United States

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Treasury Report on International Tax Issues: Staying the Course on Efforts to Curtail Tax Base Erosion

The US Treasury Department recently issued a long-awaited report on its study of current US earnings stripping rules, the effectiveness of transfer pricing rules under Sec. 482 and the sufficiency of the US income tax treaty network in limiting perceived abuse. With regard to each of the three areas covered by the Study, this article provides relevant background, summarizes Treasury's conclusions and offers the additional insights of the authors.

1. Introduction

The US Treasury Department (Treasury) recently issued a long-awaited report on its study of current US earnings stripping rules, the effectiveness of transfer pricing rules under Sec. 482 and the sufficiency of the US income tax treaty (treaty) network in limiting perceived abuse (the Study)[1]. The Study – actually three integrated reports – was requested by Congress as part of the American Jobs Creation Act of 2004 (AJCA).[2] According to Treasury, the three reports were presented together, rather than separately, "because of the common thread, which links them together – the potential for exploitation of inappropriate income-shifting opportunities to erode the US corporate tax base".[3] A fourth study requested in the AJCA, one analysing the effectiveness of US anti-inversion rules enacted as part of the AJCA, has yet to be completed. And yet, it was Congressional concern over corporate inversions that led to Congress's request for the three reports released to date.

Responding to intense public scrutiny of several corporate expatriations, the AJCA enacted new Sec. 7874,[4] which addresses the tax consequences of several types of inversion transactions. However, as noted by the Study, the AJCA did not expressly "alter other provisions relevant to the dynamics of inversion transactions", namely US earnings stripping provisions, transfer pricing rules under Sec. 482 or domestic law provisions relating to treaty abuse. Rather, Congress directed Treasury to study these inversion-related provisions, and to report on the effectiveness of the new Sec. 7874. Issuance of the report on Sec. 7874 has been delayed, pending the issuance of further guidance and additional study.

With regard to each of the three areas covered by the Study, this article will provide relevant background, summarize Treasury's conclusions and offer the additional insights of the authors. In sum, the Study takes a wait-and-see approach to earnings stripping, recommending that additional data be collected and assessed. With regard to transfer pricing and treaty abuse, the Study recommends that Treasury stay the course by maintaining current regulatory, administrative and treaty negotiation initiatives.

2. Earnings Stripping

2.1. Background

Prior to 1989 there was significant concern that, notwithstanding common law thin capitalization principles, foreign-controlled domestic corporations (FCDCs) were inappropriately eroding the US tax base by making excessive deductible interest payments to foreign related persons. Such "earnings stripping" interest payments would reduce the overall tax burden of the foreign company to the extent that the interest was subject to low foreign tax and was subject to benefits under a US treaty reducing or eliminating otherwise applicable US withholding tax. Sec. 163(j), enacted in 1989 in response to this concern, denies a corporation's deduction for interest to related persons if:

- the corporation's debt-to-equity ratio exceeds 1.5 to 1;
- its interest expense exceeds 50% of the taxable income adjusted to better reflect cash flow; and
- the related recipients of the interest pay no US tax thereon.

For taxable years after 1993, the provision also applies to interest paid to unrelated persons if the indebtedness is guaranteed by a related person that is either tax exempt or a foreign person.

There has been renewed interest in the efficacy of the earnings stripping rules since 2001, principally as a result of the corporate inversion phenomena. A corporate inversion is a transaction through which the corporate structure of a US-controlled group of companies is altered so that a new foreign corporation replaces the existing US parent corporation as the ultimate parent of the group. A common feature of many inversions is substantial indebtedness of the new US group to the new

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1. US Department of the Treasury, Report to The Congress on Earnings Stripping, Transfer Pricing, and US Income Tax Treaties (November 2007) (available at www.treas.gov/offices/tax-policy/library/ajca2007.pdf).
2. PL 108-357.
3. Study, at 1.
4. Unless indicated otherwise, all statutory references are to the Internal Revenue Code and the regulations thereunder.

