# LEGISLATIVE OVERRIDE OF INCOME TAX TREATIES: THE BRANCH PROFITS TAX AND CONGRESSIONAL ARROGATION OF AUTHORITY

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## I. INTRODUCTION: CONGRESSIONAL QUEST FOR REVENUE

With the budget deficit at an unprecedented level, Congress is under great pressure to increase government revenues. In response to that pressure, Congress enacted the Tax Reform Act of 1986[1] and the Revenue Act of 1987,[2] both of which are expected in the short term to reduce the deficit.[3]

While pursuing large revenue increases, Congress finds it politically expedient to disguise the impact of those increases. By shifting the tax burden to corporate taxpayers, for example, Congress can sell a tax increase to the voting public by proclaiming that individual taxes have actually gone down.[4] But as commentators of all political and economic persuasions recognize, corporations do not pay taxes—people pay taxes.[5] In effect, Congress can promise the certainty of lower individual taxes in exchange for the uncertainty of who will actually bear the higher corporate rates.

Another useful political expedient is to raise the taxes of those who do not vote. The Tax Reform Act of 1986, for example, increased the tax burden imposed on foreign taxpayers by introducing an entirely new taxing regime—the branch profits tax.[6] Under the new regime, foreign corporations engaged in a trade or business in the United States are taxed twice on the same income—once on income effectively connected with the conduct of the trade or business,[7]

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[1]Pub. L. No. 99-514, 100 Stat. 2085 [hereinafter the Tax Reform Act of 1986].

[2]Pub. L. No. 100-203, 101 Stat. 1330-82 [hereinafter the Revenue Act of 1987].

[3]The "revenue neutral" Tax Reform Act of 1986 was predicted to increase tax collections by $12 to $15 billion in 1987. STAFF OF JOINT COMM. ON TAX'N, 99TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 1378 (1987) [hereinafter 1986 Bluebook]; Sheppard, *Good Times, Bad Times: Treasury's Higher Revenue Estimates*, 34 TAX NOTES 6 (1987). The Revenue Act of 1987 is predicted to increase revenues by approximately $9.4 billion in 1988, $14.4 billion in 1989, and $15.8 billion in 1990. H.R. CONF. REP. NO. 495, 100th Cong., 1st Sess. 1025 (1987).

[4]Indeed, the projected impact of the Tax Reform Act of 1986 was to shift more than $120 billion in tax burdens from individuals to the corporate sector over a four-year period. 1986 Bluebook, *supra* note 3, at 1378.

[5]It is still unclear who bears the corporate tax. It may be that shareholders receive a lower rate of return on their investment, lenders receive a lower rate of interest, customers pay higher prices, suppliers receive less for their raw products, workers receive lower wages, or any combination thereof.

[6]I.R.C. § 884.

[7]I.R.C. § 882(a).

and a second time on net earnings not reinvested in certain qualifying U.S. assets.[8]

An important aspect of this move to increase taxes on foreign taxpayers is a procedural change in the way Congress enacts tax increases. In the Tax Reform Act of 1986 and related legislation, Congress for the first time signaled its intention to override, on a wholesale basis, existing bilateral tax treaties between the United States and over thirty-five other nations if foreign taxpayers are engaged in "treaty shopping."[9]

The term "treaty shopping" is a pejorative term that refers to a "premeditated effort to take advantage of the international tax network and careful selection of the most advantageous treaty for a specific purpose."[10] The notion that the benefits derived from a bilateral treaty between the United States and another nation should be restricted to taxpayers of the United States and that other nation has strong intuitive merit. If foreign taxpayers are allowed to treaty shop then a treaty between the United States and the other nation becomes, in effect, a treaty between the United States and the world. As a result, treaty shopping tends to reduce the benefits of bilateral tax treaties born out of unique economic, political, and social considerations.

To find nobility in the United States' quest to curtail treaty shopping, however, is not necessarily to salute the methods used. Bilateral treaties are negotiated, signed, and ratified by both parties. Each tax treaty that the United States has negotiated contains an agreed-upon procedure for amending or terminating the treaty. The consequences of unilaterally overriding bilateral commitments through domestic legislation are unclear,[11] and there is little indication that Congress examined the possible consequences of a legislative override in enacting the Tax Reform Act of 1986.

Tax treaties play an important role in enhancing the competitiveness of domestic business and encouraging the inflow of investment capital from the residents of U.S. treaty partners. Data compiled by the Commerce Department[12] indicates that the book value of U.S. direct investment abroad has grown from \$220 billion in 1980 to \$260 billion in 1986.[13] Approximately 75% of this investment is in countries having an income tax treaty with the United States.[14] Foreign direct investment into the United States has grown from \$83 billion in

[8]I.R.C. § 884.

[9]*See Technical Corrections Act of 1987: Hearings on S. 1350 Before the Senate Subcomm. on Finance Taxation*, 100th Cong., 1st Sess. (1987) (statement of O. Donaldson Chapoton, Deputy Assistant Treasury Secretary for Tax Policy) *reprinted in* BNA, DAILY TAX REPORT, July 23, 1987, at J-4 [hereinafter Chapoton].

[10]Rosenbloom, *Tax Treaty Abuse: Policies and Issues*, 15 LAW & POL'Y INT'L BUS. 763, 766-68 (1983) [hereinafter Rosenbloom].

[11]*See* Chapoton, *supra* note 9, at J-2 (discussing possible consequences of a legislative override).

[12]The Commerce Department data understate the value of U.S. direct investment abroad relative to investment in the United States because (1) the data are based on book value rather than fair market value and (2) U.S. investment abroad tends to be more mature. *Id.* at J-6 n.1.

[13]*Id.* at J-2.

[14]*Id.*

1980 to $209 billion in 1986.[15] In 1986, 94% of this foreign direct investment in the United States was made by residents of treaty partners.[16] The recent increase in international economic activity presents a tempting target for a revenue-hungry Congress.

This article focuses on the branch profits tax and examines the changing attitude of the United States towards its bilateral income tax treaty commitments. It begins by considering those provisions of the Tax Reform Act of 1986 and other legislation relating to the branch profits tax that conflict with various treaty provisions found in U.S. bilateral tax treaties. After examining the relationship between treaty commitments and domestic legislation, the article considers the consequences of and alternatives to the override of international income tax treaties through the enactment of domestic legislation.

## II. THE TAX REFORM ACT OF 1986 AND TREATY OVERRIDES

### A. *The Branch Profits Tax*

#### 1. *The Branch Profits Tax on Branch Earnings*

The branch profits tax became a part of the tax landscape in the Tax Reform Act of 1986.[17] Prior to 1987, a foreign corporation owned by foreign investors and doing business in the United States was taxed at the regular graduated corporate rates on income effectively connected with a U.S. trade or business.[18] If foreign investors operated in the United States through a domestic corporation, the outcome was the same.[19]

Differences in treatment arose, however, when the corporation distributed its earnings to its foreign investor owners. In the case of a domestic corporation, the dividend was taxed at a 30% (or reduced treaty) rate under sections 871(a) and 881, with the tax being collected under the withholding rules of sections 1441 and 1442. In the case of a foreign corporation, it was less likely that a dividend paid to foreign investors would be subject to any U.S. tax. If less than 50% of the corporation's gross income for the three preceding taxable years was derived from income effectively connected with a U.S. trade or business, the dividends were not subject to U.S. taxation.[20] Even if the corporation had income, 50% or more of which was effectively connected with the conduct of a U.S.

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[15] *Id.*

[16] *Id.*

[17] For a discussion on the branch profits tax, see Blessing, *The Branch Tax*, 40 TAX LAWYER 587 (1987); Delta, *Branch Profits Tax Under the TRA 1986*, 16 TAX MGMT. INT'L J. 39 (1987); Feingold & Rozen, *New Regime of Branch Level Taxation Now Imposed on Certain Foreign Corporations*, 66 J. TAX'N 2 (1987); Fisher & Rubinstein, *The Branch Level Taxes of the Tax Reform Act of 1986*, 18 TAX ADVISER 634 (1987); New York State Bar Association Tax Section, *The Branch Profits Tax: Issues to be Addressed in the Regulations*, 34 TAX NOTES 607 (1987); Yu & Tretiak, *Tax Planning Ideas Under the Branch Level Tax Regime*, 13 INT'L TAX J. 327 (1987).

[18] I.R.C. §§ 882, 11.

[19] I.R.C. §§ 882, 11.

[20] I.R.C. § 861(a)(2)(B) (1986). Under the current version of section 861(a)(2)(B), the triggering rate is 25%.

trade or business, only the amount of the dividend that was proportional to the percentage of its U.S. effectively connected income was subject to U.S. tax.[21] Most importantly, many tax treaties exempted from U.S. tax dividends paid by treaty-benefited foreign corporations to non-U.S. residents or citizens.[22]

Congress' stated intent in enacting the branch profits tax was to subject the income earned by foreign corporations operating in the United States to the same two levels of tax as income earned and distributed by domestic corporations.[23] In the latter case, income is taxed at a maximum marginal rate of 34% when earned by the domestic corporation and is subject to a maximum 30% tax when the corporation makes a dividend payment to its foreign investor owners.[24] In the case of a foreign corporation operating in the United States, income is taxed at a maximum marginal rate of 34% when it is earned[25] and is now subject to an additional 30% branch profits tax when the income is repatriated by the foreign corporation (or deemed repatriated because it is not reinvested in "U.S. assets").[26] In effect, the branch profits tax attempts to treat the branch as if it were a domestic corporation.

The new branch profits tax is levied on the "dividend equivalent amount" in lieu of a withholding tax on dividends paid by the foreign corporation.[27] The dividend equivalent amount equals the foreign corporation's earnings and profits

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[21] I.R.C. § 861(a)(2)(B) (1986).

[22] *See, e.g.*, Netherlands Income Tax Treaty, Apr. 29, 1948, art. XII, CCH TAX TREATIES ¶ 5816, P-H TAX TREATIES ¶ 66,113.

[23] *See* H.R. REP NO. 426, 99th Cong., 1st Sess. (1985) (U.S. branches of foreign corporations engaged in business in the United States should be subject to same substantive tax rules as U.S. corporations).

[24] I.R.C. §§ 871(a), 881(a).

[25] I.R.C. § 882.

[26] I.R.C. § 884.

[27] I.R.C. § 884(e)(3). The starting point for computing the dividend equivalent amount of a foreign corporation is the corporation's earnings and profits, rather than its taxable income, because the branch profits tax is generally aimed at taxing a hypothetical dividend from the branch. As in calculating earnings and profits to determine what amount of an actual corporate distribution constitutes a dividend, not all of the items deductible in computing corporate taxable income will be deductible in computing the dividend equivalent amount for the branch profits tax. For example, net operating loss carryovers, permitted for regular tax purposes under section 172, do not decrease the dividend equivalent amount since the loss in a previous year does not impair the ability of the foreign corporation to make distributions in the current year. Similarly, depreciation for regular taxable income purposes is more accelerated than the depreciation permitted for dividend equivalent amount purposes. I.R.C. § 312(k). Since depreciation is less accelerated for purposes of calculating the dividend equivalent amount, it is possible for a foreign corporation to have branch profits tax liability even though there is no taxable income that would be taxed under sections 882 and 11.

While some items deductible in computing taxable income are not deductible in computing the dividend equivalent amount, there are other items that are deductible for purposes of computing the dividend equivalent amount that do not reduce taxable income. For example, U.S. income taxes paid or accrued decrease the dividend equivalent amount.

Although the dividend equivalent amount is defined in terms of earnings and profits, there are some important differences. Dividend distributions reduce the earnings and profits account for purposes of evaluating subsequent distributions. However, actual dividends paid do not reduce the dividend equivalent amount because the purpose of the branch profits tax is to measure what could have been distributed, not what actually was distributed.

For special rules excluding certain items from the dividend equivalent amount that otherwise would be included, see I.R.C. § 884(d)(2).

effectively connected with the conduct of a trade or business in the United States, subject to certain specified adjustments.[28] To the extent that effectively connected earnings and profits are invested in U.S. net equity, the dividend equivalent amount is decreased.[29] In effect, the base amount to which the branch profits tax applies is decreased because the branch is deemed not to have repatriated the earnings to the corporation's home country. Conversely, to the extent that a foreign corporation's U.S. net equity decreases (because of an actual repatriation of assets or because U.S. property of the branch which previously was invested in U.S. net equity is converted into other nonqualifying domestic assets), the dividend equivalent amount is increased.[30] This increase reflects the fact that earnings of a previous year are being repatriated or are treated as having been repatriated.[31]

The term "U.S. net equity" is defined as "U.S. assets reduced by U.S. liabilities."[32] The term "U.S. assets" is defined as "money and [the] aggregate adjusted basis of property of the foreign corporation treated as connected with the conduct of a trade or business in the United States."[33] The term "U.S. liabilities" means the "liabilities of the foreign corporation treated as connected with the conduct of a trade or business in the United States under regulations prescribed by the Secretary."[34]

To illustrate how the branch profits tax operates, suppose *F* Corporation is incorporated in 1988 in a country that does not have a treaty with the United States. It invests $800,000 to purchase an office building in the United States, but not the land on which it is located. In 1988, *F* Corporation earns rent of $80,000, has a depreciation deduction of $24,000, and has other deductible business expenses of $16,000. *F* Corporation's net income subject to the regular U.S. corporate income tax is thus $40,000, on which it pays a corporate income tax of $13,600.[35] In 1988, *F* Corporation has effectively connected earnings and profits of $30,400—$40,000 of taxable income plus a $4000 section 312(k) adjustment,[36] minus the $13,600 federal income tax. On the other hand, *F* Corporation has an increase in U.S. net equity of $780,000—the $780,000 adjusted basis in the building (net of depreciation allowed under section 312(k)).[37]

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[28] I.R.C. § 884(a), (b).

[29] I.R.C. § 884(b)(1).

[30] I.R.C. § 884(b)(2)(A).

[31] Under section 884(b)(2)(B), the increase in the dividend equivalent amount is limited to the difference between post-1986 effectively connected earnings and profits and the aggregate dividend equivalent amount for previous years.

[32] I.R.C. § 884(c)(1).

[33] I.R.C. § 884(c)(2)(A). The adjusted basis of property is considered to be the basis for purposes of computing earnings and profits. I.R.C. § 884(c)(2)(A). Temp. Regs. § 1.884-1T, 53 Fed. Reg. 34,045 (1988).

[34] I.R.C. § 884(c)(2)(A). *See also supra* note 33.

