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An Overview of International Tax Issues

JOSEPH H. GUTTENTAG*

I. INTRODUCTION

I bring you greetings from Treasury and welcome the opportunity to reemphasize the importance of our relationship with Latin America. Just over a year ago President Clinton hosted thirty-three countries here at the Summit of the Americas, and Secretary Rubin just completed a visit to several Latin American countries. The Summit proposed to create a Free Trade Area of the Americas by the year 2005. Work continues on this dynamic project with the meeting next month in Cartagena.

The University of Miami is an obviously appropriate venue for the discussion we will have during the next two days regarding tax relationships between the U.S. and Latin America. I first appeared before a University of Miami audience about twenty-five years ago, when I discussed transfer pricing problems and other issues. The same issues remain challenges that we will discuss in the current program. The law school has continued to provide U.S. leadership in the study of inter-American and comparative law. In addition to publishing the prestigious *University of Miami Law Review* and *Inter-American Law Review*, the school provides opportunities both here, such as this program, and throughout Latin America for the necessary and desirable exchange of views.

Regional and international organizations, recognizing that Latin America gives a big "bang for the buck," continue to increase their activities in this area. The International Development Bank, the International Monetary Fund and other organizations provide substantial assistance in modernizing tax systems throughout the area.

Trade and investment flows continue to increase—these flows are up more than fifty percent each in just this decade. Investments in Latin

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America from the United States in 1994 doubled that of 1992 and exceeded our investments in the Asian Pacific region. The nature of new investments reflects the increasing importance of the service sector, with heavy emphasis on communications, technology, and retail trade.

Many Latin American countries fell into a category we called "developing countries" in the past, but today the economic lines between developed and developing countries are fuzzier. Traditional developing countries still exist, but now "emerging economies," "newly industrialized countries," "dynamic emerging economies," "countries in transition," and so forth all exist. We can expect a different tax regime in each type of country suitable for its stage of economic development. We can also anticipate the possibility that some instability may arise as a country moves from one stage to another.

Today I wish to discuss with you three major focuses of the U.S. Treasury Department. First, I will mention our work with international organizations, particularly the OECD. Second, I will discuss current developments of U.S. tax law that have international implications. Lastly, I will describe our current posture with respect to income tax treaties.

II. THE UNITED STATES PARTICIPATION IN INTERNATIONAL PROJECTS

Our program this week begins by focusing on Latin American issues and then broadens to include international tax issues of more general application. Let me begin my comments with reference to the last item on the program: ethical issues. I mentioned Secretary Rubin's recent trip to Latin America. He visited Argentina to chair a conference devoted to combating money laundering. The illicit drug trade emphasizes the importance of dealing with the more than \$100 billion in drug money that flows through the U.S. every year. The U.S. plans to negotiate a hemispheric Convention on Corruption and establish links between the Organization of American States and the OECD to deal with bribery. We remain very active in promoting this policy worldwide.

It is particularly appropriate to have Don Johnston, Secretary-General designate of the OECD with us. The United States is strongly committed to the various important projects of the OECD, and I would like to tell you of some recent developments related to tax issues. U.S. businessmen tell me that governmental corruption is one of the major obstacles to many foreign transactions, and I have made the tax aspects of this issue a high priority in my office. United States policy, exemplified by the Foreign Corrupt Practices Act and our tax rules, strongly discourages participation by U.S. companies in illicit payments, and we have no intention of abandoning these important principles. The United States

remains the only country in the world that criminalizes bribery of foreign government officials. We should be proud of this posture and at the same time explore all opportunities to spread this gospel worldwide. Elimination of foreign bribery should be the goal of all governments as it is counterproductive to the development of sound economies in both developing and developed countries. Through the OECD, we have taken a major step in that direction. Last month the OECD's Committee on Fiscal Affairs (the "CFA") approved a policy which would deny tax deductions for bribes of foreign officials. The United States strongly supports adoption of this policy by the OECD, as well as a policy which would criminalize foreign government illicit payments.

We were pleased to welcome Mexico to join the U.S. and Canada as Western Hemisphere OECD members. Other Latin American countries have indicated their interest in membership, and some have applied for observer status with various OECD committees.

My work in the OECD primarily involves the CFA and tax issues related to other OECD work. You may be familiar with the landmark project to achieve an international consensus with respect to substantive and procedural aspects of avoiding double taxation resulting from transfer pricing disputes. The OECD adopted an updated transfer pricing report last year. We will be privileged to hear a discussion of this report and a comparison with U.S. rules by Frances Horner, one of the architects of the OECD report, and John Nolan, a leading U.S. transfer pricing expert. The OECD is also developing a Mutual Agreement on Investment, and the CFA is coordinating the many tax issues involved in such an agreement.

