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SPECIAL REPORTS

The Use of Tax Treaty Status in Legislation and the Impact on U.S. Tax Treaty Policy

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A novel feature of two pieces of international tax legislation enacted over the last 10 years, IRC sections 1(h)(11) and 457A, is that they turn on whether a transaction or arrangement involves a resident of a U.S. tax treaty partner that is eligible for benefits under the treaty.[1] Congress is considering a third legislative proposal with a similar feature: proposed section 894(d), which would deny tax treaty benefits for deductible payments to foreign affiliates unless the ultimate parent company of the payer and the payee also is eligible for some tax treaty benefits. Unlike traditional interactions between tax treaties and domestic law, these new provisions treat the existence of a U.S. tax treaty as the basis for favorable treatment under a statutory rule (or an exemption from otherwise generally applicable unfavorable treatment). These provisions raise technical and policy issues that stem largely from the fact that U.S. tax treaties were not intended by U.S. negotiators to serve the purposes to which legislators are putting them. In particular, U.S. negotiators have never intended for the lack of a tax treaty to signal disapproval of another country's tax system. Policymakers should reflect on legislation that turns on tax treaty status and determine whether this feature furthers legitimate policy objectives or is used to mask an inadvisable idea with some superficial appeal by exempting the bulk of foreign companies and trading partners. Further, a trend in favor of legislation of this type could have significant implications for U.S. tax treaty policy.

Section I of this article provides a short survey of the U.S. tax treaty network, and the historical and policy reasons underlying the scope of the network. Section II discusses the interaction between the provisions of tax treaties and domestic law. Section III summarizes recent legislation that turns on tax treaty status. Section IV highlights some technical and policy issues raised by such legislation, and Section V introduces some U.S. tax treaty policy implications should such legislation proliferate. Section VI offers concluding thoughts.

I. The U.S. Tax Treaty Network

The United States has a network of 57 income tax treaties covering 65 countries.[2] Although this network covers the majority of foreign trade and investment of U.S. businesses and investors, the U.S. tax treaty network has substantial gaps and is much less extensive than the treaty networks of other countries, such as the United Kingdom or the Netherlands. Part of this is explained by the historical development of the U.S. tax treaty network.[3]

In the immediate aftermath of World War II, the United States entered into income tax treaties with almost all the industrialized Western European countries,

[1]This feature has been noted by at least one commentator. *See* David G. Noren, ''Tax Havens and Tax Policy: How Should the U.S. Tax System Treat Income Earned by Multinationals in Low-Tax Jurisdictions?'' 88 *Taxes* 27, at 36 (Mar. 2010).

[2]*See* Jason R. Connery, Steven R. Lainoff, and Charles W. Cope, ''Current Status of U.S. Tax Treaties and International Tax Agreements,'' 39 *Tax Mgmt. Int'l J.* 171 (Mar. 2010).

[3]The appendix to this article provides a list of U.S. tax treaties currently in force by region and the date on which the United States first signed a tax treaty with the respective treaty partner.

as well as Japan. It was intended that these treaties would encourage the inflow of capital for postwar recovery.[4] Significant efforts were made in the 1960s and 1970s to conclude tax treaties with developing countries, but such efforts often did not bear fruit given the differences in tax treaty policies. For example, tax treaties concluded with Brazil (1967) and Argentina (1981) were never ratified because of reservations placed on the treaties by the U.S. Senate.[5] During and toward the end of the Cold War, the United States entered into treaties with countries with controlled or planned economies (for example, China, Hungary, Poland, Romania, and the Soviet Union) to try to deepen economic relations and ultimately to facilitate capital inflow into such countries. After the end of the Cold War, the United States entered into treaties with former Soviet republics such as the Baltic states of Estonia, Latvia, and Lithuania in the hopes of encouraging trade with these emerging economies and in recognition of their newfound sovereignty. These tax treaty relationships, which together account for the bulk of the U.S. tax treaty network, were established and broadened at least in part for reasons unrelated to tax policy. Further, foreign policy or other nontax policy reasons undoubtedly contributed to decisions not to pursue tax treaties with some countries. For example, as a result of the Comprehensive Anti-Apartheid Act of 1986, the United States terminated its then-existing treaty with South Africa.

In the last 20 years, much of the U.S. Treasury's tax treaty resources have been expended on updating existing tax treaties, rather than entering into treaties with new treaty partners. Beginning in the 1980s, a significant policy of the U.S. tax treaty program has been to update all existing treaties to provide for modern anti-treaty-shopping rules and lower withholding tax rates.[6] Thus, while most of the tax treaty network has turned over in the last 20 years, the scope of the network has not expanded significantly.

Partly as a result of this history, significant gaps in the U.S. tax treaty network remain. Notably, the United States does not have income tax treaties with many significant trading partners in Latin America or East and Southeast Asia, such as Argentina, Brazil, Colombia, Hong Kong, Malaysia, Singapore, Taiwan, and Vietnam. These gaps cannot be fully explained by tax policy concerns, or by assessments of these countries' diverse tax systems.

