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Tax Treaty Issues

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Tax Treaty Issues

DAVID R. TILLINGHAST*

I. THE TAX TREATY PROGRAM AT A CROSSROADS	455
II. THE WORLD OF WITHHOLDING: COMPLIANCE, THE "ADDRESS SYSTEM," CONDUIT FINANCING AND THE ENFORCEMENT OF TREATY-SHOPPING LIMITATIONS	459
III. THE APPLICATION OF INCOME TAX TREATIES TO PARTNERSHIPS AND OTHER "PASS- THROUGH" ENTITIES	467
IV. EXTENDING THE UNITED STATES TREATY PROGRAM TO LATIN AMERICA	474
V. CODA	481

I. THE TAX TREATY PROGRAM AT A CROSSROADS

There are a number of reasons why the United States' income tax treaties may soon find a place on the list of endangered species. If the Congress really means to replace the income tax with a consumption tax or something of the sort,¹ the replacement will demolish the foundation on which the U.S. treaty program is based. The potentially profound consequences of such a change must be thought through. Among these, the destruction of the mutuality of the treaties is only one, but one that could have a dramatic impact on how American companies are taxed abroad.²

Even barring such a fundamental change, the income tax treaty program faces a critical challenge: the inescapable fact that it is the tortoise in a hare-and-tortoise race that is not going to end in the way that Aesop imagined. The world economy, and the way in which international business and investment transactions are done, is evolving at a dizzying pace. By contrast, tax treaties are incredibly slow-moving creatures. They are time-consuming to negotiate and impossible to update on a regular basis. Even a single document, such as the Organization for Economic Co-operation and Development ("OECD") Model Convention, evolves only over decades.

Moreover, income tax treaties are bilateral documents attempting to survive in a thrivingly multilateral world. Apart from the fact that treaty-shopping rules do not work very well in this environment, the treaty negotiators and interpreters must try to cope with the bewildering

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1. For a succinct summary of the proposals that have been advanced, see *America's Tax Reform: A Better Way to Pay*, *ECONOMIST*, Jan. 1996, at 32-34; see also REP. NAT'L COMM'N ON ECONOMIC GROWTH AND TAX REFORM (Jan. 17, 1996), reprinted in 40 *Highlights & Doc.* 805, Jan. 18, 1996.

2. See Avi-Yonah, *The International Implications of Tax Reform*, 69 *TAX NOTES* 913 (1995).

complexities arising from the burgeoning growth of partnerships, joint ventures, "alliances", "cooperation agreements" and other arrangements that are "pass-through" entities for U.S. tax purposes, foreign tax purposes (in one or more countries) or both. Although the experts have long recognized a problem in the way in which treaties apply to such entities,³ only now is this an issue with which they have begun to wrestle.⁴

Beyond all this lie the immense difficulties produced by shifts in the nature of the world economy and the way in which economic results are achieved. The concepts embodied in the existing tax treaties (as well as in domestic law) were largely conceived in the days of a "brick-and-mortar" industrial economy.⁵ While that economy still exists, it has evolved in important ways. In addition, it has been overshadowed by the newer and more rapidly growing economy based on the technological revolution in communications and the provision of information. Rules designed to apply to the physical delivery of tangible goods or the provision of physical labor, for example, do not always work well when applied to the delivery of software or on-line services.⁶ At the same time, as we know, the use of derivative financial instruments to bundle or unbundle economic interests, synthesize securities or confer the economic equivalent of the ownership of property without actually transferring that ownership raises treaty issues that require resolution.⁷

The impact of these developments is most apparent in dealing with treaty exemptions from or reductions of withholding taxes on portfolio investment income. For more than a decade, the United States has

3. See Richard O. Loengard, Jr., *Tax Treaties, Partnerships and Partners: Exploration of a Relationship*, 29 TAX LAW. 31 (1975).

4. For a consideration of some of the issues, see AMERICAN LAW INSTITUTE, INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION II, PROPOSALS OF THE AMERICAN LAW INSTITUTE ON UNITED STATES TAX TREATIES 143-46, 245-52 (1992) [hereinafter ALI PROPOSALS]; Wm. L. Burke, *Partnerships and Income Tax Treaties*, TAX FORUM PAPER No. 504 (Dec., 1995). The international taxation of partnerships and partners was one of the subjects treated at the 49th Congress of the International Fiscal Association in Sept., 1995. See LXXXa CAHIER DE DROIT FISCAL INTERNATIONAL (1995).

5. See, e.g. Draft Double Taxation Convention on Income and Capital, OECD, Paris, 1963, which set forth many of the same provisions contained in the 1992 version of the OECD Model Tax Convention on Income and Capital (1992) [hereinafter OECD Model Convention].

6. The international taxation of computer software was one of the subjects treated at the 42d Congress of the International Fiscal Association. See LXXIIb CAHIER DE DROIT FISCAL INTERNATIONAL 36-38 (1988) (discussing application of a treaty's "permanent establishment" article to an enterprise engaged primarily in the software business).

7. See Byung Kwon Lim, *Are U.S. Tax Rules Consistent for Inbound Portfolio Investment*, 6 J. INT'L TAX 554 (1995) (discussing rules applying to loaned securities transactions and equity swaps). The international taxation of financial derivatives was the second subject treated at the 49th Congress of the International Fiscal Association. See LXXXb CAHIER DE DROIT FISCAL INTERNATIONAL (1995).

pushed forward with a determined campaign to assure that all of its income tax treaties, including those with such unlikely tax havens as China, Germany, and India, contain limitation of benefits, or "treaty-shopping", clauses. These clauses attempt to assure that treaty benefits, including withholding tax benefits, granted by the United States are unavailable to third country residents forming entities in treaty countries.⁸ Assuming that several pending renegotiations of older treaties are completed,⁹ the United States will be close to its goal.¹⁰ The question is what the effect will be when that goal is achieved.

To the extent that the result is the imposition of a thirty percent withholding tax on dividend payments,¹¹ the effect will clearly be to deter equity portfolio investment in the United States. A thirty percent gross-basis tax is excessive, and most investors will not pay it. This has been obscured by the fact that until now that rate has not actually been paid by most foreign investors.¹²

Unless other steps are taken, however, it seems more likely that the markets will react with a yawn. As discussed in more detail below, it is hardly apparent how treaty shopping rules can effectively be enforced in this context.¹³ Moreover, since interest paid on debt instruments is largely exempt,¹⁴ and gains on disposition of U.S. securities by non-resident aliens will normally also be exempt,¹⁵ the markets may simply turn to equity-flavored debt instruments such as convertibles or debt

8. Since 1981, the Senate has not approved an income tax treaty without a treaty-shopping clause. Taking heed, the Treasury has even doubled back to add treaty-shopping provisions to treaties which it had previously negotiated. See Second Protocol Amending the Convention With Respect to Taxes on Income Jan. 26, 1993, U.S.-Isr. Art. XII (adding Article 25, Limitation of Benefits, to the treaty), reprinted in 2 Tax Treaties (CCH) ¶ 4660.

9. The Treasury Department is currently renegotiating existing treaties with Austria, Ireland, Luxembourg and Switzerland. See Susan M. Lyons, *Guttentag Briefs D.C. Bar on Upcoming Treasury Guidance*, 11 TAX NOTES INT'L 966 (Oct. 9, 1995) (Statement of Joseph H. Guttentag, International Tax Counsel, Treasury Department).

10. The only major treaties which at that point will not contain some form of limitation of benefits provision will be the treaties with Japan and the United Kingdom. Other treaties without treaty-shopping clauses include those with Greece, Hungary, Iceland, Indonesia, Norway, Pakistan, the Philippines and Trinidad & Tobago. See *Tax Treaties* (CCH) ¶¶ 3403, 3803, 4003, 4303, 7003, 7307, 7503, 9703 (1995).

11. I.R.C. §§ 871(a), 881(a) (1995). Hereinafter all references to a "section" are to a section of the Code unless otherwise indicated.

12. See *infra* note 27 and accompanying text (discussion of the "address" system for determining treaty entitlement to reduced rates of withholding tax on dividends).

13. See *infra* text following note 59.

14. See I.R.C. §§ 871(h), 881(c) (1994) (portfolio interest exemption); 871(i)(2)(A) (1994) (exemption of interest on bank deposits); 871(g)(1)(B)(i), 881(e) (1994) (exemption of discount on short-term instruments).