III. DEVELOPMENTS IN UNITED STATES TAX LAW

Prior U.S. policy favored the granting of special tax benefits designed to encourage investment and trade with developing countries, particularly in Latin America. These rules included the Western Hemisphere Trade Corporations, special Subpart F rules, special foreign tax credit rules, and so forth. All of these have now disappeared. We have no intention of resurrecting them, primarily because they did not serve their intended purpose, but also because they are inconsistent with our long-standing tax policy favoring capital export neutrality. This policy is the best way to allocate capital across the globe. The U.S. also believes, and the economic evidence supports us, that tax holidays and related tax sparing treaty provisions are counterproductive. We believe that other assistance, such as providing sound economic advice through private, governmental and inter-governmental organizations, delineate much more productive routes to growth. The IRS' Office of Tax

Administrative Advisory Services, working in conjunction with CIAT, the Inter-American tax administration organization, has been of substantial help to Latin American tax administrators.

Treasury and IRS also remain deeply involved in continual enhancement of our effectiveness with respect to transfer pricing. Responding to the increasing need for updated tax rules, we recently published final cost-sharing regulations designed to provide a safe harbor for multinationals that desire to share technology across international boundaries.

We have imposed greater self-assessment responsibilities with respect to transfer pricing rules. As a part of that project, a penalty will be assessed on those who fail to make a reasonable attempt to price at arm's length and those who fail to create and maintain appropriate documentation. Final regulations published recently, while maintaining Treasury's insistence on compliance in this area, incorporate many taxpayer recommendations.

The OECD published its transfer pricing rules and its model income tax treaty in loose leaf editions, demonstrating the need to be sensitive to changing economic and other conditions and the need to use our experience to identify those areas in need of change. For example, we have witnessed the development of global trading techniques involving financial institutions and instruments. We are also seeing increasing globalization of international activities in other areas such as engineering and research. These developments require that we have rules flexible enough to deal with related tax aspects and that we have appropriate international procedures to deter tax evasion, as well as to eliminate double taxation. In this regard, we are fortunate to be able to hear an explanation of U.S. taxation of derivatives from David Rosenbloom tomorrow.

We can also anticipate the restructuring of the regulation of U.S. financial institutions. This will require us to revise our tax rules, which are based on relatively sharp divisions between traditional financial services—such as banking, insuring, and securities dealing—that will no longer exist.

We are examining closely technological developments which create new opportunities, such as use of the internet, that enable us to communicate and transmit data almost instantaneously and anonymously. However, not only does the internet afford the opportunity for desirable cultural, economic and other activity, it also creates possible intended or unintended opportunities for tax avoidance. The tax issues involved range from substantive policy issues, such as the source of resulting income, to tax administration problems, such as when the internet is

used to transfer funds outside of our banking systems. We remain alert to these issues and will be ever vigilant to insure that while we maintain tax toll booths on the information super highway, we do not impede the rapid flow of desirable information.

The increasingly active service sector places new demands on the substantive and procedural aspects of our tax laws. Our Advance Pricing Agreement ("APA") program has provided substantial assistance to the financial services sector, as well as to other service and manufacturing industries. We shall hear about this innovative program from its Director. I anticipate that we shall be relying more and more on other alternatives to litigation to resolve tax disputes. The IRS is testing the use of mediation in Appeals. We have put a foot in the water with respect to using arbitration to resolve international tax issues and should remain alert to other alternative dispute resolution methodologies available to resolve domestic and international tax controversies.

We appreciate the assistance provided to Treasury with respect to all of the above projects and many others by organizations, such as those represented here, in addition to the OECD, the International Fiscal Association, the American Law Institute, the American Bar Association, the Harvard International Tax Program, the New York Bar and, of course, the Florida Bar, to mention a few. We hope to learn more from these organizations and their members on how to improve our rules in this area, especially in dealing with new issues.