foreign parent. A 2002 preliminary report by Treasury on the corporate inversion phenomena (2002 Study) noted that the structures which resulted from inversion transactions were difficult to distinguish from structures resulting from corporate groups that began as foreign-based, or structures resulting from a merger of US and foreign groups.[5] On this basis, the 2002 Study concluded that the "policy response to the . . . corporate inversion activity", including presumably changes to the earnings stripping rules, "should be broad enough to address the underlying differences in the US tax treatment of US-based companies and foreign-based companies, without regard to how foreign-based status is achieved".[6] Since 2002, there have been legislative proposals (including Bush Administration budget proposals) to tighten the earnings stripping rules generally, and also more targeted legislative proposals to tighten the earnings stripping rules as applied to inverted companies. The AJCA addressed the corporate inversion issue by adding Sec. 7874, which treats the new foreign parent companies resulting from certain inversion transactions after 4 March 2003, as domestic companies.

2.2. Summary of conclusions and recommendations

The earnings stripping portion of the Study comes to two conclusions regarding the extent that foreign-controlled companies effectively reduce the US tax on their US operations through earnings stripping. First, although FCDCs historically have been relatively unprofitable compared to domestic-controlled corporations (DCCs), tax return data for 2004 suggest that such low profitability is not due to earnings stripping. This is particularly the case in non-financial sectors. Second, tax return data for 2004 suggest that seven sampled inverted companies appear to have been able to reduce the US tax on their US operations through earnings stripping.

Based on these findings, the Study recommends that additional data be collected to help determine whether changes to the earnings stripping rules would be appropriate. The Study was accompanied by Announcement 2007-114, which alerts taxpayers to a proposed form, Form 8926, for this purpose and solicits comments on Form 8926. Notwithstanding the "strong evidence that [certain inverted companies] have engaged in earnings stripping", the Study does not make any explicit recommendations related to the application of the earnings stripping rules to inverted companies.[7]

2.3. Missed opportunity to propose rationalization of rules

In general, the earnings stripping portion of the Study represents a missed opportunity for Treasury to suggest changes to the earnings stripping rules that would rationalize such rules and conform them to the current business environment. The empirical data suggesting that FCDCs generally do not engage in earnings stripping could have been a departure point for a discussion of the policy rationale for keeping the rules in place in their current form. Foreign direct investment in the United States has increased dramatically since the late 1980s, and such foreign investment has been an engine for economic and job growth in certain economic sectors and regions of the United States. To the extent that the current earnings stripping rules impose an excessive US tax burden on such investment by denying deductions for real business costs, foreign investment is artificially dampened and the US economy is less competitive than it otherwise would be. At the margin, this could cause a diminution in the capital base of the US economy, as assets that could be most productively used by FCDCs are less efficiently used or are abandoned altogether.

From a tax policy perspective, there has always been a certain dissonance between the earnings stripping rules and other aspects of US international tax policy. It is the longstanding policy of the US treaty programme, for example, to insist on an exemption from withholding tax for cross-border interest, including interest between related persons.[8] The United States – Canada treaty protocol signed in September 2007, for example, is the first tax treaty Canada has entered into that will exempt interest between related persons from withholding tax.[9] It is peculiar that the United States secures the benefit of an exemption from withholding tax in its tax treaties while at the same time denying or deferring deductions on the very same payments under its domestic law. This is the case, of course, notwithstanding non-discrimination provisions in those same treaties that compel the signatories to allow deductions for cross-border interest under the same conditions as if the interest had been paid to a domestic person.[10] The empirical data suggesting that FCDCs generally do not engage in earnings stripping could have been the first step in bringing the earnings stripping rules closer in line to the strands of US international tax policy that seek to eliminate tax barriers to cross-border flows of capital.