Aside from the historical development of the U.S. tax treaty network, other reasons may exist for the lack of tax treaties with these and other countries. In evaluating whether to consider tax treaty negotiations, the U.S. Treasury rightly assesses the potential benefits of a treaty to the United States and to U.S. taxpayers. The most significant benefit of tax treaties to U.S. taxpayers is relief from double taxation and from excessive taxation at source (that is, excessive withholding taxes and low thresholds for tax nexus). Accordingly, the U.S. Treasury considers practical tax obstacles to cross-border trade and investment in developing its tax treaty priorities. If a country does not impose significant income or withholding taxes and therefore there are few practical double or excessive taxation issues for U.S. taxpayers, then historically the U.S. Treasury has been reluctant to consider tax treaty negotiations.[7] In this regard, the United States terminated the extension of the U.K., Belgian, and Dutch treaties to their respective territories and former territories, many of which did not have income tax systems, in the 1980s. Conversely, if a country's tax treaty policies are such that little relief from double or excessive taxation would be provided to U.S. taxpayers, for example if a country insisted on maintaining relatively high withholding taxes, then historically the U.S. Treasury has been reluctant to consider tax treaty negotiations.[8] Also, notwithstanding benefits to U.S. taxpayers, the U.S. Treasury will not consider tax treaty negotiations when such negotiations would not be consistent with the interests of the United States, such as when the potential treaty partner would not agree to effective tax information exchange or would insist on tax sparing.[9]

A country with a robust domestic tax system may nevertheless flunk the criteria outlined above. Indeed, a country with an exceedingly robust domestic tax system, featuring high withholding taxes to protect its domestic tax base, would be excluded from tax treaty

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[4]Mitchell B. Carroll, "The Historical Development of Income Tax Treaties," in *Income Tax Treaties* 51, 57-58 (J. Bischel ed., *Practicing Law Inst.* 1978).

[5]The U.S. Senate objected to two aspects of the 1967 proposed treaty with Brazil: (1) a U.S. investment tax credit for investments by U.S. persons in Brazil, and (2) a U.S. deduction for charitable contributions by U.S. persons to Brazilian charities. The U.S. Senate objected to two aspects of the 1981 proposed treaty with Argentina: (1) a partial override of the U.S. rules allowing the taxation of foreign persons on direct and indirect investments in U.S. real property, and (2) the lack of an anti-treaty-shopping provision.

[6]*See, e.g.,* Statement of Leslie B. Samuels, Assistant Secretary (Tax Policy), Department of the Treasury, before the Senate Committee on Foreign Relations (Oct. 27, 1993) ("My purpose now is to assure the Committee that this Administration continues to view treaty abuse as an important issue. . . . We intend, as promptly as time and resources permit, to modify all of our existing treaties to include modern, effective, anti-abuse provisions"). Statement of Philip R. West, International Tax Counsel, Department of the Treasury, before the Senate Committee on Foreign Relations (Oct. 27, 1999).

[7]*See, e.g.,* Statement of Manal Corwin, International Tax Counsel, Department of the Treasury, before the Senate Committee on Foreign Relations (Nov. 10, 2009).

[8]*Id.*

[9]*Id.*

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consideration if it were not willing to reduce its taxation at source consistent with U.S. tax treaty policy.

II. Historical Interaction

Tax legislation can interact with, refer to, or make use of tax treaties in several ways. Historically, the principal interaction between tax treaties and domestic law has been the substantive effect the provisions of each have had on each other, whether in the case of an override by one set of provisions of the other, or the use of one set of provisions in interpreting the other. Under the U.S. Constitution, treaties and statutes have coequal effect.[10] A principal intention and effect of tax treaties is to override domestic law, in particular by reducing U.S. taxes on foreign persons (in exchange for reciprocal reductions in foreign taxes on U.S. persons). Thus, for example, reductions to the rate of withholding tax on outbound payments ''override'' the domestic law rate of 30 percent.

Similarly, domestic legislation can override the provisions of tax treaties if that result is consistent with the intent of Congress and the legislation was enacted later in time.[11] For example, in 1980, Congress enacted IRC section 897, which provided for U.S. tax on gains related to sales of U.S. real estate by foreign persons. Congress explicitly intended IRC section 897 to apply without regard to existing tax treaty obligations to the contrary, and all U.S. tax treaties negotiated since 1980 have incorporated these provisions.[12] Tax treaty overrides are frowned on in part because they weaken the credibility of U.S. tax treaty negotiators and invite retaliation, and as a result they have been rare.[13]

Congress sometimes attempts to mitigate the effect of new legislation that affects the taxation of treaty beneficiaries by providing for exceptions to new taxes that are consistent with what U.S. tax treaty negotiators perhaps would (or should) have negotiated had the new tax been contemplated or in existence at the time of the negotiation. One aspect of the branch profits tax of IRC section 884, enacted in 1986 to eliminate the differing treatment of foreign corporations with U.S. subsidiaries and foreign corporations operating in the United States through branch form, provides an example of this phenomenon. Some U.S. tax treaties at the time permitted the United States to impose a branch profits tax without restriction. Instead of simply imposing branch profits tax on foreign corporations entitled to benefits under such treaties consistent with the provisions of the treaties themselves, IRC section 884(e)(2) provides that the tax rate for branch profits in such circumstances is the tax rate on dividends under the applicable treaty. A foreign corporation entitled to benefits under such treaties was eligible for the reduced rate, however, only if it was a ''qualified resident'' as provided in IRC section 884(e)(4).[14] The qualified resident restriction prevented a reduction in the rate of branch profits tax under preexisting tax treaties that lacked adequate limitations on benefits provisions at the time of the enactment of IRC section 884. Thus, the drafters of IRC section 884 in some cases allowed for a reduction in the rate of branch profits tax consistent with the spirit of preexisting treaties even though such allowance was not provided for under the express terms of the treaty.[15]

Domestic legislation may also shed light on how tax treaties should be interpreted or otherwise affect the manner in which treaties apply. This sometimes occurs in response to perceived abuses. IRC section 894(c), for example, denies treaty benefits for some outbound payments to hybrid entities when those payments are not expressly addressed in the treaty itself. Congress intended for this provision to prevent investments through hybrid entities that were structured to avoid

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[10] *See* U.S. Constitution, Article VI.

[11] *See* IRC section 7852(d)(1).

[12] Congress provided for a delayed effective date for any treaties that were renegotiated to resolve conflicts between the treaty and IRC section 897. For a critique of the effect of IRC section 897 on tax treaties, see Richard L. Kaplan, ''Creeping Xenophobia and the Taxation of Foreign-Owned Real Estate,'' 71 *Geo. L.J.* 1093 (1983).