[35] *See* I.R.C. § 882. For purposes of the example, a flat 34% income tax is assumed.

[36] The $800,000 building cost must be depreciated over a 40-year period instead of a 31.5-year period. *See* I.R.C. § 168(g)(2).

[37] *F* Corporation also has a liability for the federal income tax of $13,600 but an offsetting $13,600 increase in equity for the cash used to satisfy the liability.

In sum, *F* Corporation has a $0 dividend equivalent amount in 1988 since its U.S. earnings and profits are more than offset by its increase in U.S. net equity.

Suppose that in 1989 *F* Corporation has the same operating results. Again it will pay $13,600 in regular U.S. corporate income tax on its $40,000 of taxable income. *F* Corporation will also have effectively connected earnings and profits of $30,400. It will not, however, have an increase in its U.S. net equity unless it invests additional funds in the United States. Instead, *F* Corporation's U.S. net equity will decline from $780,000 to $760,000—a decline in the building's tax basis under sections 312(k) and 1016. Accordingly, *F* Corporation's dividend equivalent amount will equal $50,400—$30,400 of U.S. earnings and profits plus a $20,000 decrease in U.S. net equity. F Corporation will therefore be liable for a 30% branch profits tax on $50,400 of deemed dividends.

2. *The Branch Profits Tax on Interest*

In conjunction with the branch profits tax, Congress also imposed a 30% tax on interest paid (or deemed paid) by a branch of a foreign corporation engaged in a U.S. trade or business.[38] In the absence of section 884(f), which imposes this branch-level tax on interest, it would be possible for a foreign corporation to avoid the branch profits tax by making interest payments to its foreign shareholders. The interest payments would decrease taxable income, effectively connected earnings and profits, and, ultimately, the dividend equivalent amount on which the branch profits tax is based.

Section 884(f)(1)(A) provides that interest paid by the U.S. branch of a foreign corporation engaged in a U.S. trade or business is treated as if paid by a domestic corporation. Consequently, under section 861(a)(1) the interest is U.S. source income and is generally subject to a flat 30% tax under sections 871(a) or 881.[39] Section 884(f)(1)(B) provides that, to the extent that the amount of interest allowable as a deduction under section 882 in computing taxable income exceeds the interest actually paid, the excess should be treated as interest paid by a fictional U.S. subsidiary (the branch) to the parent, thereby subjecting the notional interest payment to a 30% tax under section 881.

3. *The Branch Profits Tax and Secondary Withholding on Dividends*

Normally, a foreign corporation subject to the regular U.S. corporate tax on income effectively connected with a U.S. trade or business and subject to the branch profits tax is not subject to any additional tax when the foreign corporation makes a dividend distribution to its foreign investors.[40] The branch profits tax

[38]I.R.C. § 884(f). Congress sought to equalize the treatment of branch interest and the interest paid by a U.S. subsidiary. H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. II-648, *reprinted in* 1986 U.S. CODE CONG. & ADMIN. NEWS 4075, 4736 [hereinafter TRA 1986 Conference Committee Report].

[39]If the recipient is a U.S. person or a foreign person engaged in a U.S. trade or business and the interest is effectively connected, the interest will not be subject to the 30% tax but instead will be taxable to the recipient on a net income basis. I.R.C. § 864(c)(2).

[40]I.R.C. § 884(e)(3). The 30% tax on dividends may be imposed on dividends that are attributable to pre-1987 earnings and profits. I.R.C. § 884(e)(3).

on the U.S. earnings and profits of foreign corporations is intended to serve the same function as the 30% tax on dividend distributions from domestic corporations to foreign investors.[41]

Congress has retained the 30% tax on dividend distributions from foreign corporations, however, when the branch profits tax is inapplicable because an income tax treaty from which the nontreaty-shopping foreign corporation can benefit prohibits the application of the branch profits tax but allows imposition of the 30% tax on dividends.[42] In this context, the withholding tax on dividends serves as a back-up for the branch profits tax.[43]

B. *Nondiscrimination Clauses*

In each bilateral tax treaty to which it is a party, the United States incorporates a nondiscrimination clause.[44] The purpose of such a clause is to prevent one treaty partner from treating nationals of the other contracting state worse than that partner treats its own nationals. While there are variations in the form of such clauses, the current U.S. Model Income Tax Treaty[45] contains the following language in Article 24:

> Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected.[46]

This nondiscrimination requirement not only applies to "nationals" or citizens, but also to corporations of one contracting state that are taxed in the other contracting state on income attributable to a "permanent establishment" in the other contracting state.[47] As Article 24 provides:

> The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favorably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities.[48]

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[41] I.R.C. §§ 861(a)(2)(A), 871.

[42] I.R.C. § 884(e)(3).

[43] There is secondary withholding on dividends paid by a foreign corporation to its shareholders if at least 25% of the corporation's gross income during the preceding three years is effectively connected with its U.S. trade or business. I.R.C. § 861(a)(2)(B). As discussed *infra* text accompanying note 60, some treaties prevent the application of the branch profits tax. The amount subject to withholding is proportionate to the amount of the corporation's gross income from effectively connected income, as compared with its total gross income. I.R.C. § 861(a)(2)(B).

[44] For a full discussion of treaty nondiscrimination clauses, see K. VAN RAAD, NONDISCRIMINATION IN INTERNATIONAL TAX LAW (1986).

[45] United States Dept. of Treasury Model Income Tax Treaty, June 16, 1981, CCH TAX TREATIES ¶ 158, P-H TAX TREATIES ¶ 1022 [hereinafter 1981 Model Treaty].

[46] *Id.* at art. 24.

[47] *Id.*

[48] *Id.*

Essentially, a permanent establishment is an office or other "fixed place of business through which the business of an enterprise is carried on."[49]

To illustrate how such nondiscrimination provisions apply, suppose that a German corporation is engaged in the reinsurance business in the United States through a U.S. branch. Assume for the purposes of this illustration that there is no branch profits tax liability. The corporation will be taxed under sections 882 and 11 on its income effectively connected with the conduct of its U.S. trade or business. The United States also imposes an excise tax on reinsurance policies issued by foreign insurers.[50] Under the nondiscrimination article of the United States-Germany income tax treaty,[51] however, the German corporation will be exempt from the excise tax because there is no comparable tax on reinsurers that are U.S. corporations.[52]

C. *Relationship of Branch Profits Tax and Treaty Nondiscrimination Clauses*

In enacting the branch profits tax, Congress recognized that many U.S. income tax treaties contain nondiscrimination clauses that would arguably bar the imposition of such a tax.[53] Because U.S. corporations are not subject to a branch profits tax on their earnings, it could be argued that it would be discriminatory to subject foreign corporations to such a tax.

Congress' reaction to this argument was ambiguous. At one level, it appeared to reject the argument. As the 1986 Bluebook states:

> Congress generally believed that a branch profits tax does not unfairly discriminate against foreign corporations because it treats foreign corporations and their shareholders *together* no worse than U.S. corporations and their shareholders[.][54]

Congress apparently believed that because U.S. corporations are taxed on their earnings and U.S. shareholders are taxed on dividend distributions, it would not be discriminatory to subject foreign corporations and their shareholders to two taxes—one on the corporation's earnings and another (the branch profits tax) on the repatriation of those earnings.

Because Congress viewed the branch profits tax as a substitute for the second-tier withholding tax imposed on foreign shareholders of U.S. corporations, it does not appear that Congress believed the tax to be inconsistent with the principle of nondiscrimination. When a U.S. corporation earns income, it is taxed on the income once at the corporate level and a second time when the proceeds are distributed as dividends. For a foreign corporation engaged in a trade or business in the United States through a permanent establishment, income effectively connected with the trade or business is similarly taxed once when earned and a

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[48]*Id.* at art. 5.

[50]I.R.C. § 4371(3).

[51]Germany Income Tax Treaty, July 22, 1954, art. XVIII, CCH TAX TREATIES ¶ 3025, P-H TAX TREATIES ¶ 39,210.

[52]I.R.S. Letter Ruling 7846060, Aug. 18, 1978.

[53]TRA 1986 Conference Committee Report, *supra* note 38, at II-650.

[54]1986 Bluebook, *supra* note 3, at 1038 (emphasis added). *See generally* Vettel, *Branch-Level Tax and Treaty Overrides*, 35 TAX NOTES 632 (1987).

second time under the branch profits tax to the extent the income is not reinvested in qualifying U.S. assets.[55]

Nevertheless, Congress declined to take a clear stand in 1986. The 1986 Bluebook notes that

> Congress generally did not intend to override U.S. income treaty obligations that arguably prohibit imposition of the branch profits tax even though as later-enacted legislation the Act's branch tax provisions normally would do so. Congress adopted this position, however, only on the understanding that the Treasury Department will renegotiate outstanding treaties that prohibit imposition of the tax.[56]

Congress' reluctance was prudent. To equate a double tax at the corporate level for foreign corporations with a single tax at the corporate level and a second tax at the shareholder level upon distribution is to make a significant and unsubstantiated assumption about the incidence of corporate-level taxes. Unless the incidence of the branch profits tax falls wholly on the shareholders, the branch profits tax and the secondary tax on dividend distributions are not equivalent.

Studies of the incidence of the corporate tax have reached inconclusive results.[57] The burden of a corporate tax increase may fall on the shareholders, on the customers through higher prices, on the suppliers through lower prices paid for their supplies, on the workers through lower wages, or on the lenders through lower interest payments.

The argument that a corporate level branch profits tax is equivalent to a withholding tax imposed on individuals also violates a basic tenet of the U.S. tax system: that corporations and individuals are treated as separate taxpayers. For virtually all other tax purposes, a corporate level tax is not viewed as the equivalent of a tax on individuals. Thus, the staff of the Joint Committee on Taxation could state, with respect to the Tax Reform Act of 1986, that "the Act produces substantial reductions in individual income tax liabilities."[58] The statement was, of course, technically correct since that Act shifted more than $120 billion of the tax burden from individuals to the corporate sector. But it was fundamentally inconsistent with provisions in the same Act based on the assumption that a corporate level branch profits tax could be viewed merely as the equivalent of a withholding tax on income received by individuals.

[55]If the branch profits tax applies, there is no additional U.S. tax when the foreign corporation distributes its U.S. income to shareholders in the form of a dividend. I.R.C. § 884(e)(3)(A).

[56]1986 Bluebook, *supra* note 3, at 1038.

[57]*See, e.g.*, M. KRYZANIAK & R. MUSGRAVE, THE SHIFTING OF THE CORPORATE INCOME TAX 16 (1963); Harberger, *The State of the Corporate Income Tax: Who Pays It? Should it Be Repealed?*, NEW DIRECTIONS IN FEDERAL TAX POLICY FOR THE 1980s 161 (C. Walker & M. Bloomfield eds. 1983); Ballentine & McClure, *Taxation and Corporate Financial Policy*, 94 Q.J. ECON. 351-53 (1980); Harberger, *The Incidence of the Corporation Income Tax*, 70 J. POL. ECON. 215, 236 (1962).

[58]1986 Bluebook, *supra* note 3, at 17.

D. *Treaty and Code Limitations on Benefits Provisions*

The net result of the congressional ambivalence appears to be that treaty nondiscrimination provisions may preclude the operation of the branch profits tax for the present time.

In Notice 87-56,[59] the Service indicated that the branch profits tax would not be applicable to qualified residents of countries either with 1981 Model Treaty nondiscrimination clauses[60] or nondiscrimination clauses found in some of the older treaties.[61] Accordingly, nondiscrimination clauses in treaties with the following countries will preclude the application of the branch profits tax to a corporation that is a qualified resident of such a country: Aruba, Austria, Belgium, China, Cyprus, Denmark, Egypt, Finland, Germany, Greece, Hungary,

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[59]1987-2 C.B. 367. *See also* Temp. Regs. § 1.884-1T(h), 53 Fed. Reg. 34,045 (1988).

[60]Treaties based on the 1981 Model Treaty contain nondiscrimination clauses preventing a more burdensome tax on foreign taxpayers than on U.S. corporations. Because the branch profits tax is not imposed on U.S. corporations, treaties containing these nondiscrimination clauses prevent taxing the U.S. branches of foreign corporations.

The following treaties contain nondiscrimination clauses similar to the one in the 1981 Model Treaty: Belgium Income Tax Treaty, July 9, 1970, art. XXIV, CCH TAX TREATIES ¶ 590C, P-H TAX TREATIES ¶ 17,054; China Income Tax Treaty, Apr. 30, 1984, art. XXIII, CCH TAX TREATIES ¶ 1426, P-H TAX TREATIES ¶ 72,123; Cyprus Income Tax Treaty, Mar. 19, 1984, art. VII, CCH TAX TREATIES ¶ 2010, P-H TAX TREATIES ¶ 29,107; Egypt Income Tax Treaty, Aug. 24, 1980, art. XXVI, CCH TAX TREATIES ¶ 8031, P-H TAX TREATIES ¶ 34,126; Finland Income Tax Treaty, Mar. 6, 1970, art. VII, CCH TAX TREATIES ¶ 2658, P-H TAX TREATIES ¶ 37,037; Hungary Income Tax Treaty, Feb. 12, 1979, art. XXI, CCH TAX TREATIES ¶ 3624, P-H TAX TREATIES ¶ 45,121; Iceland Income Tax Treaty, May 7, 1975, art. VII, CCH TAX TREATIES ¶ 3710, P-H TAX TREATIES ¶ 46,107; Italy Income Tax Treaty, Apr. 17, 1974, art. XXIV, CCH TAX TREATIES ¶ 4335, P-H TAX TREATIES ¶ 53,054; Jamaica Income Tax Treaty, May 21, 1980, art. XXV, CCH TAX TREATIES ¶ 4386Y, P-H TAX TREATIES ¶ 55,125; Japan Income Tax Treaty, Mar. 8, 1971, art. VII, CCH TAX TREATIES ¶ 4393G, P-H TAX TREATIES ¶ 54,037; Korea Income Tax Treaty, June 4, 1976, art. VII, CCH TAX TREATIES ¶ 4810, P-H TAX TREATIES ¶ 56,107; Malta Income Tax Treaty, Mar. 21, 1980, art. XXV, CCH TAX TREATIES ¶ 5428, P-H TAX TREATIES ¶ 61,125; Morocco Income Tax Treaty, Aug. 1, 1977, art. XXII, CCH TAX TREATIES ¶ 5625, P-H TAX TREATIES ¶ 64,122; Netherlands Income Tax Treaty, Apr. 29, 1948, art. XXV, CCH TAX TREATIES ¶ 5829, P-H TAX TREATIES ¶ 66,126; Norway Income Tax Treaty, Dec. 3, 1971, art. XXV, CCH TAX TREATIES ¶ 6078, P-H TAX TREATIES ¶ 69,055; Philippines Income Tax Treaty, Oct. 16, 1982, art. XXIV, CCH TAX TREATIES ¶ 6627, P-H TAX TREATIES ¶ 74,124; United Kingdom Income Tax Treaty, Dec. 31, 1975, art. XXIV, CCH TAX TREATIES ¶ 8103X, P-H TAX TREATIES ¶ 89,054.

