

# Legal Structure of Tax Treaties

by Michael J. McIntyre (2003, revised 2010)

The United States has an extensive network of bilateral tax treaties. More than 50 U.S. treaties are currently in force, and the number has been increasing steadily in recent years. All of the treaties are based in large part on the model treaty and accompanying commentary prepared by the Organisation for Economic Co-operation and Development (OECD)<sup>1</sup> or the model treaty and commentary prepared by the United Nations (UN).<sup>2</sup> The United States published its own “model” treaty from time to time, most recently in 2006.<sup>3</sup> These model treaties are discussed in §1.3, below. Section 1.1 discusses the basic objectives of tax treaties. Section 1.2 describes the coverage and scope of the typical U.S. tax treaty.

A tax treaty is a type of contract. The two countries that enter into a bilateral tax treaty are referred to in the treaty and elsewhere as the Contracting States. Like any treaty, a tax treaty is to be interpreted according to the provisions of international law relating to treaties. That law has been codified in the *Vienna Convention on the Law of Treaties* (1986). The United States is not a signatory to that convention. It has acknowledged, however, that it is bound by the convention to the extent that the convention embodies customary international law.

## § 1.1. Objectives of Tax Treaties

A major objective of income tax treaties is to facilitate cross-border trade and investment by eliminating the income tax impediments to these cross-border flows. A second major objective of most income tax treaties is to remove an inappropriate incentive to foreign commerce by preventing cross-border fiscal evasion.<sup>4</sup>

Historically, the major income tax impediment to participation in the global marketplace has been the risk of double taxation. Without some special relief mechanism, a company that is

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<sup>1</sup> See OECD Committee on Fiscal Affairs, *Model Tax Convention on Income and on Capital* (2008), hereafter “OECD Model Treaty” or “OECD Commentary” as the context requires. The OECD Model is published in looseleaf form and is updated frequently.

<sup>2</sup> United Nations Department of Economic and Social Affairs. *United Nations Model Double Taxation Convention Between Developed and Developing Countries* (2001), hereafter “UN Model Treaty” or “UN Commentary” as the context requires. Updated version on line at: [http://faculty.law.wayne.edu/tad/Documents/UN/UN\\_Model\\_Treaty\\_2010.pdf](http://faculty.law.wayne.edu/tad/Documents/UN/UN_Model_Treaty_2010.pdf)

<sup>3</sup> Reference is made throughout this chapter to the U.S. Model Treaty (2006) and to the Treasury Department’s explanation of the model. See Treasury Department, *United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006* (2006) (hereafter “*Technical Explanation of U.S. Model Treaty* (2006).” The “model” reflects the U.S. negotiating position on new tax treaties and is not a model treaty in the normal usage of that term. The U.S. Model Treaty and technical explanation have no binding legal effect. The current model treaty replaces the 1996 model, which, in turn, replaced the 1981 model.

<sup>4</sup> The U.S. Model Treaty (2006) and most actual U.S. treaties provide in the preamble that the convention is being established “for the avoidance of double taxation and the prevention of fiscal evasion.”

subject to tax on its worldwide income by its country of residence will face a substantial risk of double taxation when it engages in substantial economic activities in another country.

All U.S. tax treaties seek to eliminate double taxation. The primary mechanism that the United States employs to eliminate double taxation, reflected in Article 23 of the U.S. Model Treaty (2006), is the foreign tax credit. All U.S. tax treaties provide that the United States will give a credit to its taxpayers for the income taxes imposed by its treaty partner. Those treaties also provide that the treaty partner will give comparable tax relief to their residents with respect to income taxes paid to the United States. Some countries give that relief through the credit mechanism, whereas other countries give relief by exempting their taxpayers on certain income earned in the United States. In some cases, the United States uses an exemption method for granting relief from the risk of double taxation. For example, it exempts foreigners on certain interest and royalty income sourced in the United States.

