAFF OF THE J. COMM. ON TAXATION, OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES, JCS-02-5, at 178 (2005).

97. PRESIDENT'S ADVISORY PANEL ON TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM (2005). In describing the proposed "Simplified Income Tax Plan," the report notes that the current law residency test is based on the place a business entity is organized. Id. at 135. This rule makes an artificial distinction that allows certain foreign entities to avoid U.S. taxation even though they are economically similar to entities organized in the United States. This rule may give businesses an incentive to establish a legal place or residency outside the United States to avoid paying tax on some foreign income. The report notes that several large companies have used a similar technique to avoid taxes under our current system. Id. The report states that recently enacted legislation created rules to prevent existing corporations from moving offshore but does not prevent newly organized entities from taking advantage of the rules. Id. Consequently, to prevent this tax-motivated ploy, the Simplified Income Tax Plan would provide a comprehensive rule that treats a business as a resident of the United States (and subject to U.S. tax) if the United States is the business's place of legal residency or if the United States is the business's place of "primary management and control." Id. The report indicated that this new two-pronged residency test would ensure that businesses whose day-to-day operations are managed in the United States cannot avoid taxes simply by receiving mail and holding a few board meetings each year "at an island resort." Id.


99. See id. at 192, which specifies that the proposed revised system of territorial taxation on business income would require the renegotiation of existing income tax treaties, which are premised on the assumption that the United States will continue to operate a worldwide tax system. "For example, existing treaties generally require the United States to allow foreign tax credits for foreign corporation income taxes and dividend withholding taxes under certain circumstances." Id. at 192-93. "These treaties would have to be revised to reflect the conversion from a credit mechanism to an exemption mechanism." Id. at 193.
potential gaps being exploited in treaty tax planning will continue to present ever increasing challenges. Further, many changing business practices (as evidenced, for example, by the impact of the digital economy) will present important challenges in this context.

XI. MY PERSONAL OBSERVATIONS ABOUT DEAN GALVIN

On a personal note, I very much appreciate the invitation to participate in honoring Charley Galvin by providing this article to this Symposium issue of the SMU Law Review. Dean Galvin was my first Dean as a law professor. I very well remember when we first met—when he came to interview me when I was the Deputy General Counsel at the Export-Import Bank of the United States. I believe he was intrigued by the experience that I earlier had across the street in Washington, D.C. working on tax legislative matters at the Treasury. He took a risk when inviting me to teach federal taxation courses at the SMU School of Law in the Fall Semester, 1973 (perhaps even extending a temporary teaching commitment to me without fully informing his faculty). That is when my tax law teaching career began—with his support as Dean and his example as a leading tax scholar.

Charley was then among a limited group of the premier U.S. tax law academics, and he provided an on-site example about how to function as a tax academic when probing various facets of appropriate tax policy. At some point I became aware that he may have earlier encountered conflict and criticism by examining some of the fundamental premises for providing certain (perhaps excessive) energy industry tax benefits. His analysis and thoughtful position in this context was eventually validated with rational statutory changes, but I saw how he set an example in taking the “high road” of tax policy analysis, despite external criticisms (including those of some law school potential donors). In retrospect, that perspective was really quite refreshing, particularly in contrast to some of the contemporary thrust of tax policy analysis primarily to achieve legislative advocacy purposes.

Charley’s positive influence on me and my tax academic career cannot be exaggerated. He began as a very considerate mentor. He continued and has always been thoughtful and supportive of my academic progress. And he has been a consistent friend. Thank you Charley!