[13] U.S. tax treaty partners understandably have reacted negatively to U.S. tax treaty overrides. *See* OECD Committee on Fiscal Affairs, *Report on Treaty Override*, 1989 (hereinafter ''OECD, *Treaty Override*''). For analysis of U.S. tax treaty overrides, see Edward K. Dennehy and Stephen E. Ehrlich, ''Tax Treaty Interpretation and Conflicts with U.S. Federal Law,'' *Tax Notes*, Mar. 2, 2009, p. 1101, *Doc 2009-774*, or *2009 TNT 39-17*; Anthony C. Infanti, ''Curtailing Tax Treaty Overrides: An Argument,'' *Tax Notes Int'l,* Aug. 6, 2001, p. 747, *2001-20914*, or *2001 WTD 151-15*; Philip F. Postlewaite and David S. Makarski, ''The A.L.I. Tax Treaty Study — A Critique and a Modest Proposal,'' 52 *Tax Lawyer* 731 (1999); Richard L. Doernberg, ''Overriding Tax Treaties: The U.S. Perspective,'' 9 *Emory Int'l L. Rev.* 71 (Spring 1995); David Sachs, ''Is the 19th Century Doctrine of Treaty Override Good Law for Modern Day Tax Treaties?'' 47 *Tax Law.* 867 (1993-1994); and New York State Bar Association Section of Taxation, ''Legislative Overrides of Tax Treaties,'' *Tax Notes,* Nov. 30, 1987, p. 931.

(Footnote continued in next column.)

[14] IRC section 884(e).

[15] The drafters of IRC section 884 gave less regard to the many U.S. tax treaties at the time that did not permit the United States to impose a branch profits tax. Under IRC section 884(e)(1)(B), a foreign corporation entitled to benefits under such treaties is eligible for the reduced rate only if it is a qualified resident as provided in IRC section 884(e)(4). The superimposition of LOB rules that had not been negotiated constituted an override of these treaties. *See* Richard L. Doernberg, ''Legislative Override of Income Tax Treaties: The Branch Profits Tax and Congressional Arrogation of Authority,'' 42 *Tax Law.* 173 (1989); Jonathan A. Greenberg, ''Section 884 and Congressional 'Override' of Tax Treaties: A Reply to Professor Doernberg,'' 10 *Va. Tax Rev.* 425 (1990).

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both U.S. and foreign taxes. IRC section 894(c) therefore attempted to provide a targeted interpretive solution to whether and when hybrid entities are eligible for treaty benefits. Similarly, the conduit rules of Treas. reg. section 1.881-3 deny treaty benefits for outbound payments in some ''back-to-back'' financing arrangements by allowing the IRS to disregard the participation of intermediate entities that might otherwise be entitled to treaty benefits. Whether IRC section 894(c) or Treas. reg. section 1.881-3 (under the authority of IRC section 7701(l)) overrode existing tax treaties, or merely provided an interpretive gloss on such treaties, is subject to debate.[16]

More fundamentally, critical terms in tax treaties sometimes are explicitly defined with reference to the domestic law of the taxing state, and the default rule for determining the meaning of undefined terms also looks to the domestic law of the taxing state unless the context requires otherwise.[17] Thus, domestic legislation can change the impact of treaties by modifying the definition of a general term, such as dividend or interest.[18] Although such a change generally is not considered an override of tax treaties as it is pursuant to their explicit terms, one could imagine a change to a domestic law definition that could be considered to override the treaty rules (for example, a change to the domestic law definition of dividend that applied for purposes of tax treaties only).

Further, tax treaties often incorporate even broader references to some aspects of domestic law, with the understanding that details may change without upsetting the expectations under the treaty. For example, U.S. tax treaties typically include a ''relief from double taxation'' article that requires the United States to provide a foreign tax credit for foreign taxes paid, consistent with the principles of the current U.S. foreign tax credit rules as they may change from time to time, but without changing the general principle of the article.[19] Significant changes to the U.S. foreign tax credit rules therefore can change the impact of treaties without being considered an override,[20] although presumably a fundamental change to the rules that would materially reduce the ability of U.S. taxpayers to credit taxes paid to a treaty partner could be subject to challenge unless Congress clearly evidences an intent to override existing treaty obligations.[21]

III. Tax Treaty Status in Domestic Law

As noted above, the principal historical interaction between tax treaties and domestic law has been the effect the provisions of each have had on each other, whether in the case of override or interpretation. Recently, legislation restricting statutory benefits on the basis of tax treaty status has been enacted.[22] These provisions are different from the provisions described above in that they do not restrict the benefits of, or affect the interpretation of, existing tax treaties. Rather, each conditions a statutory benefit of one party to a transaction or arrangement on the existence of a tax

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[16]*See* Robert Critchfield, Nathan Honson, and Myron Mendelowitz, ''Pass-Through Entities, Double Tax Conventions, and Treaty Overrides,'' *Tax Notes Int'l,* Feb. 8, 1999, p. 587, *Doc 1999-5333*, or *1999 WTD 25-15*; Richard L. Doernberg, ''Treaty Override by Administrative Regulation: The Multiparty Financing Regulations,'' 9 *Fla. Tax Rev.* 521 (1995); Timothy S. Guenther, ''Tax Treaties and Overrides: The Multiple-Party Financing Dilemma,'' 16 *Va. Tax Rev.* 645 (1997).

[17]*See* U.S. Model Income Tax Convention of Nov. 15, 2006 (hereinafter ''2006 U.S. model''), article 3.2.