Many countries give relief from the risk of double taxation through unilateral action. Some countries, most notably the United States, grant a foreign tax credit unilaterally. Other countries unilaterally exempt their companies on income earned in foreign countries. Even when relief from double taxation is granted unilaterally, however, a tax treaty can serve a useful role in clarifying what taxes qualify for relief and in solving double-taxation problems unrelated to an overlap of source and residence taxation. For example, tax treaties contain tie-breaker rules designed to treat a dual-resident taxpayer who is otherwise a resident of both Contracting States as a resident in only one of the Contracting States.

The problems of double taxation that plagued multinational businesses in the early post-World War II period have largely been solved, partly through domestic legislation providing double-tax relief and partly through the development of an extensive network of bilateral tax treaties. The one area where significant problems of double taxation continue to arise is in the operation of the so-called arm's length standard for policing transfer price abuses.

Far less progress has been made in solving the problem of fiscal evasion. On the contrary, multinational companies have become increasingly adept at exploiting the opportunities for avoiding taxes that arise from their cross-border activities. In some respects, tax treaties have increased the opportunities for fiscal evasion by failing to prevent what is popularly called "treaty shopping."

In the past decade, the United States and other treaty countries have given increased attention to the problems of international tax avoidance and evasion—referred to collectively in tax treaties as "fiscal evasion." The OECD has provided the forum for much of the ensuing discussion. There appears to be a growing realization by government officials that the problems of double taxation that were endemic after World War II have largely been solved and that the central problem of international taxation is now the undertaxation of transnational income. As the OECD notes with characteristic understatement in the preamble to the OECD Model treaty, "[m]ethods of tax avoidance and evasion became more sophisticated," during the 1980s and

1990s.<sup>5</sup> Whether countries will band together to find effective solutions to the problems created by sophisticated tax avoidance and evasion remains to be seen.

The typical tax treaty provides protection to transnational income without reference to the legality of that income. Thus a nonresident alien deriving income in the United States from the illegal sale of narcotics is afforded the same protection under U.S. tax treaties as a person engaging in legal activities. The failure to distinguish between legal and illegal activities cannot be justified by reference to the objectives of tax treaties. Presumably the U.S. government and its treaty partners are not seeking to facilitate illegal cross-border activities. Yet the only U.S. tax treaty that limits the benefits of a tax treaty to legal income is the treaty with the former Soviet Union.<sup>6</sup> Perhaps the United States and its treaty partners are concerned about the administrative difficulties that might arise in determining whether certain income items were legally obtained. Alternatively, they may not wish to discourage inflows of capital from investors who are fraudulently avoiding taxation in their country of residence.

## § 1.2. Coverage and Scope

### § 1.2.1. General

The provisions of an income tax treaty generally apply to persons who are “residents of one or both of the Contracting States.”<sup>7</sup> A resident may be an individual, a company, or any other legal entity given tax significance under the laws of a Contracting State. The treaty rules for determining the residence of individuals are addressed briefly below.

Some articles of a tax treaty may apply to persons who are not a resident of a Contracting State. For example, in the U.S. Model Treaty (2006), the nondiscrimination article applies to nationals as well as to residents.<sup>8</sup> In addition, the exchange of information article allows exchanges of information with respect to residents of third countries.<sup>9</sup>

The United States reserves its rights, except as specifically provided in the treaty, to tax its citizens as provided in its internal laws, notwithstanding any provisions of the treaty to the contrary. This reservation of rights is referred to as the “saving clause.” For example, if a resident of Japan performs independent personal services in the United States that qualifies for an

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<sup>5</sup> OECD Model Treaty, “Introduction,” para. 8.

<sup>6</sup> See U.S./U.S.S.R. treaty, Art. VIII (“The benefits of this Convention are available only with respect to the taxation of income from activities conducted in a Contracting State which are carried on in accordance with the laws and regulations in force within such Contracting State whether at the national, republic or state, or local levels.”). This provision was inserted at the insistence of the Soviet Union. See “Technical Memorandum to Accompany Income Tax Convention between the United States and the Union of Soviet Socialist Republics” (preliminary draft), October 4, 1973.