[61]Some of the older U.S. treaties provide that the citizens or subjects, including corporations, of one of the contracting states shall not, while a "resident" in the other state, be subject to more burdensome taxes than the citizens or subjects of the other states residing in its territory. In other words, a foreign corporation resident in the United States cannot be subject to the branch profits tax if U.S. corporations are not. Treaties containing nondiscrimination clauses that incorporate the "resident" concept include: Austria Income Tax Treaty, Oct. 25, 1956, art. XVIII, CCH TAX TREATIES ¶ 521, P-H TAX TREATIES ¶ 16,118; Denmark Income Tax Treaty, June 17, 1980, art. XXIV, CCH TAX TREATIES ¶ 2077, P-H TAX TREATIES ¶ 31,054; Germany Income Tax Treaty, July 22, 1954, art. XVIII, CCH TAX TREATIES ¶ 3021, P-H TAX TREATIES ¶ 39,118; Greece Income Tax Treaty, Feb. 20, 1950, art. XVI, CCH TAX TREATIES ¶ 3119, P-H TAX TREATIES ¶ 41,116; Ireland Income Tax Treaty, Sept. 13, 1949, art. XXI, CCH TAX TREATIES ¶ 4124, P-H TAX TREATIES ¶ 51,122; Luxembourg Income Tax Treaty, Dec. 18, 1962, art. XX, CCH TAX TREATIES ¶ 5323, P-H TAX TREATIES ¶ 60,120; Netherlands Antilles Income Tax Treaty, Aug. 8, 1986, art. 24, CCH TAX TREATIES ¶ 5898A, P-H TAX TREATIES ¶ 65,124; Pakistan Income Tax Treaty, July 1, 1957, art. XVII, CCH TAX TREATIES ¶ 6220, P-H TAX TREATIES ¶ 70,117; Sweden Income Tax Treaty, Mar. 23, 1939, pro., CCH TAX TREATIES ¶ 7328, P-H TAX TREATIES ¶ 81,124; Switzerland Income Tax Treaty, May 24, 1951, art. XVIII, CCH TAX TREATIES ¶ 7421, P-H TAX TREATIES ¶ 82,119.

Iceland, Ireland, Italy, Jamaica, Japan, Korea, Luxembourg, Malta, Morocco, Netherlands, Netherlands Antilles, Norway, Pakistan, Philippines, Sweden, Switzerland and the United Kingdom.[62] Alternatively, treaties with the following countries would permit the application of the branch profits tax: Australia, Barbados, Canada, France, New Zealand, Poland, Romania, South Africa, the Soviet Union and Trinidad & Tobago.[63]

1. *New Code "Treaty Shopping" Provisions*

Notwithstanding this apparent concession to international law, if a treaty nondiscrimination clause precludes the imposition of the branch profits tax, the tax may still apply if there is treaty shopping.[64] The Tax Reform Act of 1986 seeks to prevent treaty shopping by providing in effect that a foreign corporation can claim the benefits of a tax treaty prohibiting imposition of a branch profits tax only if the corporation is a "qualified resident" of the treaty country,[65] regardless of whether the corporation is treated as a resident for treaty purposes. A foreign corporation that is not a qualified resident of the treaty country is considered to be treaty shopping. A publicly-traded foreign corporation is a qualified resident if its stock is "primarily and regularly traded on an established securities market" in its country of residence.[66] A nonpublicly-traded corporation residing in a treaty country is a "qualified resident" if it meets a "shareholder"[67] and a "base erosion"[68] test. A corporation is not a qualified resident if 50% or more (by value) of the corporation's stock is beneficially owned by individuals who do not reside in the treaty country or are not U.S. persons.[69]

To prevent nontreaty-country foreign investors from treaty shopping by capitalizing a treaty corporation with a large amount of debt while having residents of the treaty country hold shares of the corporation having little or no value, section 884(e)(4)(A)(ii) further provides that a foreign treaty corporation is not a qualified resident if 50% or more of its income is used to pay its liabilities to persons who are not residents of the treaty country or the United States.

[62]I.R.S. Notice 87-56, 1987-2 C.B. 367; Temp. Regs. § 1.884T(h)(3), 53 Fed. Reg. 34,045 (1988).

[63]Temp. Regs. § 1.884-1T(h)(4), 53 Fed. Reg. 34,045 (1988). Some of these treaties reduce the applicable rate for the branch profits tax.

[64]For a definition of "treaty shopping," see *supra* text accompanying note 10.

[65]I.R.C. § 884(e).

[66]I.R.C. § 884(e)(4)(B)(i). A publicly-traded corporation's wholly-owned subsidiary can also qualify if the parent corporation is organized and trades its stock in the same treaty country. I.R.C. § 884(e)(1)(B)(ii). Similarly, a foreign corporation that is wholly owned by a domestic corporation whose stock is publicly traded on an established securities market in the United States is a qualified resident. I.R.C. § 884(e)(4)(B)(i).

[67]*See* I.R.C. § 884(e)(4)(A)(i).

[68]*See* I.R.C. § 884(e)(4)(A)(ii).

[69]Neither I.R.C. § 884 nor the Committee Reports discuss how the "50 percent test" is to apply. *But see* Temp. Regs. § 1.884-5T(b), 53 Fed. Reg. 34045 (1988) (requirements relating to stock ownership). In addition to the objective tests in section 884(e)(4)(A)-(B), the Secretary is authorized to determine whether or not treaty shopping is occurring. I.R.C. § 884(e)(4)(C). A corporation is a qualified resident if it is engaged in an active trade or business in the country of residence or obtains a ruling from the Service that tax avoidance is not a principal purpose for incorporating in the treaty jurisdiction. Regs. § 1.884-5T(a)(3)-(4).

Nondiscrimination articles are not the only provisions that are unavailable to treaty-shopping corporations following the Tax Reform Act of 1986. Many U.S. bilateral treaties contain provisions that reduce or eliminate withholding on interest payments made by one of the parties to the treaty. For example, suppose that the U.S. branch of a Netherlands corporation makes a $1,000 interest payment to a Swiss lender. If the treaty between the United States and the Netherlands is applicable, there will be no withholding tax on the interest paid by the Netherlands corporation.[70] Under the treaty between the United States and Switzerland, if applicable, the tax on the interest received by the lender may be reduced from the 30% rate mandated under the Code[71] to 5% under Article VII of the treaty.[72] There is some confusion as to which treaty, if either, would apply to reduce the withholding tax on the interest payments.

Similarly, suppose that the U.S. branch of the Netherlands corporation does not make an interest payment to the Swiss lender. Instead, the interest payment is made from the home office of the Netherlands corporation in Amsterdam. Even if the loan proceeds are used by the home office and are not used at all by the U.S. branch, the interest payments to the Swiss lender may be allocated to the U.S. branch and subjected to the branch profits tax on interest as if the interest were paid from a wholly-owned U.S. subsidiary to its foreign parent in the Netherlands.[73] As in the above case of interest actually paid, confusion also exists in the case of a deemed interest payment as to whether any treaty might apply and, if so, which one.

Under the treaty shopping provisions of the branch profits tax, neither treaty may be applicable. Under section 884(f)(1), interest paid (or deemed paid) by the U.S. branch of a foreign corporation is treated as if it were paid by a U.S. corporation.[74] According to the 1986 Bluebook, the applicable treaty for interest actually paid is the one between the United States and the country of the recipient.[75] For interest deemed to be paid by the U.S. branch of a foreign corporation, the applicable treaty is the one between the United States and the country of the corporation's home office.[76]

In Notice 87-56,[77] the Service went beyond the 1986 Bluebook concerning interest actually paid by the U.S. branch of a foreign corporation. According to

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[70]Netherlands Income Tax Treaty, Apr. 29, 1948, art. XII, CCH TAX TREATIES ¶ 5816, P-H TAX TREATIES ¶ 66,113. This assumes that the recipient is not "a citizen, resident, or corporation of the United States." *Id.*

[71]I.R.C. § 881(a).

[72]Switzerland Income Tax Treaty, May 24, 1951, art. VII, CCH TAX TREATIES ¶ 7410, P-H TAX TREATIES ¶ 82,108.

[73]I.R.C. § 884(f)(1)(B). The interest allocation is determined under Regulations section 1.882-5 in accordance with asset values in the branch and the home office.

[74]In the case of interest not actually paid but deemed to be paid by a U.S. branch, the interest is considered to be paid by a wholly-owned domestic corporation to its foreign parent. I.R.C. § 884(f)(1)(B).

[75]1986 Bluebook, *supra* note 3, at 1042.

[76]This follows from the fiction that the interest is paid by a wholly-owned U.S. subsidiary to its foreign parent. I.R.C. § 884(f)(1)(B).

[77]1987-2 C.B. 367. *See generally* Plutte, *Notice 87-56, The Interaction of Branch Profits Tax and Tax Treaties*, 17 TAX MGMT. INT'L J. 25 (1988) (discussing I.R.S. Notice 87-56).

the Notice, a taxpayer can rely on the treaty between the United States and either the country of the foreign recipient of the interest or the country of the foreign corporation-payor of interest.[78] The Notice does not address interest that is deemed to be paid by the U.S. branch of a foreign corporation. Without further guidance from the Service, it seems that only the treaty of the foreign corporation's home office could be applicable.[79]

The appropriate treaty will not apply unless a resident is a "qualified resident" as defined in section 884(e)(4).[80] The requirements for determining a qualified resident are the same as those used for the branch profits tax.[81] Failure to satisfy the Code requirements for a qualified resident means that there can be no treaty relief from full taxation of interest payments (or deemed interest payments) even if the appropriate treaty contains no provision limiting benefits to qualified residents.[82]

### 2. *Interaction of Code "Treaty Shopping" Provisions and the Branch Profits Tax*

The application of the Code limitations on benefits provision in section 884(e)(4) with respect to the branch profits tax creates some troubling results. Consider two corporations formed in the Netherlands. Assume that neither corporation is a qualified resident of the Netherlands (*e.g.*, 50% of the stock is held by French residents). Each corporation conducts its only trade or business in the United States—one through a wholly-owned U.S. subsidiary and the other through a branch—and each corporation repatriates the earnings generated from the U.S. trade or business to the corporate home office in the Netherlands.

For both Netherlands corporations, the earnings and profits produced by the U.S. trade or business will be taxed by the United States.[83] In the case of the Netherlands corporation with a U.S. subsidiary, the dividends paid to the parent corporation will be subject to the second tier tax at a reduced rate pursuant to the treaty between the United States and the Netherlands.[84] The reduced treaty rate is available even though the Netherlands corporation is not a qualified resident under section 884(e)(3) because that provision does not apply to dividends paid by a U.S. corporation.

[78]*See* Temp. Regs. § 1.884-4T(b)(8), 53 Fed. Reg. 34,045 (1988) (describing the effect of treaties on interest paid by a U.S. trade or business).

[79]Temp. Regs. § 1.884-4T(c)(3), 53 Fed. Reg. 34,045 (1988). Apparently the branch profits tax does not apply to the second tier of the excess interest payment from the foreign corporation to the lender. Presumably, either the treaty applicable to the foreign corporation or the treaty applicable to the recipient could apply to this regulation even if neither the foreign corporation nor the recipients were treaty shopping.

[80]*See* I.R.C. § 884(e)(3)(B), (f)(1).

[81]*See supra* text accompanying notes 64-69.

[82]*See, e.g.*, Netherlands Income Tax Treaty, Apr. 29, 1948, CCH TAX TREATIES ¶ 5803, P-H TAX TREATIES ¶ 66,100 (contains no article for limiting benefits).

[83]*See* I.R.C. §§ 11 (U.S. subsidiary), 882 (U.S. branch).

[84]Under Article VII of the Netherlands Income Tax Treaty, a 5% tax is imposed on the distribution from the U.S. subsidiary to the Netherlands parent corporation. Netherlands Income Tax Treaty, Apr. 29, 1948, art. VII, CCH TAX TREATIES ¶ 5811, P-H TAX TREATIES ¶ 66,108.

For the Netherlands corporation with a U.S. branch, however, there is no treaty relief. Even though the nondiscrimination clause in the treaty[85] bars the imposition of the branch profits tax on Netherlands corporations with U.S. permanent establishments without qualification, section 884(e)(3) makes the treaty inapplicable. Thus, the two Netherlands corporations, engaged in identical activities in the United States, will have different tax consequences depending on whether those activities are conducted through a U.S. subsidiary or a U.S. branch.

Similar anomalies exist with respect to interest payments made from U.S. earnings. Suppose the French investors in the foregoing example form an additional corporation, Loanco, in the Netherlands, which makes a loan to each of the two Netherlands corporations conducting a U.S. trade or business. In the case of the Netherlands corporation with a U.S subsidiary, interest payments made to Loanco will not be subject to taxation in accordance with the United States-Netherlands treaty.[86] In the case of the Netherlands corporation with a U.S. branch, however, the interest payments from the branch will be subject to a 30% tax that cannot be reduced by reference to the United States-Netherlands treaty. Neither the payor-corporation nor the recipient are "qualified residents" of the Netherlands within the meaning of section 884(e)(3). Again, the tax consequences to the two corporations conducting a U.S. trade or business depend on the form of the trade or business—U.S. subsidiary or U.S. branch.

It is disturbing that the new Code treaty shopping provisions place such a premium on form. Perhaps even more disturbing is the possibility that the Code treaty shopping provisions may apply to deny treaty benefits when there is no treaty shopping. Suppose that a Netherlands corporation conducting a U.S. trade or business through a U.S. branch incurs a loan from Swissbank, an unrelated bank organized in Switzerland. Assume that the proceeds are used by the Netherlands corporation solely in the Netherlands. Moreover, suppose that the interest payments are made by the Netherlands corporation from its home office in Amsterdam out of earnings not effectively connected with the conduct of the U.S. trade or business.