[18]*See* OECD, *Treaty Override*, para. 4(b) (''It cannot have been contemplated that, having once entered into a treaty, a State would be unable to change definitions of terms used in its domestic law provided such changes were compatible with the context of the treaty''). For a recent practical example of this, see new IRC section 871(l), which defines income from some derivative transactions as ''dividend equivalents'' that are treated as dividends for purposes of withholding under IRC sections 871 and 881 and for purposes of tax treaties, but not otherwise. Before this legislative change, such income typically would have been treated as other income that typically is exempt from source country taxation under U.S. income tax treaties, rather than dividend income, which typically is subject to source country taxation.

[19]*See* 2006 U.S. model, article 23(2).

[20]*See, e.g.*, *Pekar v. Commissioner*, 113 T.C. 158 (1999), *Doc 1999-28520*, *1999 WTD 171-19*; *Kappus v. Commissioner*, 83 T.C.M. (CCH) 1203 (2002), *Doc 2002-3456*, *2002 WTD 29-23*, *aff'd*, 337 F.3d 1052 (2003), *Doc 2003-18423*, *2003 WTD 155-24*.

[21]For example, the U.S. Treasury recently has proposed that foreign tax credits be determined on a pooled basis. Under this proposal, a U.S. taxpayer's section 902 credits would be limited based on the ratio of foreign taxes to earnings and profits of all foreign subsidiaries. Thus, the credibility of taxes paid by a subsidiary of a U.S. corporation to a treaty partner may be limited significantly depending on the nature of other investments of the U.S. taxpayer. Although in theory all taxes paid eventually will be creditable up to the U.S. rate on (U.S. determined) foreign-source income, in practice this will be the case only if all foreign earnings are distributed. *See* Department of the Treasury, ''General Explanation of the Administration's Fiscal Year 2011 Revenue Proposals'' (Feb. 2010), at 41, *Doc 2010-2363*, *2010 WTD 22-26*. For a thorough discussion of implications of this proposal on U.S. tax treaties, see Robert H. Dilworth, ''Proposed Multilateral FTC Polling and U.S. Bilateral Tax Treaties,'' *Tax Notes Int'l*, Sept. 21, 2009, p. 1045, *Doc 2009-18637*, or *2009 WTD 180-13*.

[22]A somewhat similar phenomenon occurred in the 1980s, when legislation was enacted as part of the Caribbean Basin Initiative to provide statutory benefits to Caribbean countries and territories that had entered into tax information exchange agreements with the United States. *See, e.g.*, IRC section 274(h)(6). Although sections 1(h)(11) and 457A do not appear to have had as a purpose the provision of incentives to non-treaty countries to enter into tax treaties with the United States, one commentator suggests that they may have that effect. *See* Noren, *supra* note 1, at 36 (''such rules arguably have the salutary effect of encouraging more countries to enter into treaties with the United States'').

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treaty for which another party is eligible. That is, benefits are conditioned on whether a transaction or arrangement involves a resident of a U.S. tax treaty partner that is eligible for benefits under the treaty. Since 2003, Congress has enacted two provisions that condition statutory benefits based on tax treaty status: IRC section 1(h)(11), which provides for a reduced rate of tax on some dividends, and IRC section 457A, which accelerates the recognition of income in some deferred compensation arrangements. More recently, Congress has considered a proposal to deny tax treaty benefits to deductible payments to foreign affiliates unless the ultimate parent company of both the payer and the payee is itself eligible for tax treaty benefits. This section summarizes these provisions.

A. IRC Section 1(h)(11)

In 2003 Congress enacted IRC section 1(h)(11), which provides for the taxation of qualified dividend income at the reduced rates applicable to capital gains. The term ''qualified dividend income'' means dividends received from domestic corporations and ''qualified foreign corporations.'' One way for a foreign corporation to be considered a qualified foreign corporation is if the corporation ''is eligible for benefits of a comprehensive income tax treaty with the United States which the Secretary determines is satisfactory for purposes of this paragraph and which includes an exchange of information program.''[23] The legislative history indicates that Congress intended that a corporation be considered ''eligible for benefits of a comprehensive income tax treaty'' for this purpose ''if it would qualify for the benefits of the treaty with respect to substantially all of its income in the taxable year in which the dividend is paid.''[24]

The impact of the tax treaty status rule in IRC section 1(h)(11) is mitigated to some extent when viewed in context. A foreign corporation whose stock is actively traded on a U.S. stock exchange is treated as a qualified foreign corporation for purposes of the rule notwithstanding tax treaty status; thus, the tax treaty status rule only affects dividends received by U.S. individuals from foreign corporations whose stock is not traded on a U.S. exchange. Further, foreign corporations that are passive are precluded from being treated as qualified foreign corporations notwithstanding tax treaty status,[25] and the benefits of qualified foreign corporation treatment with respect to U.S. controlled corporations are limited.[26] Thus, not all foreign corporations eligible for tax treaty benefits are treated as qualified foreign corporations, and some foreign corporations that are not eligible for tax treaty benefits are so treated.

B. IRC Section 457A

As part of the Tax Extenders and Alternative Minimum Tax Relief Act of 2008 (the 2008 Act), Congress enacted IRC section 457A, which provides for an immediate inclusion of deferred compensation from some foreign corporations or tax-indifferent parties. Under IRC section 457A, compensation deferred under a nonqualified deferred compensation plan of a nonqualified entity is includable in gross income as soon as there is no substantial risk of forfeiture of the rights to such compensation. Although as initially proposed IRC section 457A was designed to focus on hedge funds and investment managers, as enacted it applies broadly. Thus, any foreign corporation is a nonqualified entity unless substantially all of its income is either effectively connected with the conduct of a trade or business within the United States, or subject to a comprehensive foreign income tax. See IRC section 457A(b)(1). The term ''comprehensive foreign income tax'' means, regarding any foreign person, the income tax of a foreign country if such person is eligible for the benefits of a comprehensive income tax treaty between the foreign country and the United States, or the person demonstrates to the satisfaction of the secretary that the foreign country has a comprehensive income tax. See IRC section 457A(d)(2).