<sup>7</sup> U.S. Model Treaty (2006), Art. 1(1); OECD Model Treaty (2008), Art. 1.

<sup>8</sup> See U.S. Model Treaty (2006), Art. 24.

<sup>9</sup> U.S. Model Treaty (2006), Art. 26. In addition, Article 19 (Government Service) may apply to an employee of a Contracting State who is resident in neither State.

exemption under Article 14 (Independent Personal Services) of the U.S./Japan treaty, the United States normally is prevented by the treaty from taxing that income. If the Japanese resident, however, is also a citizen of the United States, the saving clause permits the United States to tax that income under the normal Code rules.

Several articles of the typical tax treaty provide that the favorable treatment of an item of income provided by those articles is available only to the “beneficial owner” of that income item. Articles 10 (Dividends), Article 11 (Interest) and Article 12 (Royalties) of the U.S. Model Treaty (2006) all provide that the limitations on U.S. withholding rates apply only to income “beneficially owned” by a resident of the other Contracting State. This concept of the beneficial owner is intended to limit the use of tax treaties to avoid taxation.<sup>10</sup> Treaties following the OECD Model Treaty have similar language.

Since the early 1980s, the United States has insisted on the inclusion of a Limitation on Benefits article in all its new or revised tax treaties. The goal of that article is to prevent tax avoidance through treaty shopping — the use of treaties by conduit entities not properly entitled to treaty benefits.

The typical treaty specifies the taxes that are covered by the treaty. The OECD Model provides that the treaty is to apply “to taxes on income and on capital imposed on behalf of a Contracting State or of its political subdivisions or local authorities.”<sup>11</sup> Tax treaties following the U.S. Model Treaty (2006) apply to the federal corporate and personal income tax but not to subnational taxes.<sup>12</sup> The Social Security tax (FICA) is specifically exempted from coverage under the model treaty. To reduce the need for amendments to the treaty, Article 2 of the U.S. Model Treaty provides that the treaty will apply to taxes that are identical, or substantially similar, to the taxes enumerated in the treaty.

### **§ 1.2.2. Residence of Individuals for Treaty Purposes**

The starting point in determining the residence of an individual is domestic law. Most tax treaties include tie-breaker rules to prevent an individual from being a resident of both of the Contracting States for tax purposes. The tie-breaker rules are addressed in § 3.03. The United States retains the right in all of its treaties to tax U.S. citizens in most cases even if the citizen is treated as a nonresident under a U.S. tax treaty. This preservation of U.S. tax jurisdiction over citizens is called the saving clause.

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<sup>10</sup> See OECD Commentary (1997) to Article 1, para. 10.

<sup>11</sup> OECD Model Treaty (2008), Art. 2.

<sup>12</sup> U.S. Model Treaty (2006), Art. 2(1)(a). Article 24 (Non-Discrimination), however, does apply to state and local taxes. The U.S./Canada treaty provides that the Contracting States will assist in the collection of subnational taxes. In recent years, an assistance-in-collection article has become rather common,

### § 1.2.3. Residence of Legal Entities

The residency of a legal entity is determined primarily under the internal laws of the Contracting States. A company is treated as a U.S. resident if it was created or organized under the laws of the United States or a political subdivision. If the other Contracting State uses this same test, a company will not be a dual resident for treaty purposes. Dual residency may occur, however, if a company is treated as a resident of the other Contracting State by reference to its place of management. The U.S. favored rule is that such a dual resident company will be treated as a resident of the United States.<sup>13</sup>