15. Gain from the sale or exchange of property is not fixed or determinable annual or periodical income subject to withholding tax. Treas. Reg. § 1.1441-2(a)(3) (1995).

with a stock-indexed principal amount.¹⁶ Even beyond this, so long as payments on derivative instruments, such as equity swaps, are not subject to withholding tax,¹⁷ the market will provide foreign investors with the returns they desire without reliance on treaties. If the United States really wants to enforce a thirty percent withholding tax on dividends, it has some distance to go; if it does not, then its efforts to date have created a lot of treaty superstructure for naught.

As if the foregoing were not enough, the treaty program also faces the issues raised by the attempt to extend the network to developing countries,¹⁸ thereby reviving in a new era the importance of issues left unresolved in the old—for instance, the “tax-sparing” issue, the framing of reasonable bargains with countries which tax income only on a territorial basis, and the implications of cases in which substantial withholding taxes are imposed on services furnished to residents of a country even when those services are performed in the United States.¹⁹

This is, to say the least, a daunting array of challenges. It remains to be seen how well they can be met. There is no reason to believe that the United States will or should simply throw up its hands and decide that treaties are not worth having. But in the next century, if not in this one, they may go the way of the dinosaur unless a major effort is made to rethink and reformulate their terms. This is not an effort that the United States can make alone. Thus, to an already imposing list of tasks must be added the task of persuading other countries that the time has come to take action. At a minimum, a quantum leap in the resources devoted to modernizing the OECD Model Convention²⁰ or, better yet, the development of a multilateral convention. For example, the sophisticated technicians in the finance ministries of our major trading partners and on the staff of the Committee on Fiscal Affairs of the OECD are aware of the problems and are no doubt anxious to resolve them. However, whether governments can be made to take these matters seriously—and whether the private sector even wants to see them addressed—is another question.

16. See Lim, *supra* note 7, at 560.

17. *Id.* at 561-62.

18. Such countries are primarily in Latin America, but are also in Eastern Europe and elsewhere.

19. See discussion *infra* note 91 and accompanying text.

20. OECD Model Convention, *reprinted in* Tax Treaties (CCH) ¶ 191.

II. THE WORLD OF WITHHOLDING: COMPLIANCE, THE "ADDRESS SYSTEM," CONDUIT FINANCING AND THE ENFORCEMENT OF TREATY-SHOPPING LIMITATIONS

A common feature of income tax treaties is that they reduce or eliminate the statutory withholding tax of thirty percent imposed on various kinds of investment flows, including dividends, interest, and royalties.²¹ From the investor's point of view, the statutory rate of withholding tax is intolerably high. As a result, it is critical, if not essential, to qualify for treaty relief, and almost as critical to be assured that the relief will not be long delayed (since delayed cash flow reduces the rate of return). On the other hand, the tax administrator is concerned with ensuring that treaty benefits are extended only to those entitled to them. The tension between these diametrically opposing pulls has proved extraordinarily difficult—indeed, so far impossible—for the United States to resolve.

There are basically four ways to determine whether an investor is entitled to claim the benefit of a treaty withholding tax provision. The first is a refund system;²² the payor of an income item withholds at the full statutory rate, and the investor applies for a refund. The second is a "pre-certification" system;²³ this requires the investor to procure and furnish to the payor a certification by the appropriate tax authority of such investor's tax status in the treaty country (e.g., that he or she is a tax resident there). The third method is what may be termed a "self-certification" system,²⁴ under which the investor supplies the payor with a sworn statement that he or she qualifies for the treaty withholding tax benefit involved. Finally, there is what might be dubbed a "self-executing" system²⁵ under which treaty rates automatically apply to specified payments.

The United States now employs the "self-certification" system for determining withholding tax on all withholdable payments other than dividends.²⁶ For dividends, the United States utilizes the "address" system, under which a withholding agent is entitled to assume that a divi-

21. See United States Treasury Department, Model Income Tax Treaty of June 16, 1981, Arts. 10, 11, 12 [hereinafter Treasury Department Model Convention], *reprinted in* Tax Treaties (CCH) ¶ 211.

22. See *infra* note 28 and accompanying text.

23. This system is used, for example, by the Danish taxing authorities in providing the reduced withholding tax on dividends under Article VI of the Income Tax Treaty between Denmark and the United States.

24. See *infra* note 26 and accompanying text.

25. See *infra* note 27 and accompanying text.

26. Treas. Reg. § 1.1441-6 (1995). See INTERNATIONAL TAX EVASION/TAX TREATY ISSUES, 100th Cong., 1st Sess. 109-10 (1987) (Statement of Commissioner of Internal Revenue, Lawrence Gibbs) [hereinafter *Gibbs Statement*].

dend qualifies for treaty withholding tax relief if it is paid to an address located in the treaty country.²⁷

The "address" system is obviously not only lax but irrational. Fraud aside, everyone knows that in the ordinary course of business affairs huge amounts of dividends are paid to banks and brokers for the account of their customers, who are frequently not residents of the country in which the account is maintained.

The "self-certification" system is better only in the sense that, in order to claim a treaty benefit to which the investor is not entitled, someone must file a false (or at least inaccurate) sworn statement. The IRS has, however, no way to substantiate the claimed entitlement.

The "pre-certification" system gives some, though hardly complete, comfort that treaty entitlement exists. However, it is time-consuming and in some cases extremely difficult to operate. Withholding on portfolio investment flows is, after all, a volume business. The lion's share of the payments pass through financial intermediaries, and even a single bank or broker may be collecting payments for thousands of clients. It is at least doubtful whether foreign tax authorities will be capable of making such certifications on a broad scale or whether they will have the resources to devote to the task. Getting just one or two treaty countries to do the job is not enough since funds will then be routed through other treaty countries. Under these circumstances, no country is going to clamor to undertake this task.

The refund system is actually used by some countries.²⁸ It may be more or less workable depending, first, on the speed with which refund claims are processed and second, on the stringency with which the claims are examined.

The U.S. Experience. Almost twenty years ago, Jerome Kurtz, then Commissioner of Internal Revenue, proposed that the withholding regulations be amended to abandon self-certifications and to adopt a refund system.²⁹ In 1982, the Congress, distressed that the Treasury Department had failed to adopt Commissioner Kurtz's proposal and that U.S. withholding procedures continued to be lax, instructed the IRS and Treasury to replace the existing procedures with new and more effective regulations.³⁰ We are still waiting for them.

It is not that the IRS and Treasury have not tried; the problem is

27. Treas. Reg. § 1.1441-3(b)(3) (1995).

28. Most notably Germany. See *Taxation of Corporations in European Countries*, Germany § 6.4 note 1, in SUPPLEMENTARY SERVICE TO EUROPEAN TAXATION (INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION 1995).

29. See *Gibbs Statement*, *supra* note 26, at 110.

30. See Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 342, 96 Stat. 635 (1982).

that in the real world there are major constraints on what can be done. While the IRS would like to police entitlement to treaty benefits effectively, it has limited resources to apply to the task. At the same time, the private sector has made it clear that any procedures that mandate unreasonable compliance efforts or measurably delay the receipt of investment returns will chill investment in the United States.³¹ This makes the Treasury Department blink. In any case, compliance is complicated by the fact that investment flows frequently pass through the hands of several nominees or intermediaries on the way to their ultimate owners, and even identifying these owners may be a task of considerable difficulty.³²

The fundamental issue is whether there is any substantiation of claims to treaty benefits; if so, this must be done either by the IRS or by a foreign tax authority. There is very little that the U.S. payor, the withholding agent, can be asked to do. It can be asked to verify that it has received any documentation that the regulations prescribe, such as certifications, and that these are formally correct. However, absent actual knowledge of the facts, which it will rarely have, the U.S. payor will not be in a position to verify the substance of the claim of treaty entitlement. Moreover, if the withholding agent is in doubt, it will generally withhold at the full statutory rate, since it can have liability if it fails to withhold what it should have.³³

Commissioner Kurtz proposed a system under which refunds of withheld tax would be made to foreign investors as part of the IRS' general refund procedures, under which refunds are made after annual returns are filed.³⁴ However, the private sector persuaded the Treasury that investors could not be asked to wait up to a year or more for their money.³⁵ The Treasury came up with a counter-proposal for a "quickie" refund procedure, under which refunds of withheld taxes would have been made within ninety days of the withholding.³⁶ The markets were not enthusiastic about this proposal either; and it would have required the IRS to devise and install an entirely new refund system, which was estimated to require five years of effort and millions of dollars of expense.³⁷

In 1984, in response to the Congressional charge to develop new

31. See INTERNATIONAL TAX EVASION/TAX TREATY ISSUES, 100th Cong., 1st Sess. 6-7 (statement of Acting Assistant Secretary of the Treasury for Tax Policy, O. Donaldson Chapoton) (1987) [hereinafter *Chapoton Statement*].