Interim guidance under IRC section 457A provides that the term ''comprehensive income tax treaty'' in this context means every income tax treaty of the United States in force as of January 8, 2009, other than the treaties with Bermuda and the Netherlands Antilles.[27] In contrast, the Bluebook accompanying the 2008 Act states that Congress intended for the Treasury to consider whether a particular treaty has modern LOB rules in interpreting the term ''comprehensive income tax treaty.''[28] Although the Bluebook pointed to Hungary and Poland as examples of treaties lacking

[23]IRC section 1(h)(11)(C)(i)(II). The IRS has published an updated list of qualifying treaties. *See* Notice 2006-101, 2006-2 C.B. 930, *Doc 2006-22093*, *2006 WTD 210-13*, *superseding* Notice 2003-69, 2003-2 C.B. 851, *Doc 2003-21501*, *2003 WTD 190-21*, which contained a prior list.

[24]H.R. Rep. No. 108-126 (May 22, 2003), at 42.

[25]*See* IRC section 1(h)(11)(C)(iii).

[26]*See* Notice 2004-70, 2004-2 C.B. 724, *Doc 2004-19931*, *2004 WTD 197-10*, section 4.02.

[27]*See* Notice 2009-8, 2009-4 IRB 347, *Doc 2009-407*, *2009 TNT 5-5*, Q&A 10. The Bermuda treaty provides only limited benefits in the insurance sector, and the Netherlands Antilles treaty was terminated except for some interest payments on grandfathered instruments.

[28]*See* Joint Committee on Taxation, ''General Explanation of Tax Legislation Enacted in the 110th Congress,'' JCS-1-09 (Mar. 2009) (hereinafter ''2009 Bluebook''), at 531, *Doc 2009 6027*, *2009 TNT 51-18*.

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LOB rules, other treaties lack LOB rules.[29] Notably, the Bluebook also stated that different concerns motivated IRC section 457A and IRC section 1(h)(11) and that therefore guidance issued on what constitutes a comprehensive income tax treaty for purposes of either section ''should in no way be considered to bind any guidance issued under'' the other.[30]

C. Proposed Section 894(d)

More recently, Congress has seriously considered a provision that would limit eligibility for reduced treaty withholding rates based on whether the common foreign parent of the payer and the recipient is also entitled to benefits under a treaty. This provision was included most recently in the Small Business and Infrastructure Jobs Tax Act of 2010 (H.R. 4849), which was passed by the House of Representatives in March. This proposal provides that withholding tax may not be reduced under a treaty for deductible related-party payments ''unless any such withholding tax would be reduced under a treaty of the United States if such payment were made directly to the foreign parent corporation.'' The provision overrides all existing treaties, most of which have carefully drafted LOB provisions designed to ensure that beneficiaries of reduced withholding rates have sufficient nexus to the contracting state.[31] Unlike the other legislation discussed in this article, this proposal conditions treaty benefits, rather than statutory benefits, on status under a second tax treaty. Thus, the proposal is both an override of U.S. tax treaties (as between the U.S. and the country in which the recipient is resident) and a provision of domestic law that turns on tax treaty status (in this case, based on whether the ultimate parent of the corporate group is eligible for treaty benefits under a U.S. tax treaty).[32]

[29]There are no LOB rules in the current U.S. tax treaties with Greece, Pakistan, the Philippines, and Romania, as well as the treaty with the Soviet Union (which continues to apply to former Soviet republics that have not negotiated new tax treaties, namely Armenia, Azerbaijan, Belarus, Georgia, Kyrgyzstan, Moldova, Tajikistan, Turkmenistan, and Uzbekistan).

[30]*See* 2009 Bluebook, at 531. It would be curious if legislative history drafted after the enactment of a statute could be interpreted to allow an interpretation of ''comprehensive income tax treaty'' in the context of section 457A that is different from that in the only other section of the code that uses that term, IRC section 1(h)(11). *See Hotel Equities Corp. v. Commissioner*, 546 F.2d 725 (7th Cir. 1976) (quoting *Atlantic Cleaners & Dyers, Inc. v. United States*, 286 U.S. 427, 433 (1932)).

[31]*See* Philip D. Morrison, ''Overriding Income Tax Treaties in Codifying a New LOB,'' 38 *Tax Mgm't Int'l J.* 637 (2009).

[32]An earlier version of this proposal was introduced by Rep. Lloyd Doggett, D-Texas, in 2007, and passed by the House of Representatives in 2007 as part of H.R. 2419, The Farm, Nutrition, and Bioenergy Act of 2007. The earlier version of the bill was broader, applying in cases when either the common parent was not eligible for tax treaty benefits or the tax treaty benefits for which it was eligible were less favorable than the benefits being claimed by the recipient of the deductible payment. Thus, the earlier version of the bill did not turn on tax treaty status so much as apply an overriding derivative benefits type rule.

IV. Technical and Policy Issues

The tax treaty-related provisions discussed in this article raise a host of technical and policy issues, some of which are summarized below.

A. 'Eligibility' for Treaty Benefits

As a technical matter, it may be difficult at the margin to determine whether a foreign company is ''eligible for the benefits'' of a tax treaty for purposes of rules such as those of IRC sections 1(h)(11) or 457A,[33] as opposed to a resident of the tax treaty partner. In general, residency is defined based on whether a company is subject to tax as a resident (rather than based on the source of its income) by a country. In contrast, to be eligible for the benefits of a U.S. tax treaty, a company would have to show that it meets one of several objective tests under the LOB article of the particular tax treaty. This may be difficult, particularly if the foreign company does not receive U.S.-source payments or operate a U.S. business, and thus has no reason to determine whether it is actually eligible for tax treaty benefits under these rules. In such a case, presumably eligibility for treaty benefits would be tested on a hypothetical basis — if the foreign company received U.S.-source income or operated a U.S. business, would it be entitled to treaty benefits?