Special problems are presented by fiscally transparent entities such as partnerships, limited liability companies (LLCs), and certain estates and trusts. The U.S. treaty position is that an item of income derived by a resident of a Contracting State through a fiscally transparent (pass-through) entity is entitled to the treaty benefits afforded to such residents only if the income is treated under the domestic tax laws of that Contracting State as derived by one of its residents. For example, assume that a USCo, U.S. corporation, distributes a dividend to BCo, an entity organized under the laws of the Bahamas that is treated as fiscally transparent by the United States. If the owners of BCo are considered by Canada to be subject to Canadian tax on that dividend, then the dividend will be treated by the United States as derived by a resident of Canada. If Canada treats the dividend as derived by a nonresident company, however, then the United States will tax the dividend without reference to the U.S./Canada treaty.<sup>14</sup>

### § 1.3. Model Tax Treaties and Commentaries

By far the most influential model treaty is the OECD Model Treaty, prepared by the Organisation for Economic Co-operation and Development. It was published in draft form in 1963, and the first official version was published in 1977. Virtually all tax treaties entered into since the draft model was published have followed that model in many respects.

The OECD Model Treaty is an ambulatory document that has evolved over time. When the 1963 draft was written, the major industrial countries that made up the OECD were poles apart on many issues of international tax policy. Some governments were decidedly liberal, some staunchly conservative, some socialists in general outlook, some defending the mercantile values of the pre-World War II period, and some, regrettably, were tainted by their collaboration during the war with the Nazis. Because unanimous consent was required for agreement on the provisions of the model under OECD internal rules, the law of the least common denominator prevailed. Many hard issues were avoided, the interests of developing countries were largely ignored, and little or no effort was made at developing mechanisms for controlling transnational fiscal evasion.

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<sup>13</sup> U.S. Model Treaty (2006), Art. 4(3). See, e.g., U.S./Canada treaty, Art. 4(3) (providing that if a dual-resident company “was created under the laws in force in a Contracting State, it shall be deemed to be a resident of that State.”); U.S./Australia treaty, Art. 3(1)(g)(ii) (defining an Australian company as a company that is a resident of Australia under Australia’s domestic tax law and is not a U.S. corporation under U.S. domestic law).

<sup>14</sup> See *Technical Explanation of U.S. Model Treaty* (2006), Art. 4, paras. 58-62.

Despite the almost inevitable weaknesses of the 1963 draft, it proved to be an enormous success. It unquestionably achieved its central goal, which was the substantial reduction of international double taxation. A key to achieving that goal was the successful promotion of uniform rules for taxing and not taxing transnational income.

As noted above, the first official vision of the OECD model was published in 1977. The 1977 model lived in suspended animation for the next fifteen years, notwithstanding the major changes in the ways that multinational companies conducted their businesses and in the ways that governments were taxing the income of those businesses. In significant part, the success of the OECD Model has inhibited its ability to respond to changing circumstances. With thousands of treaties already negotiated, a change in the model upsets existing expectations. In 1992, the OECD published a revised treaty in looseleaf form. The changes made from the 1977 model were relatively minor. The looseleaf format of the 1992 model, however, signaled a commitment of the OECD to frequent modifications. Changes in the model have been made several times since 1992, although so far most of the changes have been rather modest.

Responsibility for the model treaty within the OECD rests with the Committee on Fiscal Affairs. The members of that committee are senior tax officials of the member states. That committee accomplishes its work through the permanent secretariat and several Working Parties. Working Party No. 1 has responsibility for revising the model treaty.

The OECD Model Treaty provides a pattern for countries to use in concluding bilateral tax treaties. No country is bound to follow the model. The model itself suggests alternative approaches to certain problems. For example, it endorses both the exemption and the credit method as acceptable mechanisms for relieving double taxation. The model sets certain maximum withholding rates for dividends and interest, but it does not attempt to induce countries to avoid rates below the recommended maximums. Like any model, it has no legal effect. Its influence comes from the embodiment of its terms in actual bilateral treaties.

The UN Model Treaty was developed by an Expert Group assembled by the United Nations as an alternative to the OECD model. First published in 1980, it was not revised for many years and was becoming moribund. New life was breathed into it with the publication of a revised edition in 2001. The purpose of the UN model is to give some visibility to the perspective on treaties of the developing countries.