2.4. About-face on inverted companies based on anecdotal data

Perhaps the most remarkable aspect of the earnings stripping portion of the Study is Treasury's about-face on the issue of earnings stripping by inverted companies. As noted above, Treasury's 2002 Study on inversion transactions concluded that policy responses in this area "should be broad enough to address the underlying differences in the US tax treatment of US-based companies and foreign-based companies, without regard to how foreign-based status is achieved".[11] This conclusion was further

5. Office of Tax Policy, US Department of the Treasury, Corporate Inversion Transactions: Tax Policy Implications (May 2002) (available at www.treas.gov/press/releases/docs/inversion.pdf (2002 Study).
6. 2002 Study, at 2.
7. Study, at 31.
8. See e.g. 2006 US Model Income Tax Treaty, Art. 11(1) (exempting interest from source country withholding tax).
9. 2007 United States – Canada Protocol, Art. 6.
10. See 2006 US Model Income Tax Treaty, Art. 24(4).
11. 2002 Study, at 2.

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reinforced by a series of Bush Administration budget proposals that included generally applicable changes to the earnings stripping rules. Although the Study does not make any recommendations with regard to the application of the earnings stripping rules to inverted companies, the findings of "strong evidence that [certain inverted companies] have engaged in earnings stripping" certainly could be used inappropriately by proponents of targeted legislation tightening the earnings stripping rules as applicable to inverted companies.[12]

The findings in the Study related to inverted companies are based on data related to seven companies that undertook inverted transactions prior to 4 March 2003, the effective date of Sec. 7874. The Study itself acknowledges issues with basing broad conclusions on such a small sample of companies, noting that there were additional inverted companies for which data were not available, and that inverted companies were compared to a broad set of FCDCs or DCCs (rather than, for example, to FCDCs headquartered in similar jurisdictions). Further, the Study is agnostic about whether the apparent ability of inverted companies to engage in earnings stripping results from statutory deficiencies or from deficiencies that could be addressed through regulation or other guidance. Finally, the Study notes that there were no high-profile corporate inversions since 2002, suggesting that the enactment of Sec. 7874 effectively eliminated this issue going forward. At some point it is appropriate to question the continuing dedication of resources to the taxation of a handful of companies the tax treatment of which was laboriously considered and explicitly grandfathered by the AJCA in 2004.

2.5. Comments

By recommending that additional data be accumulated to assess the earnings stripping issue and proposing a means to collect such data, the Study is far from the last word on the earnings stripping issue. The Study may precipitate a delay in the consideration of legislative proposals in this area while additional data are collected and assessed. Taxpayers and practitioners should continue to monitor the legislative and other activity related to this issue.

3. Transfer Pricing

3.1. Summary of conclusions

The central conclusion of the transfer pricing portion of the Study is that Treasury should continue doing what it is doing – updating and strengthening the regulations applicable to cost sharing arrangements (CSAs), intercompany services and global dealing operations. The Study observes that notwithstanding "marked improvement" in both the regulatory regime and enforcement efforts, a review of tax return data and economics literature does "not allay the concerns about potential income shifting from non-arm's-length transfer pricing".[13] The Study appears to attribute any persistent pricing manipulation to inadequacies in applicable regulations, as opposed to weaknesses in administration and enforcement of the existing rules. The Study makes it clear that Treasury's most pressing concern is the use of CSAs to accomplish outbound migration of profits from US-based intangible property. There are no recommendations of further disclosure requirements in view of the high audit rates for affected taxpayers, existing disclosure and information-sharing programmes, and Treasury's acknowledgement of the already high burden on taxpayers in this regard.

3.2. The government's achievements

According to the Study, the five-part strategy to improve administration of Sec. 482, articulated in a 1999 report to Congress, remains essentially unchanged. The strategy calls for:
(1) additional regulatory guidance;
(2) encouraging upfront compliance;
(3) building international consensus on standards,
(4) promoting advance pricing agreements (APAs); and
(5) pursuing strategic litigation.