32. See *Gibbs Statement*, *supra* note 26, at 111-12.

33. I.R.C. § 1461 (1994).

34. See *Gibbs Statement*, *supra* note 26, at 110.

35. See *Chapoton Statement*, *supra* note 31, at 7.

36. See *Gibbs Statement*, *supra* note 26, at 112-13; *Chapoton Statement*, *supra* note 31, at 7.

37. See *Gibbs Statement*, *supra* note 26, at 113; *Chapoton Statement*, *supra* note 31, at 7-8.

rules, the IRS proposed new regulations calling for a "pre-certification" procedure, under which the tax authorities of treaty partners would provide certificates attesting that investors who claimed to be residents under the treaty were paying taxes as residents. This was to be backstopped by a "refund with certification" system for those who did or could not get their paper work done on time.³⁸ In the subsequent hearings, both the investment community and the United States' treaty partners made it clear that such a system was both unworkable and unacceptable. Foreign governments pleaded that they neither had the resources to commit to the task nor the appetite for undertaking it. The financial community emphasized the difficulty of processing the necessary paperwork through the layers of intermediaries that would inevitably be involved.³⁹ As a result, the proposed regulations were simply frozen; the IRS and the Treasury, having given it a college try, apparently decided there was nothing more that they could do.

The inadequacies of the existing system have not disappeared, however, and now the IRS and the Treasury are looking at the problem again. It is interesting to speculate about what they will come up with. It is hard to believe that the proposals rejected earlier—the refund system and the pre-certification system—are suddenly going to appear more feasible than they did before, at least for the broad range of transactions. But there are some changes that might be contemplated. While they represent only a relatively small part of the problem, royalties may be somewhat easier to handle than other payments; in typical cases, they are paid under ongoing agreements between parties that know each other. Some form of certification or substantiation seems more feasible for these than for the more volatile flows, such as dividends. Of course, at the present time, interest paid to foreign persons is essentially exempt except in the case of related party payments;⁴⁰ and as to the latter, as well as dividends paid from U.S. corporations to parent corporations or other direct investors, imposing more stringent requirements on withholding agents may be feasible. Even with respect to dividends, at least the "address" method could be abandoned. A self-certification from an interested party is not much, but at least it can provide the basis for imposing criminal and other penalties in cases where for some reason the real facts come to light.

Conduit Financing Arrangements. Up to this point, the discussion has been directed to the simplest of the issues involved in whether treaty

38. Prop. Treas. Reg. § 1.1441-6, 49 Fed. Reg. 35513 (1984).

39. See *Gibbs Statement*, *supra* note 26, at 111-12; *Chapoton Statement*, *supra* note 31, at 6-7.

40. See *supra* note 14.

benefits apply to the determination of withholding tax rates—whether the “beneficial owner” of a payment is a tax resident of the treaty country involved. However, there are now additional rules to be policed. These include most prominently the “conduit financing” regulations promulgated by the IRS under the authority of section 7701(l) of the Internal Revenue Code,⁴¹ as well as the treaty-shopping limitations now built into most U.S. income tax treaties.

Under the “conduit financing” regulations, if a person or entity (an “intermediate” entity) resident in a treaty country (and for the purpose of this discussion fully entitled to the benefits of the applicable treaty) enters into a “financing transaction”⁴² with a U.S. person (a “financed entity”) but that transaction is part of a “financing arrangement”⁴³ involving a second, related “financing transaction” between the treaty person and a third party (a “financing entity”) resident in a country to which the same treaty benefits do not apply, the IRS may ignore the intermediary and impose withholding tax as if the payments made by the U.S. person had been made directly to the third party. This will be done only if the District Director, exercising broad discretion, determines that there is a “financing arrangement” and that the “financing arrangement” has as one of its principal purposes the reduction of U.S. withholding tax.⁴⁴ Special provisions are included which are designed to permit bona fide group finance companies to operate so long as they take financial risk and have managerial and operational substance.⁴⁵

Back-to-back loans are the obvious principal targets of these rules, although they reach a broader range of transactions.⁴⁶ While the rules apply in many cases in which all of the parties to the “financing arrangement” are related, they may also apply in cases where one of the three participating entities is not related to the other two.

The Treasury Department and the IRS have made it clear that they will keep an eye on whether the scope of these regulations needs to be broadened.⁴⁷ For now, at least, they apply only for the purpose of determining the rate of withholding tax imposed on outbound payments to

41. Treas. Reg. §§ 1.881-3; 1.1441-6(j) (1995).

42. A term defined in Treas. Reg. § 1.881-3(a)(2)(ii) (1995).

43. A term defined in Treas. Reg. § 1.881-3(a)(2)(i) (1995).

44. Treas. Reg. § 1.881-3(a)(3) (1995).

45. Treas. Reg. § 1.881-3(c)(3) (1995). For a recent discussion of these regulations, see Michael Hirschfeld, *Final Regs. Refine Rules on Abusive Conduit Financing*, 6 J. INT'L TAX. 484 (1995).

46. The definition of “financing transaction” includes advances, leases, licenses and a limited class of redeemable stock transactions. Treas. Reg. § 1.881-3(a)(2)(ii) (1995).

47. See, e.g., *Culbertson Briefs D.C. Bar on Conduit Regulations, Transfer Pricing*, 35 HIGHLIGHTS & DOC. 681-82 (Oct. 18, 1994).

foreign persons.⁴⁸

The U.S. government is clear in its own mind that applying those regulations, no doubt worthily designed to prevent abusive tax avoidance schemes, involves no violation of the treaties which apply to the intermediate financing parties in the proscribed "financing arrangements."⁴⁹ Its pronouncements emphasize the intention that treaty benefits be granted only for transactions the substance of which accords with its form.⁵⁰ Whether this position is correct is largely academic; the regulations will be enforced and even if they override the affected treaties they probably represent controlling "later law."⁵¹

It is worth noting in passing, however, that the U.S. position is hardly unassailable. A court approaching the issue of treaty entitlement in the same way that the Tax Court did in *Aiken Industries*⁵² would look, in this case in vain, for some language in the treaty itself which would sanction the withdrawal of treaty benefits. Particularly in those treaties which embody express treaty-shopping ("limitation of benefits") clauses which would not touch the transactions involved,⁵³ express treaty sanction is hard to find. At least one responsible commentator has concluded that the regulations are inconsistent with the treaties.⁵⁴

Of importance in the context of this discussion is the way in which the "conduit financing" regulations deal with the various parties' liability for withholding tax. Obviously, an entity can enter into a loan or other financing transaction without having any idea that it may be related to another transaction in such a way that it is part of a "financing arrangement" subject to recharacterization under the regulations. Such a

48. Treas. Reg. § 1.881-3(a)(1) (1995).

49. See Treas. Reg. § 1.881-3(d)(3) (1995); Prop. Treas. Reg. § 1.881-3, 59 Fed. Reg. 52110, 52112 (1994) (Preamble).

50. Prop. Treas. Reg. § 1.881-3, 59 Fed. Reg. 52110, 52112 (1994) (Preamble).

51. Although treaties constitute the law of the land, a later enacted statute will prevail over a contrary provision of a pre-existing treaty. See ALI PROPOSALS, *supra* note 4, at 63-72. Since § 7701(l) expressly authorizes the "anti-conduit" regulations, they presumably have the same force.

52. *Aiken Indus., Inc. v. Commissioner*, 56 T.C. 925 (1971), *acq.* 1972-1 C.B.

53. One of the rules frequently embodied in limitation of benefits or "treaty-shopping" provisions would deny benefits to an otherwise qualified treaty country entity if 50% or more of its gross income is used to make deductible payments to persons resident in third countries. See, e.g., Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes, Aug. 29, 1989, U.S.-F.R.G. Art. 28 ¶ 1(e)(aa), *reprinted in* Tax Treaties (CCH) ¶ 3249.57 [hereinafter *German Treaty*]. A financing arrangement which is subject to the regulations need not, of course, involve interest payments which are this large in relation to the gross income of the intermediate entity. Even if that entity failed to qualify under the cited "treaty-shopping" rule, it might qualify under another.