To some degree, the UN model has achieved its goal. Hundreds of tax treaties have been negotiated that contain provisions found in the UN Model Treaty and not found in the OECD Model Treaty. The UN Model Treaty, however, follows the OECD model very closely on most matters. To avoid the bias of the OECD treaty in favor of capital exporting countries, the UN model eliminated the maximum withholding rates on interest, dividends, and royalties proposed in the OECD model, and it liberalized somewhat the rules relating to permanent establishments. From the perspective of capital importing countries, these changes are desirable. They allow a country, for example, to impose a significant withholding tax on royalties payments and to limit opportunities for earnings stripping by multinational firms. The UN model also makes clear that tax avoidance, not just evasion, is a legitimate concern of a country in negotiating a tax treaty.

Unfortunately, the UN model has not yet offered an effective challenge to the analytical underpinnings of the OECD model. For example, it has accepted without challenge the OECD decision to honor the formal structures of multinational businesses except in the most extreme cases. It has accepted the OECD decision to take a transactional approach to the tax avoidance problems created by the use of artificial transfer prices by multinational businesses.

The OECD has belatedly recognized the desirability of bringing the developing countries within the consensus on patterns of international taxation fostered through its model treaty. Toward that end, the Committee on Fiscal Affairs has opened up the process of revising the OECD Model Treaty by providing representation to nonmember countries and certain other interested parties. This process of inclusion is at a very early stage, and its future direction is uncertain. The early indication, however, is that the inclusion is intended to co-opt the developing countries rather than to adopt the OECD Model Treaty to be more favorable toward taxation by the source country. For example, the recent work of the OECD on the taxation of electronic commerce has given almost exclusive jurisdiction to tax that income to the residence country.

Despite its dominance, the OECD model does have some friendly competition from the model treaty published by the U.S. Treasury Department. The current U.S. Model Treaty (2006) is consistent with the OECD model in all important respects. It provides different, generally more precise, language for capturing the common policies of the two models. In addition, it fills in some of the voids in the OECD model, especially with regard to such controversial issues as treaty shopping and the use of hybrid entities for international tax avoidance. And it conforms the general language of some articles of the OECD model to the language of the Internal Revenue Code.

According to the Treasury Department, the U.S. model “is not intended to represent an ideal United States income tax treaty. Rather, a principal function of the Model is to facilitate negotiations by helping the negotiators identify differences between income tax policies in the two countries.”<sup>15</sup> The model is not the unbending negotiating position of the United States. According to the Treasury Department, “it is unlikely that the United States will ever sign an income tax convention that is identical to the Model.”<sup>16</sup>

A useful guideline in interpreting tax treaties based on the OECD Model Treaty is the OECD Commentary, prepared by the member states of the OECD. The Commentary presents the majority view of the OECD members on how various provisions of the treaty should be interpreted. It also includes reservations of OECD members who are not part of the consensus. In recent years, nonmember states have been invited to indicate their reservations to the positions taken in the Commentary. To some degree, the OECD has used the Commentary as a device for updating the model treaty by infusing a new interpretation onto the old language of the model.

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<sup>15</sup> *Technical Explanation of U.S. Model Treaty* (2006), “Introduction,” at para. 6.

<sup>16</sup> *Id.* at para. 7. Perhaps the emphasis should be on the word “identical.” The U.S. Treasury has not always exercised restraint when it has enjoyed the upper hand in treaty negotiations. The negotiations with Russia and Spain, for example, resulted in treaties that apparently were very close to the Treasury’s then unpublished model.

As noted above, the U.S. Treasury Department also provides an official commentary on the U.S. Model Treaty (2006). That commentary takes the form of a “Technical Explanation,” thereby providing parallelism to the official document that the Treasury Department prepares when a proposed tax treaty is submitted to the Senate for its advice and consent. Although less detailed than the OECD Commentary, it offers useful insights into the thinking of Treasury Department officials on some major policy issues addressed in the model treaty. In contrast to the OECD Commentary, revisions of the Technical Explanation are infrequent.