Please do not get the impression that information flows are always north to south. As with trade and investment, information flows along a two way street. For example, the proliferation in the United States of limited liability company laws was undoubtedly triggered by the use of long-standing civil law limited liability companies found in most Latin American jurisdictions. Treasury is now wrestling with the so-called "check the box" proposal to allow entities to elect to be taxed as corporations, which in the U.S. are subject to two levels of taxation, or as pass-through entities. The major concerns with respect to the check the box proposal center on the international area, specifically the problems presented by organizations treated as taxable by one jurisdiction and as transparent by another, the so-called hybrids. We look forward to the presentation by Mr. Burke on this subject this afternoon. Mr. Tillinghast has a most interesting and useful matrix in his paper which helps us analyze these issues, and we await his presentation.

We shall also hear discussions of tax aspects of Latin American/U.S. cross-border transactions—in both directions. Without trying to characterize Latin American tax systems too generally, there are substantial differences among them and between them and a more typical

OECD system, which I would like to describe briefly. There is a tendency to rely on non-OECD tax systems, often territorial by definition or in practice. Coordinating "asset" taxes with our foreign tax credit system has been a challenge. The trend toward eliminating reliance on non-income based taxes by several Latin American countries facilitates coordination of the two countries' tax systems and eliminates some barriers to entering negotiations for double tax agreements.

We have noted some shifts in thinking about tax conventions with developing countries, and we are working through the OECD to determine how best to identify issues of particular concern to the broad range of economies represented by non-member countries.

IV. THE UNITED STATES TAX TREATY PROGRAM

With this introduction, I would like to now turn to our tax treaty program in Latin America and in that connection discuss further some of the specific tax regimes.

We are anxious to expand our treaty program in Latin America and are encouraged by the ongoing changes in Latin American tax systems, the expansion of NAFTA, and the reformulated views regarding the efficacy of certain tax policies. I will revert to the latter issue in more detail in a few minutes.

Tax treaty expansion in this area is a high Treasury priority. First, let me give you a quick run down on where we are generally with our treaty program. Our treaty network now covers more than fifty countries, and we are working hard to keep treaties current and broaden our coverage worldwide. Five new treaties and protocols were ratified last year and are now in effect: Canada, France, Sweden, Portugal and Mexico. Treaties with Ukraine and Kazakstan are currently on hold because of concerns with respect to bank secrecy laws and their effect on the exchange of information provisions. This year we sent a protocol to the Senate for approval which would phase out the relationship with the Netherlands Antilles. We also gave notice of termination of our treaty relationships with Malta and Aruba. The notice of termination of our treaties with Aruba and Malta and the action with respect to the Netherlands Antilles signals our continued adherence to creation and maintenance of treaty relationships only when they reflect important U.S. treaty policies. The prevention of treaty shopping and the creation of broad exchange of information provisions are two of those significant U.S. treaty policies.

New treaties with Austria, Luxembourg, Switzerland, and Turkey have been initialled and should be signed shortly. We hope to complete a treaty soon with Ireland, and our negotiations with South Africa are

going well. We are also interested in expanding and updating our treaty network in the Asian Pacific Region. Within the Western Hemisphere, at the present time, we have income tax treaties with Canada, Mexico, Trinidad & Tobago, Jamaica, Barbados, and Bermuda, some of which are limited. We have information exchange agreements with many other countries. We negotiated and signed treaties many years ago with Brazil and Argentina, but were unable to bring either treaty into force. We have continued our negotiations with Argentina, Brazil and Venezuela, and have had some preliminary discussions with Chile.

Each of these countries presents a panoply of different potential obstacles that may preclude conclusion of a treaty. However, at the present time the tax systems in Bolivia, Brazil, Venezuela and Chile have at least one thing in common: they have been or are being revised, at least in part, to reflect an internationalization of their tax systems. For example, Brazil has substantially reduced its corporate tax rate very recently and adopted a worldwide taxing regime and an associated foreign tax credit system. These changes should ease problems faced by the United States and other countries desiring a tax treaty relationship with Brazil.

Let me summarize some of the major issues which we face in our treaty negotiations in Latin America.

In some cases, we are met with insistence on tax sparing provisions. As you are aware, such provisions would require the United States to give a foreign tax credit for phantom taxes which are never imposed by the treaty partner. These provisions are designed to encourage foreign investment, particularly when the treaty partner provides investment incentives through tax holidays. Our recent experience has been that more and more developing countries have turned away from such devices on the grounds that they do not work as intended. Additionally, other developed countries have not agreed to include tax sparing or have limited such provisions in their own treaties with developing countries. For example, the tax sparing provision of the new Swedish treaty with Argentina is subject to review after ten years. Many of the parties to such conventions, on both sides, find that there are substantial abuses resulting in large and unintended revenue loss without the anticipated benefits.