In the Study, Treasury touts regulatory and enforcement accomplishments in recent years. These include amendments to the cost-sharing regulations "clarifying" that compensatory stock options be included in the cost pool, and amendments to the regulations governing the application of the comparable profits method, which add compensatory stock options as a factor to be considered in assessing comparability. The Study points to examination initiatives, including routine analysis of book-tax differences, the reduction in examination cycle times (the so-called currency initiative), new opportunities for pre-filing compliance (such as the Compliance Assurance Process) and the establishment of cross-functional Issue Management Teams for cost sharing and Sec. 936 terminations. In the litigation arena, the Study notes that only one transfer pricing case, *Xilinx, Inc. v. Commissioner*,[14] has been designated for litigation. (The government suffered a loss in *Xilinx* in the Tax Court, which held that the regulations under Sec. 482 do not authorize the Commissioner to require that participants in a qualified CSA share compensatory stock option expense. The decision is now on appeal to the Ninth Circuit.) The Study also notes the recent settlement of a long-running dispute with UK-based Glaxo SmithKline, under which Glaxo is to pay USD 3.4 billion – "the largest single payment ever made to the IRS to resolve a tax dispute" – for the taxable years 1989–2005.[15] The Study lists only 11 other resolved or pending transfer pricing cases in the Tax Court since 1999.

3.3. Holes in the net

The Study presents empirical analysis of tax return data in an effort to measure controlled foreign corporation

12. Study, at 30.
13. Id. at 34-36.
14. *Xilinx, Inc. v. Commissioner*, 125 T.C. 37 (2005), appeals docketed, Nos. 06-74246 and 06-74269 (9th Cir., 29 September 2006).
15. Study, at 46.

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(CFC) profitability for 1996, 2000 and 2002. As Treasury observes, "[i]f a multinational group is systematically engaging in non-arm's length pricing . . . one would expect to observe higher CFC profitability in low-tax jurisdictions and lower CFC profitability in high-tax jurisdictions".[16] Using operating profit (pre-tax earnings excluding interest income and expense but including royalty income and expense) and the statutory tax rate of the CFC jurisdiction, the analysis shows a negative correlation between profitability and tax rate. For example, in 2002, weighted average operating margins were over 20% for CFCs operating in zero-tax jurisdictions, and less than 8% for CFCs in jurisdictions with tax rates over 35%.

The Study hastens to caveat these results. It notes that many factors could contribute to the differences: low-taxed CFCs might have more asset-intensive operations; high-taxed jurisdictions might in any given year have more start-up CFCs; CFCs in research-intensive industries may operate in low-tax jurisdictions and develop their own intangibles; and cyclical effects and other aberrations could affect the results. The Study also suggests that pre- and post-1997 results may vary due to the impact of the check-the-box regime in 1997, which the Study says may itself foster transfer pricing manipulation, or may skew the results as box-checked, single-owner entities disappear from the tax reporting landscape. Concluding that a more refined analysis is required, the Study surveys the economic literature. The papers cited by the Treasury, which are based on a more granular, company-specific analysis that accounts for non-transfer pricing factors affecting profitability, generally support the results of Treasury's own tax return information analysis. Consequently, the Study concludes, somewhat opaquely, that "the hypothesis that multinational groups engage in non-arm's length pricing . . . in order to facilitate purely tax-advantaged outcomes cannot be rejected by the available data . . . ".[17]

The Study also presents the results of an in-house survey by the IRS to identify multinationals that have been or are engaged in CSAs with their CFCs. The survey produced two "notable" conclusions. First, CFCs the parents of which engage in CSAs tend to be more profitable overall than other CFCs. Second, CFCs the parents of which employ CSAs tend to have higher profitability in low-tax jurisdictions, and vice versa, at statistically significant levels, controlling for non-tax factors and the age of the CSAs. The Study concludes that CSAs may pose a special risk of pricing manipulation.

3.4. Cost sharing arrangements

Although the areas singled out in the Study as in need of prompt attention include pricing for intercompany services transactions and global dealing operations, the issue of major emphasis in the Study, by a significant margin, is cost sharing, described as "an area that provides substantial opportunities to shift income out of the United States".[18] Of particular concern is the valuation of intangibles contributed to CSAs. Under the current regulations, CSA participants must make buy-in payments to compensate the contributor. These are to be calculated under the general rules applicable to valuation of intangibles in Treas. Reg. Sec. 1.482-4 through -6. The Study asserts that taxpayers have systematically undervalued buy-in payments by, for example, treating cost-sharing payments by CFCs as contributions of intangibles, thereby enabling purely financing participants to earn outsized returns.