Under sections 884(f)(1)(B) and 882, the interest deemed to be paid by the U.S. branch will be treated as if paid by a U.S. subsidiary to the foreign parent to the extent that the interest paid by the home office is allocated to the United States branch.[87] The United States-Netherlands treaty will not apply to the deemed interest payment, however, because the Netherlands corporation is not a "qualified resident" of the Netherlands.[88] The denial of treaty benefits under the

[85]*See id.* at art. XXV(3), CCH TAX TREATIES ¶ 5829, P-H TAX TREATIES ¶ 66,126.

[86]*Id.* at art. VIII, CCH TAX TREATIES ¶ 5812, P-H TAX TREATIES ¶ 66,109.

[87]For the method by which interest is allocated to the U.S. branch, see Regulations section 1.882-5 and Temporary Regulations section 1.884-4T(a)(2).

[88]Under Article XII of the treaty, if applicable, the 30% tax would be reduced to 0% for interest payments made by the Netherlands corporation to Swissbank. Even if the interest payment is treated as being made from a U.S. subsidiary to its Netherlands parent, Article VII(1) of the treaty provides a 0% tax rate. Netherlands Income Tax Treaty, Apr. 29, 1948, arts. XII, VII, CCH TAX TREATIES ¶¶ 5816, 5811, P-H TAX TREATIES ¶¶ 66,113, 66,107.

United States-Netherlands treaty in this situation when there is no treaty shopping seems totally inappropriate.[89]

3. *Historical Efforts to Combat Treaty Shopping*

The Treasury's concern over treaty shopping is not new.[90] In the 1945 income tax treaty between the United States and the United Kingdom, dividends paid by a corporation in one treaty country to a controlling corporation in the other treaty country were subject to a 5% withholding tax rather than the 30% rate under the Code or even the general treaty rate of 15%.[91] The 5% rate did not apply, however, if "the relationship of the two corporations ha[d] been arranged or [was] maintained primarily with the intention of securing such reduced rate."[92] The "arranged or maintained" language appeared in other U.S. income tax treaties in the 1950s.[93] The language, however, had a narrow application. For example, it did not prevent arrangements to secure the normal treaty withholding rate of 15% on dividends.[94] Moreover, it required tax authorities to determine state of mind with virtually no guidance.[95]

The United States made other sporadic attempts to prohibit perceived "treaty shoppers" from obtaining unintended treaty benefits. In treaties with Luxembourg and the Netherlands Antilles, the United States inserted nonreciprocal provisions depriving holding companies owned by third-country investors of treaty benefits that were otherwise available.[96] These third-country investors were denied certain favorable treaty benefits if the companies received special tax treatment in the treaty country of residence.[97]

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Pursuant to I.R.S. Notice 87-56, 1987-2 C.B. 367, the use of the treaty between the United States and the country of the recipient of the interest in the case of excess interest under section 884(f)(1)(B) is not permitted. As for interest actually paid, the payor corporation's treaty with the United States or the interest recipient's treaty with the United States can apply if the payor or the recipient is a "qualified resident." *See supra* text accompanying notes 69-80.

[89]*But see* I.R.C. § 884(e)(4)(C) (giving the Secretary the authority to determine there is no treaty shopping notwithstanding a violation of the objective standards of section 884(e)). *See* Temp. Regs. § 1.884-5T(a), 53 Fed. Reg. 34,045 (1988).

[90]For a review of treaty provisions limiting treaty benefits, see generally Rosenbloom, *supra* note 10.

[91]United Kingdom Income Tax Treaty, Apr. 16, 1945, art. VI, CCH TAX TREATIES ¶ 8111 P-H TAX TREATIES ¶ 89,107.

[92]*Id.*

[93]*See, e.g.*, Austria Income Tax Treaty, Oct. 25, 1956, art. VI, CCH TAX TREATIES ¶ 509, P-H TAX TREATIES ¶ 16,106; Denmark Income Tax Treaty, June 17, 1980, art. XX, CCH TAX TREATIES ¶ 2063, P-H TAX TREATIES, ¶ 31,040; Ireland Income Tax Treaty, Sept. 13, 1949, art. VI, CCH TAX TREATIES ¶ 4109, P-H TAX TREATIES ¶ 51,107; Netherlands Income Tax Treaty, Apr. 29, 1948, art. VII, CCH TAX TREATIES ¶ 5811, P-H TAX TREATIES ¶ 66,108; Switzerland Income Tax Treaty, May 24, 1951, art. VI, CCH TAX TREATIES ¶ 7409, P-H TAX TREATIES ¶ 82,107.

[94]Rev. Rul. 79-65, 1979-1 C.B. 458.

[95]*See, e.g.*, I.R.S. Letter Ruling 8230091, Apr. 28, 1982; I.R.S. Letter Ruling 8124038, Mar. 17, 1981.

[96]Luxembourg Income Tax Treaty, Dec. 18, 1962, art. XV, CCH TAX TREATIES ¶ 5318, P-H TAX TREATIES ¶ 60,115; Netherlands Income Tax Treaty (as extended to the Netherlands Antilles), June 15, 1955, pro., art. VII, CCH TAX TREATIES ¶ 5832A.

[97]The denied benefits were generally lower rates of withholding on passive income (*i.e.*, dividends interest, royalties) received from investments in the United States.

During the 1970s, the United States began to develop a more coherent effort to limit income tax treaty benefits.[98] For example, the 1970 treaty with Finland contained a limitation of benefits provision that denied a corporation of one contracting state treaty benefits (*e.g.*, a lower withholding tax than the Code provides) for interest, dividends, or royalties if:

> (a) by reason of special measures granting tax benefits to investment or holding companies the tax imposed on such corporation by the former Contracting State with respect to such dividends, interest, or royalties is substantially less than the tax generally imposed by such Contracting State on corporate profits, and
>
> (b) 25 percent or more of the Capital of such corporation is held of record or is otherwise determined, after consultation between the competent authorities of the Contracting States, to be owned directly or indirectly, by one or more persons who are not individual residents of the former Contracting State (or, in the case of a Finnish corporation, who are citizens of the United States).[99]

The treaty with Finland introduced a two-part test to determine whether treaty benefits were to be denied. First, the provision applied only when, under the "special measures" requirement, tax in the country of corporate residence was "substantially less than the tax generally imposed" on corporate profits.[100] Second, under the "foreign ownership" test, the provision applied unless a specified percentage of a corporation's stock was owned by individuals who were residents of the country of corporate residence.[101]

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It is poor tax policy for the United States to condition treaty benefits on the treatment of certain holding companies located in the other contracting country. The United States will normally allow a foreign company a tax credit for taxes paid abroad. I.R.C. §§ 901-907. Ironically, to the extent that companies with third-country investors enjoy lower tax rates in the country of corporate residence, there is a greater likelihood of increased U.S. tax collections because the foreign tax credit will be smaller. A second problem with these limitation provisions is that the focus is on tax rates in the other contracting country and not on the tax base: If a foreign country provided the same tax rates for all companies but drastically narrowed the tax base, the treaty limitations provision would not apply.

[98]*See* Rosenbloom, *supra* note 10, at 785-810.

[99]Finland Income Tax Treaty, Mar. 6, 1970, art. XXVII, CCH TAX TREATIES ¶ 2678, P-H TAX TREATIES ¶ 37,057. The Treasury explained the article as follows:

> The purpose of this Article is to deal with a potential abuse which could occur if one of the States provided preferential rates of tax for investment of holding companies. In such a case, residents of third countries could organize a corporation in the State extending the preferential rates for the purpose of making investments in the other State. The combination of the low tax rates in the first State and the reduced rates or exemptions in the other State would enable the third country residents to realize unintended benefits.

Technical Explanation by the Treasury Department on the Convention Between the United States and Finland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Property, Signed at Washington, D.C., on March 6, 1970, *reprinted in* CCH TAX TREATIES ¶ 2685, P-H TAX TREATIES ¶ 37,065.

[100]Finland Income Tax Treaty, Mar. 6, 1970, art. XXVII, CCH TAX TREATIES ¶ 2678, P-H TAX TREATIES ¶ 37,057. *See also* Rosenbloom, *supra* note 10, at 785-87.

[101]Finland Income Tax Treaty, Mar. 6, 1970, art. XXVII, CCH TAX TREATIES ¶ 2678, P-H TAX TREATIES ¶ 37,057. *See also* Rosenbloom, *supra* note 10, at 785-87.

Other treaties in the 1970s incorporated similar articles.[102] In 1976 and 1977, the United States published a "model" income tax treaty.[103] Article 16, entitled "Investment or Holding Companies," was a more succinct restatement of the two-part test found in the Finland Tax Treaty:

> If 25 percent or more of the capital of a company which is a resident of a Contracting State is owned directly or indirectly by individuals who are not residents of that State, and if by reason of special measures the tax imposed by that State on that company with respect to dividends, interest or royalties arising in the other Contracting State is substantially less than the tax generally imposed by the first-mentioned State on corporate business profits, then, notwithstanding the provisions of Articles 10 (Dividends), 11 (Interest), or 12 (Royalties), that other State may tax such dividends, interest or royalties.[104]

This 1977 provision continued to ignore "nonspecial" measures that might result in low taxation in the country of corporate residence (*e.g.*, a low rate for all corporations). Other defects in the 1977 provision included the fact that corporate ownership was based solely on ownership of a corporation's stock, that only corporations would lose treaty benefits, and that the only treaty benefits that would be lost were those pertaining to dividends, interest, or royalties.[105]

The narrowness of the 1977 Model Treaty provision made it generally acceptable among U.S. trading partners. It was not until the Treasury sought broader limitations articles that treaty partners began to react.[106] In 1980, the Treasury proposed a new treaty with Cyprus[107] that contained more stringent limitations on treaty benefits than in any prior U.S. income tax treaty. For the first time, taxpayers other than corporations would not receive treaty benefits when such taxpayers were not subject to full tax in the country of residence.[108] Moreover, the limitations provision limited treaty benefits applying to all types of income.[109]

The proposed Cyprus treaty also contained an article addressing investment or holding companies.[110] While the formulation basically used the evolving two-part test set out in the 1977 Model Treaty, there were some differences. For the first time, the two-part test was set forth in the disjunctive rather than conjunctive. If there were "special measures" *or* foreign ownership, treaty benefits would

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[102]*See, e.g.*, Iceland Income Tax Treaty, May 7, 1975, art. XXVII, CCH TAX TREATIES ¶ 3730, P-H TAX TREATIES ¶ 46,127 (eliminating the reference to "investment or holding companies" and broadening the limitations article to apply to capital gains); United Kingdom Income Tax Treaty, Dec. 31, 1975, art. XVI, CCH TAX TREATIES ¶ 8103P, P-H TAX TREATIES ¶ 89,046 (follows the basic two-part test used in the United States-Finland treaty).

[103]United States Dept. of Treasury Model Income Tax Treaty, May 17, 1977, CCH TAX TREATIES ¶ 153, P-H TAX TREATIES ¶ 1019 [hereinafter 1977 Model Treaty].

[104]*Id.* at article XVI.

[105]Rosenbloom, *supra* note 10, at 793.

[106]*Id.*

[107]Proposed Cyprus Income Tax Treaty, art. IV, *reprinted in* S. EXEC. REP. No. 1, 96th Cong., 2d Sess. 10 (1980) [hereinafter Proposed Cyprus Treaty].

[108]*Id.*

[109]Rosenbloom, *supra* note 10, at 795.

[110]Proposed Cyprus Treaty, *supra* note 107, at art. XXVI.

be denied.[111] While substantially expanding the limitations provision applicable to companies, the proposed Cyprus treaty added a safe-harbor presumption for a corporation the stock of which was publicly traded on a recognized stock exchange of either treaty country. Such a corporation was presumed to be a resident of that country.

In 1981, the Treasury published a draft of a new model treaty[112] with the following provision:

> 1. A person (other than an individual) which is a resident of a Contracting State shall not be entitled under this Convention to relief from taxation in the other Contracting State unless
>
> (a) more than 75 percent on the beneficial interest in such person is owned, directly or indirectly, by one or more individual residents of the first-mentioned Contracting State; and
>
> (b) the income of such person is not used in substantial part, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons who are residents of a State other than a Contracting State and who are not citizens of the United States.
>
> For the purposes of subparagraph (a), a company that has substantial trading in its stock on a recognized exchange in a Contracting State is presumed to be owned by individual residents of that Contracting State.
>
> 2. Paragraph 1 shall not apply if it is determined that the acquisition or maintenance of such person and the conduct of its operations did not have as a principal purpose obtaining benefits under the Convention.
>
> 3. Any relief from tax provided by a Contracting State to a resident of the other Contracting State under the Convention shall be inapplicable to the extent that, under the law in force in that other State, the income to which the relief relates bears significantly lower tax than similar income arising within that other State derived by residents of that other State.[113]

Not only did the new model provision apply to all taxpayers and limit all treaty benefits, it also employed the disjunctive two-part test and introduced a conduit rule to determine ownership. The conduit rule in subparagraph 1(b) countered the possibility that a corporation in one contracting state might be capitalized with a large amount of debt by third-country investors, leaving valueless stock in the hands of individual residents of the contracting state.[114]

While the coverage of the limitations article in the 1981 Model Income Tax Treaty was significantly expanded, the taxpayer was permitted to show that its "acquisition or maintenance" and the "conduct of its operations did not have as a principal purpose" the obtaining of treaty benefits.[115] The burden was on the taxpayer to establish that it did not have the proscribed purpose. Furthermore,

[111] *Id.*
[112] 1981 Model Treaty, *supra* note 45.
[113] *Id.* at art. 16.
[114] Rosenbloom, *supra* note 10, at 798.
[115] *Id.* at 799.

such a showing only rebutted the presumption of foreign ownership, not the "special measures" test.[116]

In 1981, during its review of treaties and protocols involving a number of foreign countries,[117] the Senate included a reservation in the proposed treaty with Argentina similar to the 1981 Model Income Tax Treaty provision governing limitation of treaty benefits.[118]

Later that year, the Treasury issued a revised version of Article 16 of the 1981 Model Treaty that was narrower in scope than the original version.[119] The new provision did not apply to entities other than corporations and contained neither a conduit nor special measures test.[120] Furthermore, excluded from the limitation was any corporation the stock of which was listed on an "approved stock exchange" in either of the signatory countries.[121] In 1982, the United States signed treaties with New Zealand and Australia, both of which incorporated provisions similar to the revised Article 16 of the 1981 Model Treaty provision limiting

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[116]*Id.*

[117]Under review were tax treaties or protocols with the following: Argentina, Bangladesh, British Virgin Islands, Canada, Cyprus, Denmark, Egypt, Germany, Israel, Jamaica, Malta, Morocco, Philippines and the United Kingdom. Rosenbloom, *supra* note 10, at 801 n.120.