## § 2.1. Legal Nature and Effect of Tax Treaties

Section § 2.1.1 discusses the legal status of tax treaties under U.S. law. The constitutional requirements and traditional procedures for bringing a tax treaty into force are addressed in section § 2.1.2.

### § 2.1.1. Legal Status

First and foremost, a tax treaty is a treaty. That is, it is a bilateral agreement between the United States and another sovereign state. As a treaty, it differs fundamentally from a statute, such as the Code. This point was made over a century ago by the Supreme Court in the *Head Money Cases*. The Court stated:

A treaty is primarily a compact between independent nations. It depends for the enforcement of its provisions on the interest and the honor of the governments which are parties of it.<sup>17</sup>

A tax treaty has the legal effects of any other treaty. That effect is set forth in the Supremacy Clause of Article VI of the U.S. Constitution. That clause provides, in relevant part, as follows:

This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land.

Many aspects of a tax treaty may be viewed as self-executing and not requiring any congressional action to become effective.<sup>18</sup> In any event, Code section 894(a) may be viewed as giving legislative effect to tax treaty rules. It provides that the Code is to be applied “with due regard to any treaty obligation of the United States.”

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<sup>17</sup> *Edye v. Robertson*, 112 U.S. 580, 598 (1884).

<sup>18</sup> The distinction is often made between a treaty that is self-executing and one that requires enabling legislation. See *Foster v. Neilson*, 27 U.S. (2 Pet.) 253, 314 (1829) (Opinion by Chief Justice John Marshall) (“Our constitution declares a treaty to be the law of the land. It is, consequently, to be regarded in courts of justice as equivalent to an act of the legislature, whenever it operates of itself, without the aid of any legislative provision.”).

Although a tax treaty is the supreme law of the land, so also is the Code. The rules for resolving conflicts between tax treaties and the Code are addressed in § 2.1.3, below.

### § 2.1.2. Formation of a Tax Treaty

Treaties are negotiated by the Executive Branch under the authority of Article II, Section 2, of the U.S. Constitution. That section provides in relevant part as follows:

[The President] shall have Power, by and with the Advice and Consent of the Senate, to make Treaties, provided two thirds of the Senators present concur.

Under the U.S. Constitution, the House of Representatives generally is given the lead role in revenue matters. Section 7 of Article I states that “All Bills for raising Revenue shall originate in the House of Representatives.” With respect to tax treaties, however, the House has no official role. Congressional restraint on Executive power to make treaties is exercised by the Senate, traditionally through its Foreign Relations Committee.<sup>19</sup>

Most treaties are negotiated on behalf of the United States by the State Department. Tax treaties are an exception. All tax treaties are negotiated primarily by the Treasury Department and its foreign counterpart, typically officials in the foreign Treasury Department or Ministry of Finance. Although the State Department has a formal role in negotiating treaties and traditionally is consulted before a tax treaty is actually signed, its substantive role in negotiations with the foreign government is peripheral. Various sectors of the Treasury Department are involved in treaty negotiations. Primary responsibility is assigned to the Office of Tax Policy. Staff assistance is traditionally provided by the Internal Revenue Service.

Although the Treasury Department seeks some public comment in advance of treaty negotiations, the negotiations themselves are almost always confidential until the two negotiating teams have agreed on a common text. The agreed text is initialed by the negotiators and circulated for discussion within the two governments. The initialed text has no binding force and is frequently modified in minor ways as the ratification procedure moves forward.

The State Department has the responsibility for preparing an approved text. If the official language of the prospective U.S. treaty partner is not English, the State Department must approve an official translation of the treaty. Once the State Department has completed an official version of the text of the treaty, it is signed by representatives of the two Contracting States. After the treaty has been signed, it typically is made public.