54. See HOW DOMESTIC ANTI-AVOIDANCE RULES AFFECT DOUBLE TAXATION CONVENTIONS: PROCEEDINGS OF SEMINAR HELD AT THE 48TH CONGRESS OF THE INTERNATIONAL FISCAL ASSOCIATION 47-50 (Kluwer 1995) (views of Stanley Katz).

case presents obvious difficulties in imposing tax on that entity. If an entity is aware that there are related financing transactions, withholding may be required even if there may be some question whether the two may be related in such a way as to constitute a "financing arrangement" and without regard to the fact that the determination whether there was a tax avoidance purpose for the transactions will be made only on audit, which may be years away.

In recognition of these difficulties, the regulations impose liability for withholding tax on an entity participating in such an arrangement only if it "knows or has reason to know" that the financing arrangement is subject to recharacterization under the regulations.⁵⁵ Thus, if, for example, a U.S. financed entity makes a payment to an intermediate entity in a treaty country, it may withhold tax from the payment at the prescribed treaty rate unless it "knew or had reason to know". As another example, if a bank in a non-treaty country lends money to a finance company in a treaty country, which in turn lends money to a related U.S. corporation, the bank will not have liability for tax under section 881, unless it "knows or has reason to know" that a prescribed "financing arrangement" is involved.⁵⁶ This does not, however, relieve the U.S. financed entity from liability for collecting withholding tax under the withholding provisions.⁵⁷ Until now, the basic concept has been that the tax is imposed under section 871 or 881 on the foreign taxpayer and that withholding is merely a collection device.⁵⁸ Here, however, the two concepts have been divorced. For example, a U.S. person can have liability to pay a withholding a tax under section 1442 for which no liability exists under section 881. The literal language of the statute may support this result,⁵⁹ but it is certainly novel.

Enforcing Treaty-Shopping Rules. The tenacity with which the United States has pursued the objective of assuring that limitation of benefits, or treaty-shopping, clauses are included in all U.S. income tax treaties is well known. What started some fifteen years ago as an attempt to include generalized anti-avoidance rules in treaties with tax havens⁶⁰ has developed by inevitable political process into an inflexible U.S. demand in the negotiation of any treaty.

55. Treas. Reg. §§ 1.881-3(c)(4)(ii), 1.1441-6(j) (1994).

56. For a discussion of several examples set forth in the regulations, see Hirschfeld, *supra* note 45, at 491-92.

57. Treas. Reg. § 1.881-3(c)(4)(ii) (1994).

58. See I.R.C. § 1462 (1994) (withheld tax a credit against the liability of the recipient for tax under § 871 or § 881(a)).

59. I.R.C. § 1441(a) (1995) provides that a withholding agent shall "deduct and withhold . . . a tax . . ." but does not refer specifically to § 871(a) or § 881(a).

60. See ALI PROPOSALS, *supra* note 4, at 150-52.

The focus here will not be on the merits of those rules as a matter of substance but on their enforceability—or, rather, their unenforceability. Those of you who are familiar with them, and perhaps in particular the *reductio ad absurdum* represented by the countless rules embodied in the treaty with the Netherlands,⁶¹ appreciate that it is often an extremely difficult, expensive and time-consuming task for a company acting in the best of faith to determine whether it is, in the technical phrase, a “qualified treaty resident”. If the determination can indeed be made at a given time, it is even more difficult to determine how long that qualification may last, since often it will depend upon factors not within management’s control—for example, change in the ownership (or the residence of the owners) of non-traded stock,⁶² the location, volume and frequency of the trading of publicly-held stock,⁶³ or the shares of a global business carried on by group companies located in different countries.⁶⁴

Even more difficult to determine is how the IRS can enforce those treaty benefit limitations. To be sure, some cases may be easier to deal with than others. For example, a foreign business that claims the benefits of the permanent establishment provision of a treaty may be required to disclose this reliance,⁶⁵ and its claim may be audited like any other. Similarly, a foreign direct investor in a U.S. corporation may also be subject to audit. But in the case of portfolio investors, there is simply no way for the IRS to enforce treaty-shopping limitations.

It is fanciful to expect foreign tax authorities to commit the resources which would be required to administer a certification system. Here again, in principle, self-certifications could be required. For example, the IRS might permit a U.S. payor to withhold at a reduced rate on dividends paid to a recipient in a treaty country upon receiving from that

61. Income Tax Treaty, Dec. 18, 1992, U.S.-Neth. Art. 26, reprinted in Tax Treaties (CCH) ¶ 6103 [hereinafter *Dutch Treaty*]; Understanding Regarding Income Tax Treaty, Dec. 18, 1992, Neth.-U.S. Art. X-XXV, reprinted in Tax Treaties (CCH) ¶ 6113 [hereinafter *Understanding*].

62. See, e.g., *Dutch Treaty*, supra note 61, at Art. 26, ¶ 1(d) (more than 50% ownership by qualified residents of the Netherlands), ¶ 1(c)(iii) (more than 30% ownership by publicly traded Dutch companies and more than 70% ownership by residents of the United States or the European Communities), ¶ 4(a) (similar rule with respect to dividends, interest and royalty income).

63. Under Article 26, ¶ 1(c)(i) of the Dutch Treaty, a company may be qualified if its principal class of shares is actively traded. See *Dutch Treaty*, supra note 61, at Art. 26 ¶ 1(c)(i). Complex rules determining whether stock is actively traded are set forth in Art. 26, ¶ 8 and Arts. XI and XXII of the Understanding. See *Understanding*, supra note 61, at Arts. XI, XXII.

64. Under Article 26, ¶ 3 of the Dutch Treaty, a company can qualify if it is a headquarter company of a multinational corporate group. *Dutch Treaty*, supra note 61, at Art. 26, ¶ 3. Among other things, this requires that the corporate group consist of companies in at least five countries in each of which at least 10% of the gross income of the group is generated and that less than 50% of the gross income of the group be generated in any one country.

65. See I.R.C. § 6114 (1994); Treas. Reg. § 301.6114-1(b)(5)(i) (1988).

recipient either (i) a certification that the recipient is the beneficial owner of the dividend and a qualified treaty resident, or (ii) an undertaking by the recipient to pay over the amount of the reduced withholding to the Treasury unless it obtains, within a specified period, a certification from the beneficial owner that such owner is a qualified resident of the treaty country, or of another country with which the United States has a treaty providing for the same reduced rate of withholding tax.

The problem with such a solution is that it would clearly drive investors away from responsible financial intermediaries, which might conceivably be compliant, into the hands of those which clearly will not. Since funds can quickly and easily (electronically) be passed through the accounts of any number of intermediaries, investors will not suffer for access to the best investment advice if they want it.

Conclusion. A simple conclusion emerges from this whole thicket of possibly unanswerable questions: in this area (as in others) the United States has indulged its penchant for writing complicated prescriptive rules without regard to whether they are enforceable. This serves only to penalize the conscientious and reward the unscrupulous. A better way to approach this problem would be to adopt more sensible rules. An across-the-board fifteen percent withholding rate on dividends, for example—and confine the instances in which these are altered by treaty to those in which some sort of enforcement seems feasible.

In the discussion that follows, we will examine some of the extreme difficulties which arise in applying income tax treaties when income sourced in the United States is derived through a foreign entity which is a “pass-through” for tax purposes. Many of these stem from “third country” participation in the entity. At least in the case of applying withholding taxes, the solution to these problems may lie in the same direction—towards a greater uniformity in the rates of withholding to be applied.

III. THE APPLICATION OF INCOME TAX TREATIES TO PARTNERSHIPS AND OTHER “PASS-THROUGH” ENTITIES

As suggested above, more and more international transactions are being undertaken through entities that are partnerships or otherwise are treated as “pass-through” entities for U.S. and/or foreign tax purposes. This has raised difficult questions as to how these entities should be treated for purposes of income tax treaties. In particular, it is difficult to determine when the availability of treaty benefits should be based on the residence of the partnership and when it should be based on the residence of the individual partners.