[118]The reservation provided:

> A person (other than an individual) which is a resident of a contracting state and which derives income from sources within the other contracting state shall not be entitled to the benefits under this convention accorded by that other contracting state if 25 percent or more of the beneficial interest in such person is owned, directly or indirectly, by individuals who are not residents of the first-mentioned contracting state. For purposes of this paragraph, a corporation that has substantial trading in its stock on a recognized exchange in a contracting state is presumed to be owned by residents of that contracting state. This paragraph shall not apply if it is determined that the acquisition or maintenance of such person and the conduct of its operations did not have as a principal purpose obtaining benefits under the convention.

Proposed Argentina Income Tax Treaty, *reprinted in* S. EXEC. REP. NO. 44, 97th Cong., 1st Sess. 6-7 (1981).

The Senate Report elaborated:

> The treaty does not contain the provision, found in most U.S. income tax treaties and the U.S. model, that limits the use of the treaty by third country nationals. When residents of third countries can use a treaty between the United States and a treaty partner to reduce his tax liability to either or both of the countries that resident can obtain a reduction in U.S. tax without reciprocal benefits accruing to U.S. residents earning income in that third country. Unintended use can erode the U.S. tax base. This unintended use is referred to as "treaty shopping."
>
> The Committee is aware that the Argentine treaty does not offer significant treaty shopping advantages when compared to other treaties. Such possibilities may, however, develop later. It has proved difficult to renegotiate treaties once abuses develop. In any event, the Committee wishes to eliminate, to the extent possible, those abuse possibilities that do exist.

*Id.* at 6. Argentina has not approved the treaty with this reservation.

[119]*See* Treasury Department's Model Convention, Discussion Draft of Article 16, Dec. 23, 1981, CCH TAX TREATIES ¶ 152A [hereinafter Revised Article 16].

[120]Rosenbloom, *supra* note 10, at 804.

[121]*Id.* If the parent of a subsidiary has stock listed on an approved exchange in either of the signatory countries, the subsidiary is excluded from the limitation. Revised Article 16, *supra* note 119, at 1(a).

benefits.[122] In 1983, proposed protocols signed with Denmark and France contained similar limitations provisions.[123]

The growing U.S. concern over treaty shopping was underscored by the issuance of two revenue rulings in late 1984 and the termination of the Netherlands Antilles treaty in 1987. The rulings evidenced an increasing resolve to curtail treaty shopping and foreshadowed the increased efforts that the United States was soon to take unilaterally in the Tax Reform Act of 1986 and related legislation.

In Revenue Ruling 84-152,[124] a Swiss corporation (*P*) owned two subsidiaries, a Netherlands Antilles corporation (*S*) and a U.S. manufacturing corporation (*R*). When *R* required an increase in working capital, *P* loaned the funds to *S* which reloaned the funds to *R*. *R* made timely interest payments at 11% to *S*, which, in turn, made timely interest payments at 10% to *P*.[125] In Revenue Ruling 84-153,[126] a U.S. holding corporation (*P*) had a wholly-owned Netherlands Antilles subsidiary (*S*) and a wholly-owned U.S. subsidiary (*R*). In order to raise funds for *R*, *S* issued bonds to foreign persons outside the United States. *S* loaned the funds to *R* at an interest rate that was 1% higher than the rate payable on the bonds.[127]

In each case, the Service held that interest payments made by the U.S. subsidiary (of the foreign corporation in Revenue Ruling 84-152 and of the U.S. corporation in Revenue Ruling 84-153) to a related Netherlands Antilles corporation would not be tax exempt under the then existing Netherlands Antilles treaty.[128] The Service based its conclusion on a number of related factors: (1) the interest was not "derived by" the Netherlands Antilles subsidiary under Article 8(1) of the Antilles treaty merely because of temporary physical possession;[129] (2) notwithstanding the fact that the Netherlands Antilles corporations

[122]*See* New Zealand Income Tax Treaty, July 23, 1982, art. XVI, CCH TAX TREATIES ¶ 5902Q, P-H TAX TREATIES ¶ 67,046; Australia Income Tax Treaty, Aug. 6. 1982, art. XVI, CCH TAX TREATIES ¶ 402Q, P-H TAX TREATIES ¶ 15,046. *See also* Rosenbloom, *supra* note 10, at 805.

[123]Proposed Protocol to Denmark Income Tax Treaty, Aug. 23, 1983, art. VIII, CCH TAX TREATIES ¶ 2083, P-H TAX TREATIES ¶ 31,063; Proposed Protocol to France Income Tax Treaty, Sept. 9, 1983, art. XXIV, CCH TAX TREATIES ¶ 2836B, P-H TAX TREATIES ¶ 38,076. In both protocols, foreign ownership is a problem when it rises to 50% rather than 25% in the New Zealand and Australia treaties. Rosenbloom, *supra* note 10, at 809.

[124]1984-2 C.B. 381.

[125]Without further explanation, the Service noted that neither *R* nor *S* were thinly capitalized, but that *S* was not sufficiently liquid to make the loans to *R* out of its own funds. *Id.*

[126]1984-2 C.B. 383.

[127]The interest payments by *R* did not qualify for the portfolio exemption because the bonds did not meet the requirements of section 163(f)(2)(B). *Id. See* I.R.C. § 871(h).

[128]Netherlands Antilles Income Tax Treaty, Aug. 28, 1986, art. 8, CCH TAX TREATIES ¶ 5897J, P-H TAX TREATIES ¶ 65,108 (partially terminated as of December 31, 1987).

[129]The Treasury's ruling position drew strength from a Tax Court victory in 1971. In Aiken Indus., Inc, v. Commissioner, 56 T.C. 925 (1971), a Bahamian company that had loaned money to a U.S. subsidiary assigned the obligation to a Honduran subsidiary under the same terms (*i.e.*, payment schedule and interest rate) as the obligation from the U.S. subsidiary. The Honduran subsidiary realized no profit from the transaction since the interest it received from the U.S. corporation was immediately payable to the Bahamian corporation. The U.S. subsidiary claimed that no withholding was required on interest payments made to the Honduran company under section 1442 because

had corporate substance and were not sham corporations, the corporations never had dominion and control over the interest payments; (3) the primary purpose of using the Netherlands Antilles corporations was to obtain the benefits of the Netherlands Antilles treaty exemption and thus avoid U.S. taxation; and (4) notwithstanding that the transactions served some business purpose, there was not "sufficient business or economic purpose to overcome the conduit nature of the transaction."[130]

The position taken in the 1984 revenue rulings has guided the Service's position in private letter rulings as well. In Private Letter Ruling 8722009,[131] the Service ruled that interest payments from a U.S. corporation to a Netherlands corporation were not exempt from U.S. taxation under Article VIII of the United States-Netherlands treaty. Under the facts of the ruling, third country foreign investors, who had made loans to the U.S. corporation directly, restructured the loans through a recently purchased, inactive Netherlands corporation. The debt-equity ratio of the Netherlands corporation was 89:1. The Service's conclusion was based not only on the fact that the Netherlands corporation was thinly capitalized, but also on the fact that interest checks received by the Netherlands corporation were endorsed by the corporation and deposited in the foreign investors' bank accounts.

While the Treasury has actively tried to combat treaty shopping through the rulings process, it has also taken a strong stand against treaty shopping in recent treaty negotiations. Under a long-standing treaty with the United States, the Netherlands Antilles had become a major treaty shopping jurisdiction. Among the more favorable provisions were the following: (1) dividends and interest could be paid free of withholding by an Antilles corporation engaged in a U.S. trade or business;[132] (2) dividends paid to an Antilles resident were entitled to reduced withholding;[133] (3) interest received by an Antilles corporation from a U.S. corporation was often subject to no withholding;[134] (4) income from real estate located in the United States was not subject to tax in the Antilles;[135] and

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article IX of the United States-Honduras treaty required no withholding on interest payments from a U.S. corporation to a Honduran corporation not having a permanent establishment.

The Tax Court ruled that the Honduran corporation never "received" the interest payments as required under the Honduras tax treaty because the receipt of the interest and the obligation to transmit the interest to the Bahamian corporation were inseparable. *Id.* 933. The Tax Court found that the treaty provision required more than temporary physical possession; the Honduran corporation was required to have complete dominion and control in order for article IX of the treaty to apply. Characterizing the Honduran corporation as a mere "conduit," the Tax Court noted that the transaction had no economic or business purpose but existed only to avoid U.S. taxation through the treaty benefits. *Id.* at 934.

130Rev. Rul. 84-152, 1984-2 C.B. 382; Rev. Rul. 84-153, 1984-2 C.B. 383 (citing Gregory v. Helvering, 293 U.S. 465 (1935) and Aiken Indus. Inc. v. Commissioner, 56 T.C. 925 (1971)).

131I.R.S. Letter Ruling 8722009, Feb. 12, 1987.

132Netherlands Antilles Income Tax Treaty, Aug. 28, 1986, art. 12, CCH TAX TREATIES ¶ 5897P, P-H TAX TREATIES ¶ 65,112 (partially terminated as of December 31, 1987).

133*Id.* at art. 7, CCH TAX TREATIES ¶ 5897I, P-H TAX TREATIES ¶ 65,107.

134*Id.* at art. 8, CCH TAX TREATIES ¶ 5897J, P-H TAX TREATIES ¶ 65,108. This interest exemption applied only if a Netherlands Antilles corporation owned, directly or indirectly, 50% or less of the entire voting power in the paying U.S. corporation. *Id.*

135*Id.* at art. 5, CCH TAX TREATIES ¶ 5897G, P-H TAX TREATIES ¶ 65,105.

(5) if the treaty had remained in force, its nondiscrimination clause would have denied the imposition of the branch profits tax to qualified residents of the Antilles.[136]

After several years of negotiations, the United States and the Netherlands Antilles agreed on the text of a proposed new treaty that would limit many of the benefits of the former treaty.[137] Article 16, the "Limitations on Benefits" provision, provided that a corporation, partnership, or other person resident in one treaty country would not be entitled to most treaty benefits unless each of the following three tests was met: (1) more than 50% of each class of stock (or comparable interest) was owned directly or indirectly by one or more individual residents of the Netherlands Antilles or residents or citizens of the United States; (2) no shares (or other entity interests other than interests solely as a creditor) were in bearer form; and (3) less than 50% of gross income was used to make non-pro rata distributions to, or to meet liabilities to persons who were not individual residents of the Netherlands Antilles or residents or citizens of the United States.[138] While these limitations were quite strict, the proposed treaty contained a number of exceptions designed to maintain the Netherlands Antilles as a financial center for investment in the United States.[139] The United States and the Netherlands Antilles were not, however, able to agree on the extent to which the exceptions to the "limitations" article should protect third-country investors.[140]

[136]I.R.S. Notice 87-56, 1987-2 C.B. 367. *See* Netherlands Antilles Income Tax Treaty, Aug. 28, 1986, art. 25, CCH TAX TREATIES ¶ 5898B, P-H TAX TREATIES ¶ 65,125. Most Netherlands Antilles corporations would not, however, be qualified residents; thus, the branch profits tax would have overridden the nondiscrimination clause in the treaty. I.R.C. § 884(e).

[137]Nauheim & Jacobson, *Proposed United States-Netherlands Antilles Income Tax Treaty: New Opportunities for Foreign Investment in U.S. Real Estate*, 15 TAX MGMT. INT'L J. 462 (1986) [hereinafter Nauheim].

[138]*Id.* at 464. Article 16(4) contains an additional limitation rule on treaty benefits: The provision denies treaty benefits for a resident of one of the treaty countries if the tax burden or tax rate is substantially less than that which would otherwise apply if derived in the treaty country of residence or would apply to business income of the resident wherever derived. *Id.* at 465.

[139]*Id.* at 464.

[140]The proposed treaty, if ever ratified, will modify the treaty benefits in a number of ways. U.S. source dividends and interest paid to a third country resident will be subject to 30% withholding. Netherlands Antilles Income Tax Treaty, Aug. 28, 1986, arts. 10, 11, CCH TAX TREATIES ¶¶ 5897M, 5897N, P-H TAX TREATIES ¶¶ 65,110, 65,111. Dividends paid to a Netherlands Antilles resident will still be subject to reduced withholding, and interest paid to an Antilles resident will be subject to a 5% withholding tax. *Id.*

Although restrictions on dividend withholding and treaty shoppers are increased, the proposed treaty contains an important exception for "qualifying real estate companies." *Id.* at art. 16, CCH TAX TREATIES ¶ 5897T, P-H TAX TREATIES ¶ 65,116. A "qualifying real estate company" is a corporation with the following characteristics: 90% or more of the gross receipts for the three preceding years are from U.S. qualified receipts; the adjusted basis of the corporation's qualified real assets equals or exceeds 80% of the adjusted basis of all assets at the close of each quarter; and the stock of the corporation is publicly traded, registered in the name of the beneficial owner, or the identity of the ultimate owner is available to Antilles authorities. *Id. See also* Fogarasi, Renfroe, Peugh & Zaiken, *Impact of New Antilles Treaty and Proposed U.S. Law Changes on Current FIRPTA Structures*, 15 TAX MGMT. INT'L J. 386, 387-88 (1986) [hereinafter *Impact of New Antilles*

At the conclusion of the negotiation of the proposed treaty, the United States and the Netherlands Antilles exchanged notes providing that, upon enactment of U.S. tax reform, there would be an obligation "to assess the impact of the new legislation on the treaty and to negotiate amendments 'as may be necessary or appropriate' to reestablish a balance of benefits."[141] The Tax Reform Act of 1986 eliminated the benefits that the exceptions to the limitations provision were negotiated to keep in place.[142] With the United States and the Netherlands Antilles unable to agree on how the Tax Reform Act of 1986 should alter the proposed treaty, negotiations stalled. On June 5, 1987, the Government of the Netherlands Antilles officially decided not to ratify the proposed treaty because, in part, no agreement could be reached on the real estate benefits available to third-country investors in the treaty. Whether negotiations will be reopened is unclear.