Treasury's focus on CSA buy-ins is consistent with prior statements by IRS officials,[19] the designation of cost sharing as a "Tier I issue" under the IRS's Industry Issue Focus programme[20] and the recent issuance of a coordinated issue paper providing guidance to IRS examining agents auditing CSAs.[21] Interestingly, however, the Study suggests no need for additional enforcement resources or strategies, but instead posits that the primary remedy for addressing the cost sharing problem is finalization of the 2005 proposed regulations, which introduce the "investor model" for valuing the contribution of pre-existing (platform) intangibles and other valuable resources to CSAs (i.e. the calculation of the buy-in payment). The investor model is said to be "nothing more than a restatement of the familiar 'willing buyer/willing seller' standard for determining fair market value generally".[22]

The Study's discussion of the perceived weaknesses in the current regulatory net cast some doubt on the view that new or improved regulations are the antidote for aggressive use of CSAs to migrate profits. A recurring theme in the Study is that transfer pricing analysis is especially dependent on the taxpayer's specific facts and circumstances. For example, an acknowledged limitation on the Study's analysis of tax return data (discussed above) is that the available data are not at the detailed transactional level necessary to identify transfer pricing effects. Similarly, the Study notes that the precedential value of a judicial decision under Sec. 482 "may be quite limited, due to the highly factual nature of most disputes".[23] Indeed, at one point the Study states simply that "[t]ransfer pricing analysis is intrinsically an analysis of specific facts and circumstances".[24] Yet the solutions proposed in the Study are essentially prescriptive and generic – modifications and enhancements to existing rules. This tension exists throughout the document.

In some cases, it is not at all clear that current regulations (as opposed to the day-to-day administration of the regulations in specific cases) actually require tightening or

16. Id. at 57.
17. Id. at 60-61.
18. Id. at 36.
19. See e.g. 14 *Tax Management Transfer Pricing Report* 12 (12 October 2005) (referring to USD 26 billion at stake in cost sharing disputes, USD 23 billion of which relates to buy-in payments).
20. See Written Testimony of Commissioner of Internal Revenue Mark Everson before the Senate Finance Committee, IR-2006-94 (13 June 2006).
21. Coordinated Issue Paper – Sec. 482 CSA Buy-In Adjustments, LMSB-04-0907-62 (27 September 2007).
22. Study, at 61.
23. Id. at 45.
24. Id. at 55.

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other modification. For example, the Study points out that the current regulations offer no "special valuation guidance" for buy-in payments, but refer only to the general rules for valuing intangibles under Reg. Sec. 1.482-4 through -6. To be sure, as the Study notes, the valuation of "in-process" intangibles is a difficult undertaking, perhaps somewhat more so than the valuation of currently exploitable intangibles, but it is not at all clear that the highly detailed framework of the intangibles pricing regulations is insufficient to guide the analyst to reasonable answers for the questions that really matter, i.e. what rights were, in substance, contributed to the CSA, and what were those rights worth in the market, applying the ex ante approach mandated by the statutory commensurate-with-income standard? Done correctly, this basic analysis could effectively address many of the concerns raised in the Study, such as the assertion by some taxpayers that the useful life of contributed intangibles is ephemeral, or that only limited rights were granted to the CSA, or that CFCs providing only routine inputs should receive outsized returns.

Similarly, the Study asserts that once a buy-in payment is undervalued by a taxpayer, the IRS has "little practical opportunity for redress" apart from adjusting the parties' shares of ongoing expense.[25] Assuming that the year of the contribution is open, however, the IRS already has the authority under Reg. Sec. 1.482-7(g) to adjust the amount of the buy-in payment through application of the intangibles pricing provisions. Here again, more prescription may not be necessary or appropriate. Certainly, CSAs raise difficult, fact-intensive valuation issues, but so long as the arm's-length standard (as opposed to some type of apportionment) is the measure, there is no real substitute for analysing each case based on its particular facts and circumstances. Rigorous examination, greater investment in top-flight economic consultants and a credible threat of exposure to penalties under Sec. 6662(e), would go a long way towards deterring aggressive undervaluation of buy-in payments. (In this regard, it is not clear how reducing examination cycle time promotes effective examination of fact-intensive issues such as the valuation of unique intangibles.)