Territorial tax systems, still common, but on the wane, create obstacles to a bilateral convention. About half of the Latin American countries tax domestic source income only. (Incidentally, we must be careful in using the term "source" in connection with territorial tax systems, as the term is there defined to spread a much broader taxing web than in a worldwide system for which the major significance of the term may be

limited to rules designed to prevent double taxation of foreign income.) Since a territorial system only taxes income arising in the country, that country tends to see no need for a method of avoiding double taxation of income. In such cases, the question arises whether the United States should grant reduced rates of tax with respect to income which is not subject to tax in the country of residence. This issue is but a part of a much broader question. Is a territorial system sufficiently different than a system which provides exemption of certain foreign source income, such as under the French system? Should income earned by companies entitled to tax holidays receive treaty benefits? Many of these questions blend into issues involving treaty abuse and limitation of benefits.

High withholding taxes on certain types of income, combined with an extremely broad interpretation of source jurisdiction, particularly when a territorial system is in effect, create substantial obstacles to a treaty with the U.S. Such taxation creates two types of problems. First, very often the foreign tax is imposed on what is U.S. source income under our law, thereby creating a problem with respect to avoiding double taxation. Second, the broad nature of the tax system and the high rates on the consequent tax revenue, make it difficult to negotiate reductions in rates anywhere comparable to OECD standards. We have noted a trend where developing countries question the desirability of maintaining high source based taxation, but need to find alternative sources of revenue.

Many of the Latin American countries, in part because of territorial systems, have limited tax treaty networks. Apart from Brazil and Mexico, most countries have fewer than a dozen tax treaties in effect, and many of these treaties are with other Latin American countries. Also, many of them rely to a lesser extent on OECD type tax systems for significant parts of their revenues than OECD members do. Instead, there is a greater reliance on value added taxes and asset taxes.

On the positive side, we have found that treaty shopping and information exchange provisions are not substantial obstacles. In fact, many Latin American countries, particularly those which have abandoned the territorial systems, appreciate the ability to secure tax information from their treaty partners.

The very specific nature of U.S. tax law, including our treaties, requires a relatively stable tax system. Furthermore, the long lead time required to negotiate a treaty and see it come into effect, requires that we have a reasonable assurance that it will work successfully for an extended period of time without requiring modifications.

Tax reform in the United States should not discourage anyone from entering into a treaty relationship with the United States. Most reform

proposals have yet to flesh out how international income flows will be taxed. Moreover, and possibly counterintuitively, income tax treaties would still benefit many other countries, even in the unlikely event the U.S. abandons the income tax. Foreign countries may wish to encourage U.S. investment through treaty-based reductions of withholding taxes. Tax treaties also assure absence of discrimination against foreign investors.

Let me also say that the line attempted to be drawn between the OECD model for treaties between two developed countries and the United Nations model for treaties with developing countries no longer seems appropriate. This is because the economic development I mentioned earlier has blurred the distinctions between these types of countries. It is better to consider countries as lying along a continuum in their stage of development.

We were able to bring into force a treaty with Mexico in 1994 that resolves some of the problems discussed above, and I believe it works well. The mutual agreement provision of the treaty has recently helped resolve transfer pricing issues arising from changes in how Mexico taxes maquiladora operations. We have made a significant step forward with the implementation of the Mexican tax treaty and look to completing many other treaties in Latin America. We realize that tax systems and other issues differ across countries. Mexico need not be the model. There are many different forces that influence the treaty process. For example, the Mexican tax treaty played a significant role in Mexico's accession to NAFTA. A mutual interest in Chilean accession to NAFTA makes that country a logical tax treaty partner.

V. CONCLUDING REMARKS

We have an unusual opportunity here in the Americas to demonstrate how a region may coordinate its economic activities to improve the quality of life for all its people. We start with many countries with dynamic economies. Investment and trade flows do not contain the extreme peaks and valleys common in many other parts of the world. We are good friends and trusted neighbors. Our increasingly multilingual populations move us toward a better understanding of each other. The communications revolution enables us to correspond easily, inexpensively, and less troubled by differences in time zones than in most other regions of the world. Developing sound tax policies and administrations, which enable all of our countries to pay for requisite governmental functions, is key to political and economic stability. We want to assist that effort and remove any unintended tax obstacles to desirable economic opportunities in this hemisphere. I will listen closely to this

group of experts during the next two days and take back to Washington the sound advice and suggestions which I am sure I will hear.