The history of the proposed United States-Netherlands Antilles treaty, which was signed on August 8, 1986, but never ratified, illustrates the hardening stance taken by the United States against treaty shopping.[143] The failure of the United States and the Netherlands Antilles to ratify the proposed treaty coincided with the termination of the existing treaty by the United States on June 29, 1987.[144] The termination caused an uproar in the Eurobond market since it meant that Eurobonds issued through Netherlands Antilles corporations would become subject to U.S. withholding tax. In order to calm the markets, the Treasury announced on July 10, 1987, that it would modify its termination notice to leave Article 8, which exempts interest paid by a U.S. company to its Netherlands Antilles subsidiary, intact.[145] Thus, interest paid by a domestic corporation to an Antilles subsidiary remains exempt.[146]

Although unsuccessful in its negotiations with the Netherlands Antilles, the United States has, with relative ease, negotiated a protocol with Belgium that contains a limitations of benefits article similar to the proposed Antilles provision.[147] The protocol denies treaty benefits to a resident of one contracting state for dividends, interest, or royalties from the other contracting state unless at least one of three conditions is met.[148] The first condition contains the following two requirements, both of which must be satisfied: (1) more than 50% of the beneficial interest in such resident must be owned directly by individual residents of one of the contracting states or citizens of the United States and (2) more

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*Treaty*]; Renfroe & Fogarasi, *The New US/Antilles Treaty: Are There Any Benefits Left After the New Anti-Treaty Shopping Article and Changes to US Tax Laws?* 82 TAXES INT'L 3, 5-6 (1986) [hereinafter *New US/Antilles Treaty*].

[141] *New US/Antilles Treaty*, *supra* note 140, at 3.

[142] In particular, the benefits of the qualified real estate company exception were eroded. *See* Nauheim, *supra* note 137, at 468.

[143] *See id.*; *New US/Antilles Treaty*, *supra* note 140; *Impact of New Antilles Treaty*, *supra* note 140 (discussing the proposed treaty).

[144] Announcement 87-76, 1987-35 I.R.B. 58 (Aug. 31).

[145] Rev. Rul. 87-79, 1987-2 C.B. 334.

[146] *Id. See also* Rev. Rul. 87-80, 1987-2 C.B. 292.

[147] Matthews, *New Protocol to U.S.-Belgium Tax Treaty Signed*, 38 TAX NOTES 114 (1988) [hereinafter Matthews].

[148] Belgium Income Tax Treaty, July 9, 1970, pro., art. XII(a), CCH TAX TREATIES ¶ 599.

than 50% of the gross income of such person must not be used directly or indirectly to meet liabilities for interest or royalties to persons who are not residents of one of the contracting states or citizens of the United States.[149]

The second condition under which treaty benefits are permitted to a resident of one contracting state is satisfied if the dividends, interest, or royalties are derived in connection with, or are incidental to, the active conduct of a trade or business in the other contracting state.[150] The third condition is satisfied if there is substantial and regular trading in a resident corporation's stock (or the stock of a parent corporation owning at least 50% of each class of stock) on a recognized securities exchange.[151]

4. *Combatting Treaty Shopping: Treaty Negotiation or Domestic Legislation?*

The recent effort by Congress to curb treaty shopping by domestically overriding bilateral tax treaties marks a sharp change in direction. Until recently, when the United States desired changes in a bilateral treaty, it renegotiated or, in the event renegotiation was unsuccessful, terminated the treaty. Unilateral enactment of overriding legislation is different from unilateral termination in several respects. The enactment of unilateral domestic legislation may not completely terminate the treaty. Those provisions not affected by the legislation remain in effect. Even those provisions affected by the domestic legislation remain in effect for international law purposes. As a result, the failure of the United States to comply with the provisions overridden by domestic legislation results in a violation of international law and not in a termination of those provisions.

Unilateral termination, once effective, terminates all treaty provisions.[152] Because all bilateral treaties entered into by the United States contain a termination clause, such termination does not put the United States in the position of having breached its treaty obligations. Most of the termination clauses contain language similar to Article 29 of the 1981 Model Income Tax Treaty:

> This Convention shall remain in force until terminated by a Contracting State. Either Contracting State may terminate the Convention at any time after 5 years from the date on which the Convention enters into force, provided that at least 6 months prior notice of termination has been given through diplomatic channels[.][153]

It could be argued that if the United States has the unilateral right to terminate its bilateral treaty obligations, only formalists would find fault with unilateral abridgment of treaties through domestic legislation. As noted above, however, unilateral termination pursuant to a termination clause does not violate inter-

[149]*Id.*
[150]*Id.*
[151]*Id.*
[152]*See* Rev. Rul. 87-79, 1987-2 C.B. 334.
[153]1981 Model Treaty, *supra* note 45, at art. 29.

national law, while the domestic overriding of treaty provisions does. Furthermore, the timing provisions of termination clauses, coupled with the diplomatic pressure to negotiate, provide advance notice to those affected by treaty changes. In contrast, the domestic override of a treaty may go into effect immediately. Indeed, part of the attraction of treaty overrides in 1986 was the immediacy of the changes. Finally, as the recent United States-Belgium protocol clearly illustrates, unilateral termination is not an automatic consequence of the U.S. resolve to prevent treaty shopping. Renegotiation is also a likely outcome.

## E. *Other Overrides*

Perhaps even more disturbing than the specific treaty override provisions enacted as part of the Tax Reform Act of 1986 are the residual treaty override provisions enacted by Congress as part of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA).[154] The original technical corrections bill, considered but not enacted in 1987,[155] purported to give definitive rules for the relationship of the Tax Reform Act of 1986 to pre-existing income tax treaties. The legislative history accompanying the 1987 Bill identified provisions of the Tax Reform Act of 1986 thought to conflict with any existing income tax treaties. It also indicated those provisions that would apply notwithstanding any conflicting income tax treaty, and those provisions that would not apply to the extent application would be inconsistent with a pre-existing treaty.[156]

Congress intended for the enumerated list to be exhaustive. In its description of the 1987 Bill, the Joint Committee on Taxation stated:

> Except for cases that have been identified in the bill or the [Tax Reform] Act [of 1986], no cases are known where a harmonious reading of the Act and U.S. treaties is not possible.[157]

While the list purported to be exhaustive, the 1987 Bill contained a residual override provision that dealt with any unanticipated situation where a provision in the Tax Reform Act of 1986 and a pre-existing treaty conflicted. Section 112(y)(2)(C) of the 1987 Bill provided:

> (2) CERTAIN AMENDMENTS TO APPLY NOTWITHSTANDING TREATIES.—The following amendments made by the Reform Act shall apply notwithstanding any treaty obligation of the United States in effect on the date of the enactment of the [Tax Reform Act of 1986]:
>
> . . . .
>
> (C) Except as provided in the Reform Act or in paragraph (3) of this subsection

[154]Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342 [hereinafter TAMRA].

[155]H.R. 2636, 100th Cong., 1st Sess. (1987) [hereinafter 1987 Bill]. *See* Chapoton, *supra* note 9.

[156]STAFF OF JOINT COMM. ON TAXATION, 99TH CONG., 2D SESS., DESCRIPTION OF THE TECHNICAL CORRECTIONS ACT OF 1987, at 233, 234-35 (Comm. Print 1987) [hereinafter Description of 1987 Act].

[157]*Id.* at 234.

[*i.e.*, enumerated list of areas where pre-existing treaties will control], any other amendment made by the Reform Act.[158]

This blanket decision that provisions of the Tax Reform Act of 1986 should override pre-existing treaties in all future situations not specifically addressed in the 1987 Bill signified a sharp reversal of the historical relationship between treaties and domestic legislation.[159] The importance of treaties has resulted in "a firm and obviously sound canon of construction against finding implicit repeal of a treaty in ambiguous congressional action."[160] The 1987 Bill would have created a later-in-time presumption in the case of a conflict between the Tax Reform Act of 1986 and pre-existing treaties.

After the 1987 Bill failed to pass, Congress again considered the legislation in 1988. The House bill contained the same residual override provision found in the proposed 1987 Bill.[161] The Senate version of the 1988 legislation which ultimately was enacted differed slightly in tone from the House version.[162] Section 7852(d) now reads as follows:

(1) IN GENERAL.—For 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 a preferential status by reason of its being a treaty or law.

While this language does not mandate a later-in-time rule as does the House version, it is almost as strong.[163] By providing that a treaty provision has the same status as a domestic statute, the Senate version implicates the later-in-time rule that normally applies to resolve a deadlock between two inconsistent domestic statutes.

The Committee report accompanying the Senate Finance Committee version seeks to justify the unilateral treaty override policy rather than relying on treaty renegotiation because renegotiation would be "extremely difficult."[164] Inconvenience, however, is a poor excuse for violating international law.

The impact of a residual override provision on the branch profits tax may not be as severe as first feared. In the proposed 1987 Bill, Congress took the position that the branch level interest tax on excess interest did not violate the nondiscrimination clauses of U.S. bilateral tax treaties even though a similarly situated U.S. corporation would not bear the same tax.[165] As a result, the residual treaty override provision would have denied even a qualified resident corporation the

[158]1987 Bill, *supra* note 155, at § 112(y)(2).

[159]*See infra* notes 173-84 and accompanying text.

[160]Trans World Airlines, Inc. v. Franklin Mint Corp., 446 U.S. 243, 252 (1984).

[161]*See* H.R. 4333, 100th Cong., 2d Sess. § 112(aa) (1988).

[162]*See* S. 2238, 100th Cong., 2d Sess. § 112(aa) (1988).

[163]Under Code section 6114(a), if a taxpayer takes a position that a U.S. treaty overrules (or otherwise modifies) a Code provision, disclosure on the tax return is required. This disclosure provision suggests that the residual treaty override provision is not as automatic as the House version would have been. *See also* I.R.C. § 6712 (penalties for failure to disclose).

[164]S. REP. NO. 45, 100th Cong., 2d Sess. 323 (1988).

[165]Description of 1987 Act, *supra* note 156, at 237.

use of a treaty nondiscrimination provision to preclude the application of the branch level interest tax on excess interest.

However, both the House and Senate committee reports accompanying TAMRA recognize that the tax on excess interest might conflict with existing treaties.[166] To the extent a conflict exists, the treaty will apply for qualified residents.[167] This recognition makes the residual treaty override provision inapplicable to the tax on excess interest for qualified residents.

Perhaps the most alarming treaty provision affecting the branch profits tax in TAMRA is the wholesale disavowal of certain U.S. treaty commitments. The United States has entered into a series of "Friendship, Commerce and Navigation" (FCN) bilateral treaties.[168] These treaties typically contain a nondiscrimination clause, which reads in part as follows:

> [C]ompanies of either Party engaged in trade . . . within the territories of the other Party, shall not be subject to the payment of taxes . . . within the territories of such other Party, more burdensome than those borne by nationals and companies of such other Party.[169]

For example, under the nondiscrimination clause of the Netherlands FCN treaty, a Netherlands corporation—even one that is 50% or more owned by non-Netherlands nationals—cannot be treated more harshly than a U.S. corporation. Because the branch profits tax does not apply to U.S. corporations, the application of the tax to foreign corporations is considered discriminatory for purposes of the nondiscrimination article in U.S. income tax treaties.[170] It should follow then that the imposition of the branch profits tax is also discriminatory within the nondiscrimination clause of FCN treaties. Section 884(e), the treaty shopping provision, denies *income tax* treaty benefits to treaty shopping corporations as defined. It does not deny the benefits of FCN treaties. Reliance on the nondiscrimination article under an FCN treaty does not present a situation in which there is an override of an international agreement by a provision that unquestionably is valid domestic law.[171] Prior to 1988, there was no provision that directly overrode the nondiscrimination clause of FCN treaties.

With the stroke of a pen, however, Congress has unilaterally overridden all existing U.S. FCN treaties. TAMRA has amended section 884(e) to preclude any reliance on a treaty that is not an income tax treaty, such as an FCN treaty,

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[166]*See, e.g.*, STAFF OF JOINT COMM. ON TAXATION, 100TH CONG, 2D SESS., DESCRIPTION OF THE TECHNICAL CORRECTIONS ACT OF 1988, at 319 (Comm. Print 1988).

[167]*Id.*

[168]*E.g.*, Treaty of Friendship, Commerce and Navigation, Mar. 27, 1956, United States-Netherlands, 8 U.S.T. 2043, T.I.A.S. No. 3942 [hereinafter Netherlands FCN]. *See generally* Walker, *Modern Treaties of Friendship, Commerce and Navigation*, 42 MINN. L. REV. 805 (1958); Sumitomo Shoji America, Inc. v. Avagliano, 457 U.S. 176 (1982).

[169]Netherlands FCN, *supra* note 168, at 2059-60.

[170]I.R.S. Notice 87-56, 1987-2 C.B. 367. The Notice exempts only qualified residents of countries with income tax treaties containing nondiscrimination clauses from the operation of the branch profits tax.

[171]I.R.C. § 884(e).

for relief from the branch profits tax.[172] There is no attempt to make the treaties available even for qualified residents; instead, the treaties are nullified for branch profits tax purposes in their entirety.

## III. THE RELATIONSHIP BETWEEN TAX TREATIES AND DOMESTIC LAW

### A. *Status of Tax Treaties*

Within the United States, a treaty between the United States and a foreign country is the supreme law of the land and shares this status with domestically enacted federal legislation.[173] A tax convention is a "treaty" under the Constitution.[174] Accordingly, tax treaties, like other types of treaties, share the status of supreme law of the land. It is also well established that when a treaty directly conflicts with an act of Congress, the later-in-time rule prevails.[175] For example, the Tax Reform Act of 1976[176] amended section 904(a) to provide that the limitation on the foreign-tax credit be computed using the "overall" method rather than the "per-country" limitation.[177] The Service has since ruled that the newly enacted provision overrides any pre-existing treaties to the contrary.[178]

The later-in-time rule applies to direct conflicts. Mere inconsistency, without more, between a later-enacted domestic statutory provision and a prior treaty is not sufficient to override the treaty.[179] In fact, unless it is clear that the purpose of an act of Congress is to supersede a prior treaty provision, and that the earlier provision and the act cannot be fairly reconciled, the courts will favor the treaty.[180] This is especially true when the subsequent congressional action is ambiguous as to its status with regard to a pre-existing treaty.[181] If there is more than an inconsistency—that is, if there is congressional intent to override—then the prior treaty must give way to the later-enacted provision. In the case of the

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[172]*See* I.R.C. § 884(e)(1).