The treatment of partnerships under existing treaties is spotty.⁶⁶ In some of the older treaties, partnerships are ignored. Many of the newer treaties adopt a definition of treaty country resident that, although the language varies from treaty to treaty, basically provides that the term resident will include: (i) a treaty country corporation; (ii) and any other person that is subject to tax in the treaty country by reason of residence; but (iii) "in the case of income derived . . . by a partnership . . . , this term applies only to the extent that the income derived by such partnership . . . is subject to tax in [the treaty country] as income of a resident, either in its hands or in the hands of its partners. . . ."⁶⁷

In addition, the availability of treaty benefits under most treaties is made subject to a treaty-shopping provision. These provisions also appear to apply to partnerships. However, the formulation of this provision is often inconsistent with the resident definition even in the same treaty.⁶⁸

Some of the difficulties of applying existing treaties to partnerships and other pass-through entities stem from the particular language used in the drafting.⁶⁹ This is the least of the problems, however. The fact is that it is virtually impossible to grasp all of the substantive issues which "pass-through" entities present, much less to understand how they might appropriately be resolved.

The number of variables that have to be taken into account is mind-boggling. At least in many cases, three or more taxing jurisdictions may be involved: the country in which income is sourced, the country in which the entity is located, and one or more third countries in which one or more participants in the equity of the entity (partners) are resident. The entity may be treated as a "pass-through" by all of these jurisdictions or only by one or two. The third countries involved may or may not have treaties with the United States. If one thinks of a partnership—such as an investment partnership, for example—having dozens of partners, the complexities can become overwhelming. For example, one German participant in the recent International Fiscal Association Congress referred to a case in which foreign-sourced royalties were received by a German partnership having in excess of 400 partners.

As a general framework for discussion, consider the following

66. See Committee on Taxation of International Transactions, *United States Tax Treatment of Partnerships and Partners under Income Tax Treaties*, 50 REC. ASS'N B. CITY N.Y. 773 (1995) [hereinafter CITY BAR REPORT].

67. The quoted language appears in paragraph 1(b) of Article 4 of the Treasury Department Model Convention, *supra* note 21, at Art. 4, ¶ 1(b). For a detailed discussion of the language used in various treaties, see CITY BAR REPORT, *supra* note 66, at 779-95.

68. See CITY BAR REPORT, *supra* note 66, at 801-03, 805.

69. *Id.* at 795-96.

chart. A "P" indicates that the country concerned treats the entity under consideration as a pass-through; an "E" indicates that the country taxes it as an entity. The chart refers to one third country, in which a participant is resident. Of course, in actuality, there may be many of these, they may characterize the situation differently, and they may or may not have treaties with the source country and the country in which the entity is resident.

<i>Source Country</i>	<i>Entity Country</i>	<i>Third Country</i>
P	P	P
P	P	E
P	E	E
P	E	P
E	P	P
E	P	E
E	E	P

Perhaps the only way to tackle such a complex subject is to try to create building blocks, taking simple cases first and seeing how far the analysis can go.

Case 1: Two Countries; Pass-Through Treatment in Both. The plain vanilla case is one in which, let us say: (i) there is an entity resident in a treaty country (the residence country); (ii) all of the participants are also residents of that country; (iii) it derives income from the other country (the source country); and (iv) both countries treat the entity as a "pass-through." It seems clear that in this case, each partner should be regarded as the treaty country resident entitled to claim the benefits of the treaty, since that is the person subject to tax in both the source and in the residence country. There is no occasion to apply "treaty-shopping" concepts, unless one or more of the partners is an entity, in which case the concepts should be applied to that entity.⁷⁰

Case 2: Two Countries; Pass-Through in Source Country; Entity Tax in Residence Country. Suppose, however, that the same entity is not treated as a "pass-through" in the residence country, although it is treated as a partnership in the source country.⁷¹ In this case, it would make sense to treat the entity as a resident of the residence country for purposes of allowing it to claim the benefits of the treaty. The double

70. For this purpose, the income of the entity and the amounts of deductible payments made by it to residents of third countries for purposes of applying the treaty-shopping rules would include its share of the income derived and payments made by the partnership. See Understanding Regarding the Scope of the Limitations on Benefits Article in the Convention Between the Federal Republic of Germany and the United States, U.S.-F.R.G., Example V, *reprinted in Tax Treaties (CCH)* ¶ 3252.

71. See ALI PROPOSALS, *supra* note 4, at 247-48.

tax to be relieved is the entity-level tax imposed in the treaty country, just as it would be if the source country also regarded the entity as a taxable entity. If the United States were the residence country, it could presumably agree to give the entity a foreign tax credit for taxes imposed in the source country. The entitlement could be given even if, under domestic law concepts, the taxes may have been imposed on the participants or partners.⁷² On the other hand, under U.S. concepts, a treaty cannot impose a tax that is not imposed by the Code.⁷³ As a result, if the United States were the source country, it could not collect a tax which it would not collect from the individual partners. On these simple facts, this should not normally be a problem.⁷⁴

The fun begins when one posits that among the participants in the entity are two, one of whom is a resident of a third country with which the source country has a treaty (with terms that differ from the terms of the treaty with the country in which the entity is resident) and the other of whom is a resident of a third country with which the source country does not have a treaty.

Case 3: Three Countries; Pass-Through Treatment in All. To take again the simplest case, suppose that all of the countries involved treat the entity as a "pass-through." In this case, one's first reaction is to say that the source country would apply its tax separately to each participant's (partner's) share of the entity's income. As to the income accruing to the partner whose country has no treaty with the source country, the source country would apply its domestic law. The income accruing to the third-country participant whose country has a treaty with the source country would be taxed in accordance with that treaty. This appears to be the result contemplated by the Memoranda of Understanding entered into by the United State in connection with its treaties with Germany and Finland.⁷⁵

Two reservations may be entered, however. As applied to withholding taxes on investment income, the complexities involved could be extreme. Again positing an investment partnership with dozens, if not hundreds, of partners, it would be necessary to ascertain the shares of each in the partnership's income and then to identify the

72. *Id.* at 248.

73. *Id.* at 80-82.

74. If, however, the rate of tax on corporations is higher than on individuals or if on the same facts the taxable income of a corporation would be computed to be more than that of an individual, the individuals might have a valid claim to pay the lesser tax computed under the Code rules. This situation could presumably arise only when the foreign entity is engaged in business in the United States through a permanent establishment and is therefore subject to net income tax. A provision could be made to allow the entity, or the participant involved, to claim the reduced rate on a properly filed return.

75. See CITY BAR REPORT, *supra* note 66, at 793.

treaty rates (or statutory rate) applicable to each share. Presumably, each partner resident in a treaty country (or the partnership on behalf of those partners) would have to file whatever form of certification the source country requires in order to permit reduced withholding. To say the least, this could get messy.

It is also not clear that disregarding the entity is the correct answer when applying the articles of a treaty not relating to investment income—such as the permanent establishment and business profits articles or the non-discrimination article. At least when the entity is engaged in an active business in the country in which it is resident, it has a real economic presence there and contributes to that country's economy.⁷⁶ Moreover, at least in the United States, applying the statutory "doing business" rule to some of the entity's income, while applying a number of disparate permanent establishment articles, perhaps, to other income shares again introduces substantial complexity. Perhaps a rule could be developed, similar to the rule used in the treaty-shopping articles, under which an entity engaged in an active business in its country of residence would be considered an enterprise entitled to treatment of its business profits under that country's treaty, regardless of the residence of its participants.⁷⁷

Case 4: Three Countries; Entity Tax in its Country. Now consider the case in which the same entity is taxable as an entity in its country of residence, while being treated as a "pass-through" in the country of source.⁷⁸ As concluded above, it seems sensible for the source country to treat the entity in the same way it treats a residence country corporation. The question is what treatment is accorded to the third country participants.

First, consider the participant resident in a country with which the source country does not have a treaty. Under its domestic law, the source country would impose a tax on that person's share of the entity's income. Under the proposal made above, however, the source country, in deference to the entity tax imposed in the country of the entity's residence, will extend treaty relief to this income, as it would if the entity were a corporation. If the source country retains its right to tax a portion of the entity's income which accrues to the benefit of a non-treaty participant, there will be an entity-level conflict (not to mention another question of identification to be solved). On the other hand, is it appropriate for the source country to conclude a bargain with the entity's

76. See Burke, *supra* note 4, at 28.

77. See, e.g., *German Treaty*, *supra* note 53, at Art. 28, ¶ 1(c) (qualifying certain companies engaged in the active conduct of a trade or business in the residence country).