The application of such a test is further complicated by the substance of the standard LOB rules in modern U.S. tax treaties.[34] For example, if the foreign company is not publicly traded and is owned by third-country residents, then it likely could qualify for treaty benefits only under the ''active trade or business'' test or by obtaining discretionary relief from the competent authorities.[35] The active trade or business test, however, only applies to allow treaty benefits to items of income related or incidental to the business activities of the foreign company in its country of residence.[36] According to the legislative history of IRC section 1(h)(11), a foreign corporation is only considered eligible for treaty benefits ''if it would qualify for the benefits of the treaty with respect to substantially all of its income'' in

[33]These issues are less likely to arise in the context of proposed section 894(d) given the narrow focus of that provision on the eligibility for treaty benefits on specific payments.

[34]For commentary on the difficulties in applying the eligible for benefits test, see New York State Bar Association Tax Section, ''Report on Dividends Provisions of the Jobs and Growth Tax Relief Reconciliation Act of 2003,'' *Doc 2003-19875*, *2003 TNT 172-14* (Sept. 4, 2003).

[35]*See* 2006 U.S. model, articles 22(3) and (4).

[36]*See id.*, article 22(3)(a).

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the year of the dividend.[37] In constructing the hypothetical basis on which to apply the test, may the foreign company assume that it is being tested regarding income that would be related or incidental to its trade or business? Should the guidance from the legislative history be interpreted to mean that a foreign company could claim treaty eligibility based on the active trade or business only if substantially all of its income is related or incidental to its business activities, or in some other manner? Further, if a foreign company is resident in a treaty country but does not meet any of the objective LOB tests, what if anything may it assume about the potential application of discretionary relief by the competent authorities?

The proposal is both an override of U.S. tax treaties and a provision of domestic law that turns on tax treaty status.

Similar issues arise under tax treaties with a so-called triangular branch rule and derivative benefits rule included in some LOB articles.[38] Under a triangular branch rule, a foreign company that otherwise would be eligible for tax treaty benefits would not be eligible under some circumstances if the income was earned by a permanent establishment in a third country and therefore exempt from tax in the foreign company's home country. Under a derivative benefits rule, treaty benefits are permitted if the same income would have been eligible for the same (or more favorable) treaty benefits if paid to the parent company of the recipient. Each of these rules leaves open the possibility that a foreign company may be eligible for treaty benefits for some items of income, but not others. Would such rules be taken into account in determining eligibility for benefits under IRC section 1(h)(11) or IRC section 457A, and if so, in what way?

B. Tax Treaty Status as a Proxy

From a policy perspective, the treaty-related provisions discussed in this article appear premised on the notion that having a tax treaty with the United States means that a country has a robust tax system, as well as the notion that not having a tax treaty with the United States means that a country may lack a robust tax system.[39] For example, proposed section 894(d) was recently highlighted as a measure aimed at curbing tax haven abuse.[40] This raises two issues. First, is it appropriate for U.S. tax rules in general, and the legislative provisions noted in this article in particular, to turn on whether a foreign corporation is subject to significant foreign tax? Second, when it is appropriate, is the U.S. tax treaty network a good proxy for a list of countries that impose significant corporate income taxes?[41]

1. The Nature of the Foreign Tax System

In the case of IRC section 1(h)(11), Congress appears to have intended to limit the reduced tax rate to the dividends from earnings that have been subject to substantial tax at the corporate level. This is sensible if one views IRC section 1(h)(11) as a step toward an integrated system, and in this regard the extension of the reduced rate to *any* class of foreign corporations is noteworthy.[42] However, when the foreign corporation is

[37]H.R. Rep. No. 108-126 (May 22, 2003), at 42. This guidance may apply for purposes of interpreting section 457A.

[38]*See* 1989 Germany-U.S. treaty, articles 28(5) and 28(3), as amended by 2006 protocol.

[39]This was not the case with the early versions of proposed section 894(d), which seemed more focused with treaty shopping concerns that the drafters felt had been inadequately addressed by U.S. tax treaty negotiators. In the context of section 1(h)(11), the drafters of those provisions also appeared reluctant to extend statutory benefits when there was an absence of tax information exchange. Although this concern may be legitimate, the United States has many tax information exchange agreements with countries outside the tax treaty network that broadly ensure the availability of information exchange.

[40]*See* Chuck O'Toole, ''Levin Says Deferral Can Wait but Targets Tax Havens, Bush Tax Cuts,'' *Tax Notes Int'l*, Mar. 22, 2010, p. 1051, *Doc 2010-5708*, or *2010 WTD 51-2*.

[41]The U.S. Treasury recently proposed a more direct approach to determining whether income has been subject to significant levels of foreign tax in a different context. *See* Department of the Treasury, ''General Explanation of the Administration's Fiscal Year 2011 Revenue Proposals'' (Feb. 2010), at 43. Treasury officials have indicated that an effective tax rate of less than 10 percent may be considered low for these purposes. All U.S. tax treaty partners have statutory rates above 10 percent, as do many countries that do not have tax treaties with the United States. Note that the proposal applies only to U.S. controlled foreign corporations, for which effective tax rate data is more readily obtained based on current information reporting requirements. Similar tax rate tests have been proposed in a variety of other contexts. *See, e.g.*, American Bar Association, ''Report of the Tax Force on International Tax Reform,'' 59 *Tax. Law.* 649, 744 (2006) (proposing to treat entities subject to little local-country income tax as passthrough entities for U.S. tax purposes). For a discussion of the use of and potential issues with a tax rate test, *see* Noren, *supra* note 1, at 37.