[173]U.S. CONST. art. VI, cl. 2. The concept that treaties and the laws of the United States are of equal dignity has been subject to substantial question, despite well-established Supreme Court pronouncements to the contrary. Committee on U.S. Activities of Foreign Taxpayers of the New York State Bar Association Section of Taxation, *Legislative Overrides of Tax Treaties,* 37 TAX NOTES 931, 932-33 (1987) [hereinafter *Legislative Overrides*]; L. HENKIN, FOREIGN AFFAIRS AND THE CONSTITUTION, 163-64 (1972).

[174]Samann v. Commissioner, 313 F.2d 461, 463 (4th Cir. 1963); American Trust Co. v. Smyth, 247 F.2d 149, 153 (9th Cir. 1957).

[175]Reid v. Covert, 354 U.S. 1, 17-18 (1957).

[176]Pub. L. 94-455, 90 Stat. 1520 (1976).

[177]Pub. L. 94-455, § 1031, 90 Stat. 1620-24 (1976).

[178]*See* Rev. Rul. 80-201, 1980-2 C.B. 221. Austria Income Tax Treaty, Oct. 25, 1956, art. XV, CCH TAX TREATIES ¶ 518, P-H TAX TREATIES ¶ 16,015 (providing foreign tax credit limitations in force as of a specified date when the Code provided a "per-country" limitation).

[179]Cook v. United States, 288 U.S. 102, 118-20 (1933); Whitney v. Robertson, 124 U.S. 190, 194 (1888); RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 134 (1986) [hereinafter RESTATEMENT].

[180]*See* Menominee Tribe v. United States, 391 U.S. 404, 412-13 (1968); *Cook,* 288 U.S. at 118-20; RESTATEMENT, *supra* note 179, at § 115(1)(a).

[181]*See* Trans World Airlines, Inc. v. Franklin Mint Corp., 466 U.S. 243, 252 (1984).

foreign tax credit limitation, the Service finds the requisite intent in a statement in the Senate Report accompanying the Tax Reform Act of 1976.[182]

In the case of the branch profits tax, there can be no serious argument that section 884(e) is merely inconsistent with existing treaties. The provision on its face, supported by the legislative history, is clearly intended to override pre-existing treaty obligations. Moreover, there is little question that, as a matter of domestic law, Congress has the right to override pre-existing treaties. It should be noted that, although a subsequent act of Congress may supersede a provision of a prior treaty as domestic law, this "does not relieve the United States of its international obligation[s] or the consequences of a violation."[183] Moreover, the right to override does not make override right as a matter of policy.

B. *Policy Against Override*

Notwithstanding the firm adherence to the later-in-time rule by domestic courts when it is evident that Congress intends to override a treaty provision, compelling policy reasons militate against the mechanical override of a prior treaty by a subsequent act of Congress. Income tax and FCN treaties, like other treaties, not only establish a predictable framework of rights, they also evidence an intention to resolve international issues in accordance with the norms and procedures of international law.[184] Because an act of Congress that overrides a treaty provision does not relieve the United States of its international obligations under the treaty,[185] the United States exposes itself to a variety of retaliatory measures that may penalize U. S. businesses abroad.[186] It is not clear that the United States should place its willingness to adhere to treaties and, on a more general level, the rules of international law in question by abrogating treaty provisions when other avenues are available.

Income tax and FCN treaties are inexorably entangled with the political and foreign policy objectives of the United States and, therefore, implicate considerations far beyond those of domestic tax policy.[187] Indeed, tax and FCN treaties, like other treaties, are within the province of the Senate Foreign Relations Com-

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[182]*See* Rev. Rul. 80-201, 1980-2 C.B. 221, 222 (citing S. REP. No. 938, 94th Cong., 2d Sess. 237 (1976):

> It is the committee's intent that all existing treaties are to be applied consistently with this amendment by using the overall limitation in computing the allowable foreign tax credit.

Similarly, in Revenue Ruling 80-223, 1980-2 C.B. 217, the Service ruled that the enactment in the Tax Reduction Act of 1975 of certain provisions governing the foreign tax credit for taxes paid with respect to oil and gas overrode any conflicting treaty provisions to the contrary. The Service grounded its decision in the direct statement in the Senate Finance Committee Report. *See* S. REP. No. 938, 94th Cong., 2d Sess. 237 (1976).

[183]RESTATEMENT, *supra* note 179, at § 115(1)(b). *See* Vienna Convention of the Law of Treaties, May 23, 1969, art. 27, 8 I.L.M. 679 [hereinafter Vienna Convention], which provides that unilateral abrogation of a treaty by subsequent legislation, though effective as a matter of domestic law, is a violation of international law.

[184]*Legislative Overrides*, *supra* note 173, at 932.

[185]RESTATEMENT, *supra* note 179, at § 115(1)(b).

[186]*Legislative Overrides*, *supra* note 173, at 933.

[187]*Id.*

mittee, rather than the Senate Finance Committee.[188] Tax and FCN treaties are often signed for economic and political purposes rather than for tax purposes, and even if few real tax concerns motivate the signing of a tax treaty, such treaties may be useful for improvement of general diplomatic and political relations.[189]

Moreover, the prevention of treaty shopping with respect to the branch profits tax does not present any new problems. There is nothing magical about the percentage tests adopted in the section 884(e) definition of a treaty-shopping corporation. The United States has negotiated a variety of limitations provisions in its outstanding treaties. Preventing treaty shopping in the branch profits tax context ought to be subject to the crucible of international negotiation like other treaty-shopping problems.

The need for long-term stability and predictability is implicit in the function of tax treaties. This need arises because taxation influences "the basic commercial structure through which international trade is conducted and because of the difficulty of revising such structures to adjust to changes without incurring what are in effect retroactive financial penalties in the form of tax liabilities."[190] This is especially true in an era when the economic interdependence of nations around the world and the apparent need of the United States to attract foreign investment have become a sobering reality. It is unwise to toy with the growth and maintenance of our own economic stability by adopting a practice that undermines the foundations of a stable commercial environment.

C. *Redress for Violations of International Law*

An international agreement derives its status as law in the United States from its character as an international legal obligation.[191] While an act of Congress may supersede a prior agreement for domestic law purposes, such legislation does not relieve the United States of its international obligations.[192] In such an instance, the international obligations are said to survive any subsequent restrictions in domestic law.[193] When the United States overrides treaty provisions through subsequent federal legislation that is, or is deemed to be, inconsistent with the treaty, it is not clear that effective remedies are available to an aggrieved private party.

Remedies under international law are not as developed as remedies under the domestic law of most nations, but the principles and modes of relief are similar.[194] As set forth in section 901 of the Restatement of Foreign Relations Law, "[u]nder

188Forry & Karlin, *1986 Act: Overrides, Conflicts and Interactions with U.S. Income Tax Treaties*, 35 Tax Notes 793, 794 (1987).

189*Legislative Overrides*, *supra* note 173, at 933.

190*Id.*

191Restatement, *supra* note 179, at § 111 comment b.

192*Id.* at § 115(1)(b).

193The principle is embodied in the doctrine of *pacta sunt servanda* ("agreements of the parties must be observed"). *See also* Restatement, *supra* note 179, at § 321 comment a; Vienna Convention, *supra* note 183, art. 26 at 690.

194Restatement, *supra* note 179, at § 901 comment b.

international law, a state that has violated a legal obligation to another state is required to terminate the violation and, ordinarily, to make reparation, including in appropriate circumstances, restitution or compensation for loss or injury.''[195] Presumably, the relief that would be sought by a victim of a U. S. domestic override provision would be in the nature of injunctive relief against the overriding of treaty benefits and damages in the amount of any past taxes collected as a result of the U. S. denial of treaty benefits.

In order to enforce an obligation under international law, the party seeking relief must first establish the existence of an obligation (a task that should be a mere formality in situations involving a breach of a bilateral income tax treaty) and that such an obligation has been breached.[196] Redress for breach of an international obligation may be subject to a variety of defenses similar to those in domestic legal systems, and the burden is on the responding state to establish such defenses.[197] ''That the violation was compelled or authorized by . . . domestic law is not a defense.''[198]

The comments to the Restatement state:

> The obligation of a state to terminate a violation of international law may include discontinuance, revocation, or cancellation of the act (whether legislative, administrative, or judicial) that caused the violation; abstention from further violation; or performance of an act the state was obligated but failed to perform.[199]

The goal behind the requirement of reparation is to, ''as far as possible, wipe out all the consequences of the illegal act and re-establish the situation which would in all probability, have existed if that act had not been committed.''[200] Reparation may include restitution, specific performance, monetary compensation, and acknowledgment of the violation accompanied by an apology.[201]

These general principles of relief appear on their face to offer some hope of redressing any violation of international tax treaties by the United States. The practical application of these general principles, however, makes it unlikely that foreign claimants—either the affected private parties or the treaty partner whose treaty benefits are unavailable because of U. S. domestic policy—will be able to pursue successfully international legal claims either in an international forum or in the U. S. judicial system.

A claim must be asserted by one of the treaty parties. In general, the aggrieved private party may not have standing to bring suit in an international forum for

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[195]*Id.* at § 901.

[196]*Id.* at comment a.

[197]*Id.* These defenses include duress, impossibility, waiver, force majeure, acquiescence, and estoppel—none of which appear applicable to the domestic override of a bilateral income tax treaty. *Id.*

[198]*Id.*

[199]*Id.* at comment c.

[200]*Id.* at § 901, Reporters' Note 3 (quoting Chorzow Factory (Germany v. Poland) P.C.I.J. ser. A. No. 17, at 47 (1928)).

[201]*Id.* at § 901 comment d.

a violation of the treaty.[202] For example, the Netherlands would appear to have the right to assert a claim on behalf of a Netherlands corporation (50% or more of the stock of which is owned by non-Netherlands residents) that was denied the benefits of the nondiscrimination clause in the United States-Netherlands income tax treaty and is, therefore, subject to the branch profits tax on its income effectively connected with the conduct of a U.S. trade or business.

Under international law, there are various alternatives available to a state (or indirectly to an individual or organization through a state) for seeking redress against another state. One possibility is to proceed through diplomatic channels or through procedures for dispute settlement to which the contracting states have agreed.[203]

The United States generally includes specific provisions in its income tax treaties that designate the means of resolving disputes related to the treaty.[204] Such provisions typically allow a taxpayer to present the case to the "competent authority" of the state in which the taxpayer resides or is a national if the taxpayer believes the actions of one of the contracting states result or will result in taxation inconsistent with the provisions of the treaty.[205] That competent authority is then obligated to resolve the case by mutual agreement with the competent authority of the other state.[206] In theory, therefore, this offers a foreign nation (or private individual or organization through that foreign nation) a means of seeking redress for treaty overrides by the United States. While the Treasury has expressed its disapproval of the congressional decision to override U. S. treaty commitments by domestic legislation,[207] it is unlikely that the Treasury will circumvent domestic law through the competent authority provisions in U. S. bilateral income tax treaties.

A second alternative is the International Court of Justice. As section 903 of the Restatement (Third) of Foreign Relations provides:

> (1) A state party to a dispute with another state may submit that dispute to the International Court of Justice for adjudication, and the Court has jurisdiction over that dispute, if the parties:
> (a) have by a special agreement or otherwise, agreed to bring that dispute before the Court; or
> (b) are bound by an agreement providing for the submission to the Court of a category of disputes that includes the dispute in question; or

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[202] *Id.* at § 906 comment a. Private claimants such as a corporation do, however, have standing to allege a treaty violation in U.S. courts. *See, e.g.*, I.R.C. § 7422(f)(1); Consolidated Premium Iron Ores, Ltd. v. Commissioner, 28 T.C. 127, 149-51 (1957), *nonacq.* 1958-1 C.B. 7, *aff'd*, 265 F.2d 320, 324-26 (6th Cir. 1959).

[203] *See* RESTATEMENT, *supra* note 179, at § 902(1).

[204] 1981 Model Treaty, *supra* note 45, at art. 25.

[205] *Id.* at art. 25(1). The term "competent authority" in the United States refers to the Secretary of the Treasury or his delegate. *Id.* at art. 3(1)(e). The Secretary has, however, delegated the authority to the Assistant Commissioner, International. I.R.S. News Release 47, Mar. 7, 1988, 88-10 CCH ¶ 6431, P-H ¶ 54,888.

[206] 1981 Model Treaty, *supra* note 45, at art. 25(2).

[207] *See, e.g.*, Chapoton, *supra* note 9 at G-5; Secretary Baker's Letter to Chairman Rostenkowski Regarding Conflict of Tax Reform with Existing Tax Treaties, 86 TNI 32-9 (Aug. 6, 1986).

(c) have made declarations under Article 36(2) of the Statute of the Court accepting the jurisdiction of the Court generally or in respect of a category of legal disputes that includes the dispute in question.[208]

The International Court of Justice has two kinds of jurisdiction: to "decide contentious cases" between parties and to "render advisory opinions."[209] Only states may be parties to a contentious case, not international organizations or private parties.[210] States may not, however, request advisory opinions—only certain international organizations may do so.[211]

This second alternative is available, however, only when the state parties have consented to the jurisdiction of the court. When such consent does not exist, this alternative is of no practical significance. It is most unlikely that the United States will consent to adjudication by the International Court of the propriety of domestic legislation overriding provisions of its bilateral income tax treaties. Indeed, when the United States originally accepted jurisdiction of the court,[212] it specifically excluded from that jurisdiction "disputes with regard to matters which are essentially within the domestic jurisdiction of the United States of America as determined by the United States of America."[213]

A third alternative is for the parties to engage in interstate arbitration. State parties may submit to arbitration either by special agreement between the two nations to arbitrate a particular dispute or by agreement authorizing either party to submit to arbitration any dispute belonging to a specified category of disputes included in the agreement.[214] This alternative is also of limited practical significance when the parties have not manifested consent to submit to arbitration. The bilateral income tax treaties of the United States contain no arbitration provision.

There is greater risk that a foreign nation seeking relief for violation of an international agreement by the United States may turn to unilateral remedies. As the Restatement (Third) of Foreign Relations Law recognizes:

> [A] state victim of a violation of an international obligation by another state may [lawfully] resort to countermeasures that might otherwise be unlawful, if such measures (a) are necessary to terminate or prevent further violations, or to remedy

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[208]RESTATEMENT, *supra* note 179, at § 903. All members of the United Nations, including the United States, are automatically parties to the Statute, as are some nonmembers. *Id.* at comment a.