3.5. Global dealing operations

Finalizing (re-proposing) the proposed global dealing regulations, which are now almost ten years old, is another major priority outlined in the Study. The Study notes that global dealing of financial instruments has changed significantly over time due to technological advances, globalization and the interconnection of economic activity, mandating refinement of existing law. The primary focus of the regulation project appears to be directed at the allocation of income from global dealing within a single legal entity.

The Study notes that several modern US treaties, covering jurisdictions with the main financial centres in which global traders operate, provide for allocation profits to parts of a single enterprise based on an analysis of assets, risks and functions. These treaties take into account the ongoing work of the OECD in developing guidelines for applying the 1995 OECD Transfer Pricing Guidelines by analogy to the attribution of business profits to permanent establishments (PEs). According to the Study, the OECD project "vastly narrows" differences among jurisdictions and facilitates reduction in double taxation through mutual assistance procedures. The Study says that the re-proposed regulations will be consistent with international agreement as reflected in the OECD approach. Thus, a review of the OECD report relative to global dealing operations, issued in December 2006 (the OECD Report), may provide insights as to the approach Treasury will take in the regulation project.[26] (The regulations will also provide rules for sourcing income from global dealing operations and for determining whether such income is effectively connected with a US business of a foreign corporation.)

The OECD Report explores how the "authorized OECD approach" for allocating profits within a single enterprise would apply to a global trading operation. The authorized OECD approach, building off of the Model Commentary on Art. 7 of the Model Tax Convention and the 1995 Guidelines, is that the profits to be attributed to a PE are those profits it:

> would have earned at arm's length as if it were a legally distinct and separate enterprise performing the same or similar functions under the same or similar conditions and dealing wholly independently with the enterprise of which it is a PE, determined by applying the Guidelines by analogy.[27]

In the context of global trading, the OECD Report emphasizes that each case must be analysed on its particular facts, and that there is a virtually infinite variety of business models and financial products in the modern global dealing sector.

The OECD Report contains an extremely detailed discussion of the functions performed, risks assumed and assets used in global trading operations, and it looks at different business models along the spectrum from the mostly decentralized to the fully integrated. Several themes are especially worthy of note, and may well surface in the regulations project. First, the assumption of risks – credit, market and operational – is a central driver of profit in global trading. The allocation of capital, and profit, generally follows allocation of risk. Internal assignment of risk may be respected if it is consistent with real assumption and actual management of risk. However, the OECD Report downplays the value of the enterprise function that sets out overall risk parameters for trading. Second, the high-value-added functions in the enterprise – the "key entrepreneurial risk-taking" functions – typically, but not necessarily always, centre around trading and risk management activities. Generally, under the authorized OECD approach, with regard to an asset, such as a trading book, the business unit

25. Id. at 54-55.
26. See OECD, Report on the Attribution of Profits to Permanent Establishments, Parts I (General Considerations), II (Banks) and III (Global Trading) (December 2006).
27. OECD Report, at 12-13.

housing traders and risk managers is treated as the "owner" of the asset entitled to remaining profits after assigning arm's length compensation to other participants. This approach will often favour allocation to the PE if the trading and risk management personnel are located there. Finally, in a complex, interconnected global dealing enterprise, the preferred analysis may involve the use of a profit split under which external transactional benchmarks are applied to "routine" functions and the balance is allocated to the separate parts of the enterprise based on factors such as compensation paid. The OECD Report notes that any such allocation must be made de novo in each case, and not by formulary apportionment. Similarly, the probity of any allocation method hinges on the factual comparability of the proposed external benchmarks.

Responding to public commentary, the OECD Report considers whether a "hedge fund" model may be used to allocate profits in a global trading operation. Under the hedge fund model, the fund managers receive compensation for their services, generally a small percentage of assets under management plus a share of profits, but not losses. Applied to the global dealing operation, this model would essentially cap the profits allocable to the trading function (often located in a financial centre). The OECD Report states that the hedge fund model may be appropriate as a comparable, but only if there are no material differences or adjustments may be made to account for such differences. Further, the OECD Report observes that the hedge fund model will be less reliable as a benchmark to the extent that the global trading operation earns income from dealer spreads, as opposed to proprietary positions.