[42]The question of how an integrated tax system should treat foreign investment is complex and beyond the scope of this article. The initial 2003 U.S. Treasury proposal that led to the enactment of section 1(h)(11) was a comprehensive integration proposal that did not extend to foreign corporations except to the extent that they paid U.S. tax on effectively connected income or were credited with paying U.S. tax by their U.S. subsidiaries and allocable to distributed earnings. *See* Department of the Treasury, ''General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals'' (Feb. 2003), at 17, *Doc 2003-3041*, *2003 TNT*

(Footnote continued on next page.)

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a holding company, the underlying earnings may have been taxed at the operating company level, if not at the parent level. In such circumstances, IRC section 1(h)(11)'s focus on the residence country of the parent corporation provides limited insight into whether earnings have been subject to corporate-level taxes.

For IRC section 457A, foreign corporations that are not subject to comprehensive income taxes in their countries of residence were targeted because such corporations may be indifferent as to the corresponding deferral of the payer's deduction.[43] The general reference to foreign tax systems in this context, however, is problematic. Although issues surrounding cross-border tax arbitrage can be complex and are well beyond the scope of this article, in general the U.S. tax treatment of an item earned by a U.S. person should depend on the nature of the item, not on the status of the payer under foreign tax rules or on the foreign tax treatment of the item.[44] Foreign tax systems are too varied to permit the same level of symmetry that we expect in wholly domestic transactions.

In proposed section 894(d), the drafters appear concerned that the U.S. tax treaty network may be accessed by subsidiaries of foreign companies located in tax havens. Assuming that the payee has a sufficient nexus to its country of residence to justify treaty benefits to begin with under modern LOB rules, it is unclear why the tax treaty status of the ultimate parent is relevant.[45] Although the ownership/base erosion and derivative benefits rules of modern U.S. tax treaties look to the identity and eligibility for treaty benefits of owners of an entity, they do so only in combination with tests that prevent base erosion and therefore ensure that the recipient of the income is subject to tax in its country of residence. This is the traditional and more appropriate focus of anti-treaty-shopping rules — to prevent entities with little business connection to their country of residence from being used to obtain treaty benefits for third-country residents.[46]

2. Efficacy of Focus on Tax Treaty Status

Even if it were appropriate for a statutory rule to turn on whether a foreign corporation is subject to significant foreign tax, a second question is whether the U.S. tax treaty network is an acceptable proxy for a list of countries that impose significant corporate income taxes. The use of the tax treaty network in this manner has some appeal, particularly if it is one of several administrable ways to establish entitlement to statutory benefits (as in the case of IRC section 1(h)(11)). A significant purpose of U.S. tax treaties is to mitigate tax obstacles to cross-border investment, and the United States does not enter into tax treaties with countries without an income tax.

As noted above, however, the development of the U.S. treaty network has been in some ways haphazard, and it continues to exclude many important trading partners. It is wrong to presume that countries outside the treaty network lack adequate income tax systems.[47] Indeed, some countries lack tax treaties with the United States precisely because they have very robust income tax systems and are unwilling to make significant reductions in their taxation of income at source.

An appealing aspect of focusing on tax treaty status is simplicity — it is simple to look to whether a foreign person is resident in a country with a U.S. tax treaty. This benefit is undermined to some extent by the technical issues analyzed above, namely the reliance on eligibility for benefits rather than residence.

More fundamentally, using tax treaty status to determine entitlement to statutory benefits can be troubling when the general rule restricting benefits has limited policy justification. Negative statutory proposals that target foreign controlled corporate groups obviously can upset trading partners and companies. An exclusion based on tax treaty status mitigates the negative effects of the rule on most significant foreign controlled groups and most significant trading partners, leaving the rest to fend for themselves. This is the case whether the general rule can be justified from a policy perspective or not. In the case of proposals with limited policy justification, a

23-11. In this regard, section 1(h)(11) represents an expansion of benefits to foreign corporations, albeit limited to qualified foreign corporations whose earnings likely have been taxed at the corporate level.

[43]Earlier drafts of IRC section 457A provided that a foreign tax did not constitute a comprehensive income tax ''unless such tax includes rules for the deductibility of deferred compensation which are similar to the rules of this title.'' *See* H.R. 3996, the Temporary Tax Relief Act of 2007, section 601. Such a requirement would have raised obvious administrability concerns and, if applied strictly, may not have applied to any other country given the vagaries of the U.S. deferred compensation rules.

[44]For an exhaustive discussion of appropriate and inappropriate uses of foreign law in determining U.S. tax consequences, see Philip R. West, ''Foreign Law in U.S. International Taxation: The Search for Standards,'' 3 *Fla. Tax Rev.* 147 (1996).

[45]Note again that this proposal overrides all tax treaties, without regard to whether they have strict, lax, or no LOB rules.

[46]*See* Morrison, *supra* note 31.

[47]*See* Noren, *supra* note 1, at 36 (''There are in fact non-tax-haven countries and major investment and trading partners with whom we still do not have comprehensive income tax treaties for various reasons, such as Brazil and Taiwan''). *See also* Robert H. Dilworth, ''Tax Reform: International Tax Issues and Some Proposals,'' 35 *International Tax Journal* 5 (Jan.-Feb. 2009) (noting, in the context of a proposal to exclude risk-based allocations to foreign affiliates in non-tax-treaty countries, that the ''proposal would require adjustment to accommodate any significant investment by U.S. MNCs in countries with which the United States does not have treaties, such as Argentina, Brazil, Hong Kong, Singapore, Taiwan, and the Persian Gulf states'').

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tax treaty exception may make the proposal better only in the sense of limiting its scope. In other words, rather than refine the proposal, a tax treaty status exception merely limits it.