[209]*Id.*

[210]*Id.* at § 903 comment a; *see* 1979 I.C.J. Acts & Docs. 75 (art. 34).

[211]*Id.* at § 903 reporters' note 12.

[212]*Id.* at § 903 comment c; *see* 1979 I.C.J. Acts & Docs. 77 (art. 36(2)).

[213]RESTATEMENT, *supra* note 179, at § 903 reporters' note 3. The Department of State determined that the reservation should be exercised in good faith, but that a decision by the United States that a matter is within its domestic jurisdiction of the United States is not reviewable by the court. The United States terminated its declaration of jurisdiction under article 36(2) of the Statute of the International Court of Justice on October 7, 1985. This termination did not affect jurisdiction of the court over cases under article 36(1) concerning bilateral and multilateral agreements. RESTATEMENT, *supra* note 179, at § 903 comment c, reporters' note 3.

[214]RESTATEMENT, *supra* note 179, at § 904.

> the violation; and (b) are not out of proportion to the violation and the injury suffered.[215]

The range of permissible countermeasures includes suspending or terminating *all* treaty relations under the particular treaty, freezing the assets of the offending state, and imposing economic sanctions.[216] Unilateral remedies, however, will not be undertaken lightly by U. S. trading partners. States are as reluctant to start a "tax war" as they are to start a "trade war."

It is also theoretically possible for an aggrieved treaty claimant to seek redress in the domestic courts of a foreign nation. For example, a Dutch corporation that is denied the benefits of the nondiscrimination clause in the United States-Netherlands treaty as a result of U. S. domestic law may attempt to sue the United States in the Netherlands. The sovereign immunity doctrine, however, virtually precludes a successful action against the United States in a foreign jurisdiction or, if the action is brought successfully, the enforcement of any remedy.[217]

It is also theoretically possible to pursue an international claim in the United States. But the likelihood of success is not high. Initially, it is clear that international agreements of the United States—including income tax treaties—are the law of the United States and are within the jurisdiction of the federal courts.[218] It is also clear that private claimants such as a corporation that is denied treaty benefits have standing to pursue a treaty violation claim in the federal courts.[219]

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[215] *Id.* at § 905.

[216] *Id.* at § 905 comment b.

[217] *See id.* at § 451; Foreign Sovereign Immunities Act, 28 U.S.C. §§ 1602-1611 (1982).

[218] RESTATEMENT, *supra* 179, at § 111. In The Paquete Habana, 175 U.S. 677, 700 (1900), Justice Gray stated that "[i]nternational law is part of our law, and must be ascertained and administered by the courts of justice of appropriate jurisdiction, as often as questions of right depending upon it are duly presented for their determination." Courts in the United States are required to give effect to international agreements unless an agreement is "non-self-executing." RESTATEMENT, *supra* note 179, at § 111(3). An international agreement is "non-self-executing" if the agreement manifests an intention that it is not effective as domestic law without implementing legislation. *Id.* at § 111(3)-(4). Income tax treaties are self-executing. *See* I.R.C. §§ 7422(f)(1), 894(a).

[219] I.R.C. §§ 7422(f)(1), 7442. *See* Consolidated Premium Iron Ores, Ltd. v. Commissioner, 28 T.C. 127, 149-52 (1957), *nonacq.* 1958-1 C.B. 7, *aff'd*, 265 F.2d 320 (6th Cir. 1959).

The federal district courts have original jurisdiction in all cases arising under the treaties of the United States and for income taxes alleged to have been erroneously collected. 28 U.S.C. §§ 1331, 1346 (1982). Moreover, the United States has consented to civil actions for tax refunds brought under the Internal Revenue Code or under an income tax treaty. I.R.C. § 7422(f)(1).

The Tax Court can also serve as a forum for foreign taxpayers. A foreign taxpayer who meets the jurisdictional requirements of section 7442 may petition the Tax Court for a redetermination of an income tax deficiency asserted by the government. I.R.C. § 6213. The suit can be based on a violation of either domestic law or a bilateral income tax treaty. *See, e.g.*, Consolidated Premium Iron Ores, Ltd. v. Commissioner, 28 T.C. 127, 149-53 (1957) (Canadian corporation held not liable for tax liability because the corporation did not have a permanent establishment in the United States).

The United States Claims Court was established for the purpose of adjudicating claims founded upon the federal Constitution or any laws of Congress. While such a forum would appear to be well-suited to handle claims based upon violation of treaties, Congress has specifically removed, by statute, the jurisdiction of the Claims Court to hear "any claim against the United States growing out of or dependent upon any treaty entered into with foreign nations." 28 U.S.C. § 1502 (1982). *But see* Brown & Williamson, Ltd. v. United States, 668 F.2d 747, 752 (Cl. Ct. 1982) (treaty-

The single biggest obstacle in obtaining judicial relief against the United States for a violation of international law is the principle that the United States has the domestic right to violate international law.[220] Consequently, a federal court will not enforce a prior international commitment at the expense of a later-enacted domestic provision that is directly contrary. In *Diggs v. Shultz*[221] the plaintiffs sought to overturn a federal statute permitting imports from Southern Rhodesia. The complaint alleged that the later-enacted federal statute directly conflicted with the treaty obligations of the United States under the United Nations Charter not to do business with Southern Rhodesia.[222] In ruling for the defendants, the court clearly stated the relationship between Congress and the courts with regard to the legislative override of a treaty:

> Under our constitutional scheme, Congress can denounce treaties if it sees fit to do so, and there is nothing the other branches of government can do about it. We consider that this is precisely what Congress has done in this case; and therefore the District Court was correct to the extent that it found the complaint to state no tenable claim in law.[223]

There can be no question that section 884(e) was enacted specifically to override the availability of favorable income tax treaty provisions for treaty-shopping corporations as defined. Accordingly, the federal courts will not provide judicial relief for any treaty violation dictated by later-enacted legislation.

In summary, judicial relief for foreign corporations from the decision by the United States to override its bilateral income tax treaties through domestic litigation seems unlikely. The decision to override is clear from the domestic statute and the legislative history, and the violation of international law by the United States does not appear inadvertent.

## IV. CONSEQUENCES OF AND ALTERNATIVES TO U. S. DOMESTIC TREATY OVERRIDES

### A. *International Reaction to U. S. Domestic Treaty Overrides*

Frustration over the U. S. policy of overriding its bilateral income tax treaties through domestic legislation has created bitter feelings among our trading partners. A memorandum signed by the ambassadors to the United States of the European Community's Group of Six—Belgium, France, Federal Republic of Germany, Great Britain, Luxembourg, and The Netherlands—after noting the

based claim not barred from court review because claim did not derive its "life and existence" from the treaty).

[220] RESTATEMENT, *supra* note 179, at § 115(1)(a).

[221] 470 F.2d 461 (D.C. Cir. 1972), *cert. denied*, 411 U.S. 931 (1973).

[222] 470 F.2d at 463.

[223] *Id.* at 466-67. The court also noted that "[t]he considerations underlying [treaty override] by Congress present issues of political policy which courts do not inquire into. Thus, appellants' quarrel is with Congress, and it is a cause which can be pursued only at the polls and not in the courts." *Id.* at 465.

existence and importance of the treaty shopping problem, expresses the concerns of the Group of Six as follows:

> It is the firm belief . . . of our states that the abuse of treaties should be dealt with through bilateral renegotiation of affected treaties and not through unilateral action by the United States. Double taxation treaties are intended to mitigate double taxation of income and prevent tax avoidance and evasion. As such they are an important facet of economic relations between countries. The violation of a double tax treaty by unilateral action of one contracting party undermines the basis of trust existing between the two countries involved, erodes the certainty and security intended by international agreements and ultimately poses the question as to whether an international convention for the avoidance of double taxation serves any purposes at all if it can be altered at will by one of the contracting parties. The six signatories of this memorandum strongly object to provisions which override double taxation treaties and unilaterally impose standards which may be unrelated to economic realities pertaining in their countries.[224]

The memorandum concludes with an "urgent request" for a reaffirmation by the United States of its adherence to international agreements freely entered into and for consultation with treaty partners on ways to combat the improper use of income tax treaties.[225] Similar concerns have been expressed by Robert Van Nouhuys, the Minister of Economic Affairs for the Netherlands, who notes that "the United States will be seen as an unreliable partner in the international tax field."[226]

B. *Treaty Renegotiation and Termination*

To combat treaty shopping, the obvious alternative to unilateral override through domestic legislation is treaty renegotiation. The problem of treaty shopping is widely acknowledged. Indeed, the European Economic Community's Group of Six has placed its willingness to assist in combatting treaty shopping on record: "Our states do not underestimate the existence and importance of the phenomenon of treaty shopping. Our governments are fully prepared to cooperate with the United States to combat treaty shopping."[227]

Bilateral renegotiation can be a slower process than unilateral override, but that need not be the case. The recent protocol to the United States-Belgium income tax treaty is instructive. The United States wanted to insert a strong treaty shopping article, and Belgium, in turn, wanted to reduce its withholding rate on dividends from 15% to 5% in order to encourage investment in Belgium. Negotiations began in September of 1987.[228] The protocol was signed on

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[224]*EEC Group of Six Addresses 1986 Act's Treaty Override Provisions*, 36 TAX NOTES 437 (1987) [hereinafter *EEC Group of Six*].

[225]*Id.*

[226]*Netherlands Finance Minister Says Tax Reform Act's Tax Treaty Override Provision Will Hamper Treaty Negotiations*, CCH TAX DAY: FEDERAL (Nov. 6, 1987).

[227]*EEC Group of Six*, *supra* note 224.

[228]Matthews, *supra* note 147.

December 31, 1987. If speedy renegotiation is possible with Belgium, there is no reason why similar protocols could not be negotiated with other treaty partners.

Indeed, the United States has even enjoyed some success in convincing our trading partners to insert anti-treaty shopping provisions into their treaties with other countries in order to discourage treaty shopping in the United States. The new Canada-Netherlands tax treaty, for example, contains provisions designed to curtail what the United States viewed as treaty shopping by Canadian multinationals investing in the United States through Dutch corporations.[229]

Renegotiation may also permit a broader attack on the treaty shopping problem. When a treaty shopping provision is enacted as a treaty article, it normally denies a treaty shopper any benefits under the treaty. In contrast, the limited treaty shopping provision of section 884(e) prevents treaty shopping only in the context of the branch profits tax. For example, section 884(e) does not prevent a treaty shopping foreign corporation from seeking out a treaty that provides for a low withholding rate on dividends paid from a U.S. corporation to a foreign parent.[230] From a policy perspective, if treaty shopping is undesirable then it should be discouraged across the board and not just with respect to the branch profits tax.

If the renegotiation process is unsuccessful for whatever reason, the United States always retains the possibility of treaty termination.

### C. *Nondiscriminatory Domestic Override*

Diplomacy and compliance with international law, particularly bilateral agreements which the United States willingly negotiated, are preferable to unilateral overrides. If Congress opts to override its international treaty commitments, however, it is inconsistent with sound domestic tax policy to make the override provision so selective. Treaty shopping foreign investors who form a Netherlands corporation to conduct a U.S. trade or business cannot invoke the nondiscrimination article in the United States-Netherlands treaty to avoid the imposition of the branch profits tax. If the same investors form a Netherlands corporation that operates its U.S. trade or business through a U.S. subsidiary, however, dividends paid by the U.S. subsidiary and the Netherlands corporation will enjoy reduced rates under the Netherlands treaty. It can be argued that U.S. violations of international law should be kept to a minimum. Viewed in this manner, the narrow focus of section 884(e) is justified. But if treaty shopping is a significant enough problem to justify the violation of international law, the United States ought to address the problem in a coherent and principled way.

### D. *Limited Domestic Override*

Having decided to override U.S. international obligations through domestic legislation and to do so in a selective, narrow manner, Congress may also be

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[229]*See* Cote, *New Canada/Netherlands Pact To End Treaty Shopping*, INT'L TAX REP. 4 (Jan. 1988). The new treaty eliminates the complete exemption in the Netherlands of a withholding tax on dividends paid to Canadian shareholders.

[230]*See, e.g.*, Netherlands Income Tax Treaty, Apr. 29, 1948, art. VII, CCH TAX TREATIES ¶ 5811, P-H TAX TREATIES ¶ 66,108.

faulted for the manner in which the limited domestic override provisions were enacted. If Congress was concerned that treaty renegotiation was a slow process, it might have used the threat of domestic override as an incentive to speed up the process. For example, Congress might have announced a reasonable "sunset" date after which it would act unilaterally to override treaties that had not been renegotiated.[231] Hanging a sword over the heads of our treaty partners may be heavy-handed, but it is not as heavy-handed as letting the sword fall immediately through the enactment of an override provision.

## V. CONCLUSION

In the Tax Reform Act of 1986 and accompanying technical corrections, the United States has reversed a long-standing policy of not overriding its bilateral income tax treaties through the enactment of domestic legislation. Instead of renegotiating with our trading partners to prevent undesired treaty shopping, Congress has acted unilaterally and spasmodically to curb the problem. This change in policy, while not domestically unconstitutional or illegal, puts the United States in violation of international law. Because of jurisdictional and procedural problems in pursuing judicial relief, it seems unlikely that aggrieved parties will find relief from the international violation in the judicial system. It is more likely that our trading partners will retaliate in kind by increasing the tax or trade burden on U.S. businesses operating abroad.

Aside from the very real practical problems that U.S. treaty override provisions may cause, there is a moral dimension to the problem. It is unseemly for the United States to allege Soviet violations of the ABM treaty or any other violations of international law while flagrantly disregarding its own treaty commitments.[232] The United States should not put itself in the position of being an international law breaker.

Minor and even major violations of international law are not as uncommon among our trading partners as we might wish. Nevertheless, it should be incumbent on the United States to set a high moral tone for the conduct of its international affairs. While our bilateral tax treaties may not seem as weighty or important as international commitments dealing with human rights or war and peace, commercial stability and certainty are important to the development of international economic growth. The power and right unilaterally to override treaty commitments exists. But with rights come responsibilities, and the United States has abused its worldwide responsibilities to its trading partners.

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[231] *See Legislative Overrides*, *supra* note 173, at 935.

[232] *See* Franck, *Taking Treaties Seriously*, 82 AM. J. INT'L L. 67 (1988) (arguing that United States violated its United Nations treaty commitments by refusing to pay its agreed assessed share of United Nations budget and will be violating the Headquarters Agreement by closing the Palestine Liberation Organization's observer mission).