78. See ALI PROPOSALS, *supra* note 4, at 247-48.

country which reduces the tax that under its domestic law the source country would impose on a resident of a third country?⁷⁹

Second, consider the participant resident in a third country with which the source country has a treaty. Suppose that that country, as well as the source country, treats the entity as a "pass-through" (although it is still taxed as an entity in its country of residence). That country would expect the source country to apply the provisions of its treaty—to reduce withholding tax on that participant's share of the entity's income, for example. If this is done, however, the benefit may accrue to the country in which the entity is resident, if that country applies a foreign tax credit system to the income involved.

Accordingly, if any treaty relief is to be given by the source country under its treaty with the country in which the participant is resident, this should be predicated on the country in which the entity is resident first agreeing by treaty with the participant's country to forego entity level tax on the participant's share of the entity's income (a highly unlikely possibility). Otherwise, the situation is basically the same as if the entity were a taxable corporation.

Let us now turn to cases in which the entity is considered a taxable entity in the source country.

Case 5: Entity Treatment in Source Country; Pass-Through Treatment in Others. First, consider the case in which the country of the entity's residence and a third country in which a participant is resident consider the entity to be a pass-through. A glib answer would be to require the source country in this case to follow the characterization of the entity's country. It would then impose tax as if each of the participants in the entity had directly received its share of the entity's income. Such a result seems overly intrusive into the jurisdiction of the source country.⁸⁰

If it regards an entity as a taxable object and that entity engages in business in the source country, it may (as in the case of the United States) expect to collect a corporate tax and a second layer of tax on the distribution of earnings (in the case of the United States a branch profits tax).⁸¹ Since the rules applied in the country of the entity's residence are not inherently superior to those applied at the source, the source country may understandably balk at giving up its corporate-level tax; it would

79. The only alternative would be to contemplate a provision in a treaty between the third country and the entity's country, eliminating the entity-level tax on the third-country resident's share of the income of the entity derived from the source country. There may be no such treaty; and in any event, as indicated in the text, it seems unlikely that the entity's country would agree to such a provision.

80. See ALI PROPOSALS, *supra* note 4, at 249.

81. See I.R.C. § 884 (1995).

seem anomalous for a source country to tax a foreign entity or not depending on the treatment of that entity in another country.⁸²

As to withholding taxes or the branch tax, it would seem appropriate for the source country to treat the participants in the entity as the owners of a corporation resident in the country of the entity's residence. For example, in the United States, this may entitle the entity to claim a reduction in the branch profits tax.⁸³ This reduction will redound to the benefit of participants resident in third countries. However, since the tax is imposed on the entity and would arise from activities carried on by the entity in the United States,⁸⁴ this may be appropriate. The alternative would be to provide in treaties that a resident of the treaty country that participates in a foreign entity that is a corporation for U.S. tax purposes but a pass-through in its country of residence is entitled to a reduction in such resident's pro rata share of the branch tax which corresponds to the reduction in withholding tax that would be applied if the entity were a U.S. corporation.

Case 6: Entity Treatment in Source Country and Third Country; Pass-Through in Entity's Country. This case is identical to Case Five, with the exception that the third country in which a participant is resident considers the entity not to be a pass-through entity. In this case, the third country is not imposing tax directly on the participant; and therefore, it is not apparent why that participant should receive any treaty relief from the source country.

Case 7: Entity Treatment in Source Country and Country of Entity's Residence; Pass-Through in Third Country. In this case, no conflict arises between the source country and the country of the entity's residence, since they agree that it is a taxable entity. It would not generally seem appropriate for the source country to give treaty relief to the third country participant with respect to withholding or branch taxes, since this affects the taxability of the entity in its country of residence.

More. Whether or not the foregoing discussion helps in resolving how partnerships and pass-through entities should be treated for income tax treaty purposes, it should have been persuasive that the problem is one that will require great effort and ingenuity to resolve. This conclusion would be even more forcefully driven home if the discussion continued to consider a whole range of additional problems that will not be discussed here. These relate to the double taxation relief that should

82. See CITY BAR REPORT, *supra* note 66, at 805-06.

83. See, e.g., *Dutch Treaty*, *supra* note 61, at Art. 11, ¶ 3.

84. The base of the branch profits tax is the earnings and profits of the foreign entity effectively connected with the conduct of a trade or business in the United States. I.R.C. § 884(b), (d) (1995).

be accorded to the income of an entity when its income is taxed not only at the entity level in its country of residence but also to a resident of the source country that is a participant in the entity because the source country considers the entity to be a pass-through. Does the source country give up its own residence-based tax because a tax is imposed on the income in the country of the entity's residence? If not, does the entity's country give a foreign tax credit or other relief for the tax paid by the source country resident (which it considers to be a tax imposed not on the entity which it is taxing but on a shareholder of the entity)? Does it give a credit for that tax to the extent of income derived in the source country, while the source country gives its resident a credit for its pro rata share of the entity-level tax imposed on entity income derived from other sources (as well, perhaps, as a withholding tax)? It seems clear that those responsible for the treaty program would have plenty to chew on if these were the only issues they had to solve.

IV. EXTENDING THE UNITED STATES TREATY PROGRAM TO LATIN AMERICA

Having successfully concluded an income tax treaty with its NAFTA partner, Mexico,⁸⁵ the United States is intent on extending its income tax treaty network to cover other countries in Latin America.⁸⁶ It remains to be seen whether, without the NAFTA hook, this will be feasible. Negotiating with the Latin countries will present all of the challenges of striking a bargain between a developed, (in this context) capital-exporting country, and a developing, capital-importing country, as well as some issues unique to the tax systems of individual countries involved.

The Developing Country Context. Latin American countries, like other developing countries, rely heavily for revenue on source-based taxes imposed on foreign taxpayers.⁸⁷ They impose such taxes on payments which would not be considered subject to source-based tax by most developed countries.⁸⁸ In addition, because of their revenue needs, they are less willing than developed countries to reduce these on a recip-

85. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Sept. 18, 1992, U.S.-Mex., *reprinted in* Tax Treaties (CCH) ¶ 5903.

86. Statement of Carol Doran Klein, Deputy International Tax Counsel, Treasury Department, DAILY TAX REPORT, Jan. 19, 1996, at G-4 (expanding treaties in Latin America among top-priority international issues for the coming year).

87. See, e.g., Matthew J. Kust, *Tax Treaties with Underindustrialized Countries*, 13 TAX EXECUTIVE 175, 188-89 (1961).

88. See, e.g., *infra* text at notes 109-13.

rocal basis⁸⁹ for either or both of two reasons. Some Latin countries still tax on a territorial basis.⁹⁰ Since they would impose no tax on income derived by their residents from sources in the United States, they would derive no revenue benefit from U.S. reductions in its source-based taxes. More importantly, reciprocal reduction of source-based taxes is, for them, a bad bargain because investment and technology flows are not reciprocal; their residents derive far less income from U.S. sources than U.S. residents derive from their countries (at least under the source rules which they apply). On the other hand, unless the imposition of the developing countries' source-based taxes is restrained, they will impose a substantial cost which can well act as a deterrent to badly needed private investment and technology flows.

The Tax-Sparing Controversy. Developing countries have typically argued that because of the imbalance in investment and technology flows, they should be compensated for reduction of their source-based taxes by more than a reciprocal reduction of U.S. withholding taxes.⁹¹ The most commonly proposed "equalizer" is a "tax-sparing" provision designed to stimulate foreign investment in the country.

Under a tax-sparing provision, a capital exporting country agrees that it will grant to a resident that invests in the treaty partner a "phantom" foreign tax credit for the creditable taxes that it would normally pay on designated types of income earned there but which are foregone under a "tax holiday" or similar tax incentive program designed to stimulate foreign investment in the country.⁹² Many of the United States' major trading partners have entered into such provisions in appropriate cases.⁹³ In the 1950's, the United States negotiated several treaties which contained "tax-sparing" provisions.⁹⁴ Before the Senate acted to advise and consent to them, however, the Kennedy Administration came into office; it strongly opposed "tax-sparing" and asked the Senate not to act.⁹⁵ This has been the policy of the United States ever since.

The merits of this policy can be debated at a theoretical and at a practical level. At the theoretical level, the United States' position, stripped of some of the rhetoric, seems to proceed from three related

89. See *United Nations Model Double Tax Convention Between Developed and Developing Countries*, Commentary on Art. 10, ¶ 2, ST/ESA/102 at 110-11 (1980).