Both IRC section 457A and proposed IRC section 894(d) provide examples of this phenomenon. In each case, initial proposals provided rules that denied benefits broadly. In each case, the broad denial of benefits had some conceptual coherence. In the case of IRC section 457A, the initial proposal denied the benefits of deferral related to deferred compensation received from a foreign person unless that person was subject to a tax system with deferred compensation rules similar to U.S. rules, thereby introducing the same tension in the cross-border context as exists domestically.[48] For proposed note 1, section 894(d), the initial proposal was animated by perceived treaty shopping and therefore denied benefits whenever the withholding tax on payments to foreign affiliates was less than the withholding tax that would have been applied if the payment were made to the ultimate foreign parent.[49] In each case, however, the policy justifications for these proposals ultimately were not persuasive or were outweighed by conflicting policies. Rather than abandon the ideas, the provisions were limited so as to turn on tax treaty status, thereby exempting most significant U.S. trading partners and most significant foreign-based corporate groups. This result is better than that under the initial proposals, but not as good as simply abandoning the idea or developing an alternative method to achieve the desired objective. Policymakers should carefully consider the merits of legislative proposals that turn on tax treaty status, and whether the resort to treaty status has the effect of superficially ameliorating a negative rule that should not be enacted at all.

V. Tax Treaty Implications

The technical and policy issues discussed above largely stem from the fact that U.S. tax treaties were not intended by U.S. negotiators to serve the purposes to which legislators are putting them. The LOB rules governing eligibility for tax treaty benefits, for example, were developed on the quite reasonable assumption that the foreign corporation at issue was operating a U.S. business or otherwise earning U.S.-source income, and thereby would have an interest in determining whether it was eligible for tax treaty benefits. Further, U.S. negotiators have never intended for the lack of a tax treaty to signal disapproval of another country's tax system.

One question for U.S. tax treaty policymakers is whether and how they should take legislation that turns on tax treaty status into account should such provisions proliferate. For example, should policymakers devise standards for eligibility for tax treaty benefits that are more suitable in the legislative context? These standards could apply separately from existing LOB rules and only for the purpose of determining whether a foreign corporation is entitled to the statutory benefits that turn on tax treaty status.[50]

Further, should policymakers take such legislative proposals into account in their dealings with foreign governments, and if so, how? Should those aspects of U.S. law be considered additional points of leverage, or should policymakers consider some mechanism for relief for countries that may merit favorable status in the legislative context, but regarding which a full blown treaty would be inappropriate due to policy differences or other reasons? Consider a country (High Tax) that maintains a robust tax system but is not willing to make sufficient concessions regarding its taxation of income at source to successfully conclude a tax treaty with the United States, and recall that tax treaty status has been presumed by legislators to be a proxy for robust tax systems. Should companies resident in High Tax be discriminated against because it refuses to make concessions (for example, reduce tax rates and narrow its tax base) in tax treaty discussions with the United States? Consider further a country (Territorial Tax) that maintains a territorial tax system that exempts most foreign income and provides for relatively low withholding taxes on outbound payments, but historically has not been high on the list of U.S. tax treaty negotiating priorities because of the relative lack of tax issues between the countries that could be resolved by a tax treaty. How should U.S. tax treaty policymakers respond to a request by their counterparts in Territorial Tax that the consequences of the legislation described in this article (as well as similar legislation that may be proposed in the future) should be weighed in determining whether there are significant tax barriers to cross-border investment that can be addressed by a tax treaty?

VI. Conclusion

In the last 10 years Congress enacted two legislative provisions restricting statutory benefits on the basis of tax treaty status, and divorced from benefits or restrictions provided by treaties themselves. It is considering a third such provision. This trend has received scant attention despite the significant technical and policy issues raised. These issues merit careful consideration by policymakers. ◆

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[48]*See supra* note 43.

[49]*See supra* note 32.

[50]For example, in the specific context of IRC section 1(h)(11), one commentator proposed relying on ''objective factors'' that would demonstrate that a foreign corporation and treaty resident is a ''bona fide operating company,'' including the length of time it has been in existence, the nature of its business, the number of employees, its size, the composition of assets on balance sheet, whether it is known in its industry, and whether its stock is publicly traded. *See* New York State Bar Association Tax Section, *supra* note 34.

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Appendix. List of Current U.S. Tax Treaty Partners, By Region and By Year in Which First U.S. Tax Treaty in Force Was Signed

Western Europe	
France	1939
Sweden	1939
United Kingdom	1945
Belgium	1948
Denmark	1948
Netherlands	1948
Ireland	1949
Norway	1949
Greece	1950
Switzerland	1951
Finland	1952
Germany	1954
Italy	1955
Austria	1956
Luxembourg	1962
Iceland	1975
Cyprus	1984
Spain	1990
Portugal	1994
The Americas	
Canada	1942
Trinidad and Tobago	1970
Jamaica	1980
Barbados	1984
Mexico	1992
Venezuela	1999
Sub-Saharan Africa	
South Africa	1946
Australasia	
New Zealand	1948
Australia	1953

South and East Asia	
Japan	1954
Pakistan	1957
South Korea	1976
Philippines	1976
China	1984
Sri Lanka	1985
Indonesia	1988
India	1989
Thailand	1996
Bangladesh	2004
Eastern Europe and Former Soviet Union	
Romania	1973
Soviet Union	1973
Poland	1974
Hungary	1979
Russia	1992
Czech Republic	1993
Kazakhstan	1993
Slovakia	1993
Ukraine	1994
Estonia	1998
Latvia	1998
Lithuania	1998
Slovenia	1999
Bulgaria	2007
Middle East and North Africa	
Israel	1975
Morocco	1977
Egypt	1980
Tunisia	1985
Turkey	1996

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