4. US Income Tax Treaties

4.1. Background

The United States has a network of bilateral income tax treaties with almost 70 countries. Virtually all of the treaties provide for a reduction or elimination of otherwise applicable US withholding tax on outbound payments of dividends, interest and royalties, and some treaties provide for the elimination of the insurance excise tax. Most US treaties include limitation-on-benefits provisions that are intended to limit treaty benefits, including reduction or elimination of withholding tax, to bona fide residents of the treaty partner which have a significant business nexus to that treaty partner. The tax treaty portion of the Study focuses on the question of whether the provisions reducing or eliminating withholding tax allow the inappropriate erosion of the US tax base or whether existing anti-abuse mechanisms are operating effectively to prevent such erosion.

4.2. Summary of conclusions

Like the transfer pricing portion of the Study, the treaty portion concludes that Treasury should continue to do what it is doing – systematically renegotiating and updating the few income tax treaties remaining in the US treaty network that provide for significant reductions in withholding tax and lack limitation-on-benefits rules. The Study in particular focuses on the treaties with Iceland, Hungary and Poland, and notes the exponential increase in related person interest payments to residents of Iceland and Hungary between 1996 and 2004. The Study concludes that these empirical data provide strong evidence that treaties providing for significant reductions in withholding tax and lacking limitation-on-benefits rules are susceptible to treaty shopping by residents of third countries, and also that the limitation-on-benefits rules in other treaties effectively prevent treaty shopping by third country residents.

The United States signed an updated tax treaty with Iceland in 2007 that includes a modern limitation-on-benefits provision, and is in negotiations with Hungary and Poland to do the same. The Study notes and reinforces the high priority that Treasury has placed on these negotiations.

4.3. Impact on legislative proposals

The Study surprisingly does not refer to recent legislative proposals that would curtail treaty benefits in certain cases of perceived abuse. Legislation passed by the House of Representatives in June 2007, for example, would impose a withholding tax on outbound payments to related persons that are treaty residents based on the withholding tax rate that would be applicable to a payment made from the United States to the ultimate parent of the foreign-controlled group.[28] In addition to constituting an inappropriate override of each of the existing US income tax treaties, such legislation appears premised on the purported lack of efficacy of the limitation-on-benefits rules. The Study provides support for the proposition that the limitation-on-benefits rules deter treaty shopping and have had the effect of funnelling treaty shopping activity through the handful of remaining treaties that provide for significant reductions in withholding tax and lack limitation-on-benefits rules. So long as Treasury continues to attach a high priority to plugging the holes in the limitation-on-benefits coverage in the existing treaty network, legislation imposing domestic law restrictions on treaty benefits appears unnecessary.

4.4. Comments

The Study provides empirical support for the intuitively reasonable conclusions that (1) limitation-on-benefits rules deter treaty shopping and (2) the few treaties remaining that provide for low withholding taxes and lack limitation-on-benefits rules, namely the treaties with Iceland, Hungary and Poland, offer opportunities for treaty shopping. If achieved, Treasury's goal of successfully renegotiating existing tax treaties with Iceland, Hungary and Poland to include limitation-on-benefits rules could have dramatic repercussions on the US tax treaty network and therefore bears monitoring by taxpayers and practitioners.

28. See HR 2419, Sec. 12001 (2007).

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5. Conclusion

Although it does not break much new ground, the recently released Treasury Study illuminates Treasury's current thinking on potential base erosion from earnings stripping, transfer pricing and the use of the US treaty network. With few exceptions, Treasury's attitude seems to be a continued focus on ongoing regulatory and enforcement initiatives and, in the case of tax treaties, renegotiation of the few remaining bilateral treaties with inadequate limitation-on-benefit provisions. Whether the Democratic-controlled Congress agrees with this "stay the course" approach is another matter.

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