90. See *infra* note 121.

91. See Report of the Senate Foreign Relations Committee on the Convention for the Avoidance of Double Taxation with Respect to Taxes on Income, Mar. 13, 1967, U.S.-Braz., reprinted in *Tax Treaties* (CCH) ¶ 1555 at p. 19,036 (1995); see also *infra* note 100.

92. See Richard D. Kuhn, *United States Tax Policy with Respect to Less Developed Countries*, 2 GEO. WASH. L. REV. 261, 263-68 (1963).

93. *Id.* at 268.

94. *Id.* at 265.

95. *Id.* at 267-68.

propositions. First, the treaties are not designed to relieve U.S. taxpayers from paying U.S. taxes.⁹⁶ Second, the function of the foreign tax credit is simply to remove double taxation and giving a "phantom" credit utilizes the mechanism for a purpose for which it was not intended.⁹⁷ Third, the tax incentive programs that the "tax-sparing" provisions are designed to accommodate are inefficient, encourage investors to "shop" for deals, thus leading to a destructive kind of tax rebate competition, and unwisely erode the developing country's sorely needed revenue base.⁹⁸ Developing countries regard this as an unacceptably paternalistic view, believing that tax incentives are on balance beneficial and that they are better judges than we of whether the resulting erosion of the revenue base is acceptable. They point out that, unless the "phantom" credit is given, the revenue they sacrifice in foregoing taxes flows not to investors but into the U.S. Treasury.

On a practical level, one suspects that the United States' position has a lot to do with Congressional antipathy toward spending on matters of foreign economics. To the extent that a "tax-sparing" provision gives an incentive for foreign, rather than domestic, investment, or would be scored to involve a revenue cost, there are those in Congress who can be expected to object.⁹⁹

96. See ALI PROPOSALS, *supra* note 4, at 243-44.

97. See *Double Taxation Convention With Pakistan Hearing Before the Committee on Foreign Relations, United States Senate*, 85th Cong., 1st Sess. 62-64 (1957) (statement of Stanley Surrey).

98. See Kuhn, *supra* note 93, at 266-67.

99. In the treaty which it negotiated with Brazil in 1967, the United States adopted an approach designed as an alternative to "tax sparing." It agreed to extend to U.S. investors investing in certain kinds of activities in Brazil an investment credit similar to the investment credit which was at that time extended to domestic investment in tangible capital assets. See Convention for the Avoidance of Double Taxation with Respect to Taxes on Income, Mar. 13, 1967, U.S.-Braz., Art. 7 (not in force), reprinted in *Tax Treaties* (CCH) ¶ 1503.08. This avoided some of the objections to "tax sparing": the revenue to be sacrificed would be U.S. revenue, rather than revenue of Brazil, and no "distortion" of the foreign tax credit was involved. See Stanley S. Surrey, *The United States Tax System and International Tax Relationships—Current Developments, 1965-1966*, TAXATION OF FOREIGN INCOME 274-80 (Tax Institute of America eds., 1966).

An unappreciative Senate canned the idea, entering a reservation on the article. The Foreign Relations Committee noted dryly that: "In view of the increasing deterioration in this country's domestic and international fiscal condition, the Committee does not believe that it would be appropriate at this time to encourage investments in foreign countries." See *supra* note 92, at *Tax Treaties* (CCH) ¶ 1555.

A second initiative was made in the treaty negotiated with Trinidad & Tobago in 1970. This consisted of a provision under which U.S. persons that transferred technology or technical services to a local corporation in return for stock could defer the recognition of gain until the stock was disposed of. See Convention for the Avoidance of Double Taxation, the Prevention of Fiscal Evasion with Respect to Taxes on Income, and the Encouragement of International Trade and Investment, Jan. 9, 1970, U.S.-Trin. & Tobago, Art. 7, reprinted in *Tax Treaties* (CCH) ¶ 9703.15. The Senate again entered a reservation on this article, again pleading poverty. *Id.* ¶ 9755.

At the same time, from the Latin American countries' point of view, it is not clear whether "tax-sparing" is more of a shibboleth than a practical need. If the developing country grants tax benefits to a foreign operating subsidiary of a U.S. corporation, these will be preserved so long as the subsidiary's earnings are reinvested in its business,¹⁰⁰ which is what the developing country should want, and may be preserved even if those earnings are reinvested elsewhere.¹⁰¹ In addition, many U.S. companies are in an excess foreign tax credit position. If the income that such a company derives under a "tax holiday" scheme in a developing country falls into its "overall" or "residual" foreign tax credit limitation basket¹⁰² when distributed, the company will have other creditable, foreign taxes available to offset the U.S. liability on the "tax holiday" income. As a result, the "sparing" of the developed country's tax redounds to the investor's benefit.

Other U.S. companies have overall foreign loss accounts¹⁰³ so substantial that they choose to deduct, rather than credit, foreign taxes.¹⁰⁴ For these companies, the reduction of developing country tax will have a favorable, although less than dollar-for-dollar, effect. In this case, at least the larger part of the benefit of the reduction in the developing country tax will inure to the investor's benefit.

One suspects that the tax-sparing question is academic. The United States has succeeded in concluding income tax treaties with several developing countries without offering a "tax-sparing" provision,¹⁰⁵ and it would hardly be feasible to extend this benefit to the Latin American countries without extending it to others.

Source-Based Taxation of Royalties, "Know How" and Fees. Latin American countries, like other developing countries, tend to regard payments made by a resident to a foreign person not engaged in business in the country as being subject to source-based taxation, normally a withholding tax. This "source-based-on-payment" rule conflicts with U.S.

100. This assumes, of course, that the subsidiary's earnings do not constitute Subpart F income under section 952 and that the subsidiary is not a Passive Foreign Investment Company as defined in section 1296, both of which assumptions will be true in a broad range of cases.

101. A dividend paid to the U.S. parent would be taxable income to it, of course, and a dividend paid to a foreign holding company in another country would constitute taxable Subpart F income under § 954(a)(1) & (c)(1)(A). If, however, the subsidiary can be structured so that it is characterized as a partnership for U.S. tax purposes, the earning and distribution of the subsidiary's operating income to a foreign holding company should not result in the imposition of any U.S. tax. See Rev. Rul. 93-4, 1993-1 C.B. 225; Rev. Proc. 95-10, 1995-3 I.R.B. 20.

102. See I.R.C. § 904(d)(1)(I) (1994).

103. See I.R.C. § 904(f) (1994).

104. See I.R.C. § 164 (1994).

105. See *Tax Treaties* (CCH) ¶¶ 1103 (Barbados), 2103 (China), 2703 (Egypt), 4203 (India), 4303 (Indonesia), 5003 (Jamaica), 5903 (Mexico), 6003 (Morocco), 7303 (Pakistan), 7503 (Philippines), 9703 (Trinidad & Tobago), 10,003 (Tunisia).

source rules, and most particularly those that deem the source of a royalty to be the country in which the use of the licensed intangible occurs¹⁰⁶ and the source of income from the performance of services to be the country in which those services are physically performed.¹⁰⁷ This situation may, in turn, lead to serious cases of double taxation.

High rates of withholding tax—up to thirty percent or more—are imposed on royalties paid to non-residents.¹⁰⁸ In most cases, these taxes should qualify as creditable taxes for foreign tax credit purposes.¹⁰⁹ However, in some cases they may exceed the amounts that are creditable under the applicable foreign tax credit limitation because they are imposed on gross payments and do not take into account related expenses.¹¹⁰

The situation is even more critical when similar withholding taxes are applied to income that the United States characterizes as income from the performance or furnishing of services. Again, countries like Argentina and Brazil impose substantial withholding taxes on fees paid by their residents to foreign providers of technical and other services.¹¹¹ These taxes are based on gross amounts paid but applied to income that can be earned only by incurring substantial expenses; therefore the rates may even exceed net income from the activity involved. Even worse, the taxes are often applied to income which the United States regards as having its source in the United States.¹¹² This means that the taxes will not be creditable at all except in the unusual case in which the U.S. taxpayer involved otherwise has tax credit limitation capacity.

From the U.S. point of view, the obvious solution to this problem is to eliminate or reduce these taxes. In their treaties with other countries, Argentina and Brazil have been willing to reduce the rate of withholding tax on royalties to fifteen percent.¹¹³ They have also agreed to business profits and permanent establishment articles based on the OECD Model Convention.¹¹⁴ One would have thought that, in the absence of a permanent establishment, such provisions would prevent a source country

106. I.R.C. §§ 861(a)(4), 862(a)(4) (1994).

107. I.R.C. §§ 861(a)(3), 862(a)(3) (1994).

108. See, e.g., 1 *TAXATION IN LATIN AMERICA Argentina* § 6.09; *Brazil* §§ 4.02, 6.09; *Colombia* § 6.09 (International Bureau of Fiscal Documentation 1995) [hereinafter *TAXATION IN LATIN AMERICA*].

109. Treas. Reg. § 1.903-1(a) & (b) Example (1) (1995).

110. See generally §§ 864(e), 904(d).

111. See 1 *TAXATION IN LATIN AMERICA Argentina* § 6.10; *Brazil* § 6.10.

112. Income derived from the performance of services in the United States constitutes U.S.-source income. I.R.C. § 861(a)(3) (1994).

113. For a summary of the treaties entered into by Argentina, see *TAXATION IN LATIN AMERICA Argentina* § 11.05 (1995). For a summary of the treaties entered into by Brazil, see *id. Brazil* § 11.05.

114. *Id.*

from imposing tax on a treaty enterprise furnishing the benefit of services performed outside the source country,¹¹⁵ but this may not be clear.¹¹⁶

On the other hand, from the point of view of the Latin American country—in addition to the revenue loss involved—it may not be self-evident as a matter of policy that the tax should be given up, or given up in its entirety. The information and communications revolution referred to above makes it less and less necessary for people to be physically present in a taxing country. Given computers and telephone lines or satellite dishes, much of what a Latin American resident pays for may be done elsewhere. For example, software can usually be installed from abroad without sending personnel, or even a CD, diskette, or tape.

The best that can be hoped for realistically may be a reduction of the withholding taxes involved. The United States treaty with India, for example, leaves India free to impose withholding taxes of twenty percent (during a phase-in period for certain income items) and fifteen percent on payments for so-called “included services”, generally defined as services related to the provision of intangible property or representing the provision of know-how.¹¹⁷ Other types of services are covered by articles similar to, although with somewhat tighter restrictions than, the OECD articles on dependent and independent services.¹¹⁸

The big question is whether, if this is done, the United States will act to remove the resulting double taxation. In its treaty with India, the United States insists on applying its own source rules in computing the limitation on the foreign tax credit.¹¹⁹ This automatically builds in double taxation. India is permitted to tax payments which the United

115. Under Article 7 of the OECD Model Convention, business profits of an enterprise may not be taxed by the source country unless attributable to a permanent establishment located there. The furnishing of services by an enterprise regularly engaged in the business of carrying on that activity constitutes business profits. See paragraph 11 of the Commentary on Article 12 of the OECD Model (income from the furnishing of services is covered by Article 7 and not by Article 12, relating to royalties.)

Difficult questions are raised, of course, in distinguishing between what constitutes “information concerning industrial, commercial or scientific experience,” which is subject to the royalties article, and pure services, which are not. For a discussion of this question as it applies to Mexico, see D. Roy Hershberger & Michael A. Siegel, *Services, Know-How Create Dilemmas under U.S.-Mexico Treaty*, 6 J. INT’L TAX 338, 340-41 (1995).

116. The author recently received advice from reputable Brazilian counsel that Brazil would not apply such a treaty to exempt a treaty resident from the withholding tax imposed on fees paid for services. He is seeking another opinion.

117. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Sept. 12, 1989, U.S.-India, Art. 12, *reprinted in Tax Treaties (CCH)* ¶ 4203.25 [hereinafter *Indian Treaty*].

118. *Id.* at Arts. 15, 16.

119. *Id.* at Art. 25, ¶ 3. An exception is made with respect to “included services,” but not other types of services.

States regards as U.S.-source income but the United States will not acknowledge that right to tax by affording a foreign tax credit (unless the recipient happens for irrelevant reasons to have foreign tax credit limitation capacity). Given the niggardliness of the current U.S. political climate, it may be impossible for the Treasury Department to do the right thing; but to the extent that it does not, the distortive effects of double taxation will remain.

Territorial Taxation. Some of the Latin American countries still adhere to a territorial basis of taxation.¹²⁰ This means that they impose no taxes on income derived by their residents and corporations from foreign (including U.S.) sources. This presents a dilemma.

In general, the purpose of an income tax treaty is to avoid double taxation,¹²¹ not to free income from tax altogether. In the usual case, therefore, the United States extends benefits under a treaty, such as reduced withholding taxes, only to those persons and entities which are subject to tax in the treaty country on income derived from the United States.¹²²

While there are obvious limitations on the application of this "subject to tax" principle (a tax-exempt entity may, for example, be entitled to treaty benefits),¹²³ historically, treaty benefits have not been extended with respect to income which is not taxed by the treaty partner. Thus, for example, if a country follows a system under which income is taxed to a resident only to the extent that it is remitted to that country, U.S. treaty benefits will not normally be accorded to unremitted income.¹²⁴ If this logic is applied to a treaty with a country which never taxes its residents on U.S.-source income, the United States would not agree to reduce its withholding tax on any items of U.S.-source income.

As discussed above, however, the United States may place a high priority on a reduction of withholding taxes in a developing country. If income flows are in imbalance, even a reciprocal reduction of withhold-

120. For example, in Bolivia there is no corporate-level tax, and individuals, whether resident or non-resident, are taxed only on Bolivian-source income. See 1 *TAXATION IN LATIN AMERICA Bolivia*, §§ 2, 3.06 (1993). In Paraguay and Uruguay, there is no individual income tax, and entities are taxed only on a territorial basis. See 2 *TAXATION IN LATIN AMERICA Paraguay* §§ 2.06, 3; *Uruguay* §§ 2.06, 3.

121. See ALI PROPOSALS, *supra* note 4, at 5-9.

122. In general, the definition of a "resident" entitled to the benefits of a treaty is cast in terms of that person's being subject to the plenary taxing jurisdiction of the treaty country, not necessarily taxed on every item of income but generally taxable regardless of the source of the income. See *id.* at 127-31.

123. *Id.* at 128.

124. See, e.g., Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains Art., Dec. 31, 1975, U.S.-U.K., 4, ¶(5) reprinted in *Tax Treaties* (CCH) ¶ 10903.09.

ing taxes bears hard on the developing country. Why should it even consider a unilateral reduction? There is little, if any, precedent for such a one-sided bargain. Even extending a benefit such as a "tax-sparing" article might not be sufficient recompense.

The practical answer may be simply for the United States to agree to modest reductions in its thirty percent withholding tax, which in any event is high, in exchange for like reductions in the Latin American country's withholding taxes. It is unlikely that the Latin American countries will agree to make very deep cuts in their withholding tax rates; and if, for example, a treaty provided for fifteen percent withholding taxes on each side, this would be a rather workable solution from a practical point of view.

V. CODA

There are any number of additional issues that need attention as urgently as those discussed above, but limits of time and space intrude. One thinks particularly of: the taxation of global securities and commodities trading operations and the quite similar provision of software, on-line and other services from a variety of locations through integrated computer, telephone or satellite systems; whether even in the more traditional cases the permanent establishment rules accord with modern practices; and of course the impact of financial derivative instruments on the source taxation of investment flows. All of these areas require a completely fresh analysis. But there are only so many hours in the day and so many days in the year.

Stepping back from the specifics, the overarching issue that all of these issues raise is whether the United States needs to move in either or both of two directions. The first would be to rely less on treaty rules to produce tax results that are acceptable in the real world. Reducing the statutory withholding tax on dividends (and equity swap payments?) to fifteen percent would be an example. The second would be to bring the terms of all of its treaties into congruity to the greatest extent possible. This necessarily implies, it seems clear, an effort either to persuade the United States' major treaty partners to agree on a multilateral convention or at least to devise a means to secure stronger adherence to an agreed model.

In the first case, we must face the very difficult task of straightening out domestic law, but then that would apply to all comers; there would be no need for treaty-shopping rules, withholding certificates or rules for pass-through entities. In the second case, there would still be the need to ascertain treaty qualification, but if qualification in any one of the countries with which the United States has a treaty gave rise to the

same results, at least the number of instances in which the complexities discussed above would intrude would be reduced.

Unfortunately, this all seems visionary. Even if the United States could summon the will to address such a difficult subject, would the Dutch? Would the Swiss? Would anyone else? At the moment, it appears that too many of the actors have a vested interest in the messy, and therefore manipulable, status quo.