After the treaty is signed, it is sent to the President by the State Department. The letter of submittal to the President gives a brief summary of the salient points in the proposed treaty and requests that the treaty be transmitted to the Senate for its Advice and Consent. Assuming the

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<sup>19</sup> For a detailed discussion of the role of the Senate in the treaty process, see Congressional Research Service, *Treaties and Other International Agreements: The Role of the United States Senate*, Prepared for the Senate Committee on Foreign Relations, 103d Cong., 1st sess. (1993).

President approves, he transmits the proposed treaty to the Senate with a signed letter of transmittal and the documents received from the State Department.

A proposed tax treaty received by the Senate is transmitted to the Senate Foreign Relations Committee. The Foreign Relations Committee may hold public hearings and may issue a report to the Senate with its recommendation. The Treasury Department traditionally prepares for the Foreign Relations Committee a detailed technical memorandum explaining the issues presented by the treaty. This memorandum is widely regarded as the official guide to the treaty. It explains the Treasury Department's understanding of the key terms and provisions of the treaty. It is routinely shared with the revenue officials of the other Contracting State. A companion document is also prepared for the Foreign Relations Committee by the staff of the Joint Committee on Taxation.

Although the Senate Foreign Relations Committee may decline to act on a proposed treaty, it usually prepares a report for the Senate incorporating its recommendations. It may recommend approval or rejection, or it may recommend approval subject to certain reservations. The reservations may require a renegotiation of the treaty or may only require that the Executive Branch obtain some formal understanding as to the meaning of some part of the treaty.

Senate action typically follows the Foreign Relations Committee's report to the Senate floor. After considering the recommendations of the committee, the Senate may consider additional reservations from members. If the Senate gives its Advice and Consent to the treaty by the required two-thirds majority, the treaty is transmitted to the President. In the event the Senate approval is subject to reservations, the Executive Branch must renegotiate the treaty with the other Contracting State. In some cases, the reservations are quickly accepted. In other cases, they may delay ratification or derail the treaty negotiations completely.

While the U.S. Executive Branch is seeking the approval of the tax treaty in the Senate, the other Contracting State typically is pursuing its domestic procedures for ratifying the treaty. The ratification process in the other Contracting State may lead to rejection of the treaty or the need to consider some revisions. When both sides have completed the ratification process in accordance with their laws and traditions, the instruments of ratification are prepared and signed by the President of the United States and by the appropriate official in the other Contracting State. Once the signed instruments have been exchanged, the tax treaty enters into force. An example of the technical requirements for a treaty to go into force are set forth in Article 28 of the U.S. Model Treaty.

A treaty cannot go into effect until it has entered into force. The effective date of the treaty, however, may be on, after, or before the date it entered into force. It is common for a treaty to go into effect as of the beginning of the first year following its going into force. It is also common for some parts of the treaty, such as the reduced withholding tax rates, to go into effect at a date different from the effective date for the rest of the treaty.<sup>20</sup> In some cases, the treaty takes effect retroactively—that is, before the date it went into force.

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<sup>20</sup> See, e.g., U.S. Model Treaty (2006), Art. 28(2).

### § 2.1.3. Relationship of Tax Treaties to Domestic Legislation

The Code provides in section 894(a) that its provisions are to be applied “with due regard to any treaty obligation of the United States.” The main effect of this language is to incorporate treaty rules into the Code for purposes of assessment.<sup>21</sup> This vague language intentionally leaves open the possibility that the Code might override U.S. treaty obligations in some circumstances.

U.S. constitutional law holds that the more recently adopted rule prevails in the case of an unresolved conflict between two statutory provisions or between a statutory provision and a treaty provision, unless the statute or the treaty, as the case may be, specifically provides otherwise.<sup>22</sup> This rule of interpretation is referred to as the later-in-time rule. Thus a Code provision adopted after a tax treaty has gone into effect can override the provisions of the treaty under U.S. law even without the consent of the treaty partner. Of course the power to act does not imply the right to act. Congress may be behaving contrary to U.S. obligations under international law when it overrides the provisions of a tax treaty. In some cases, international law provides a remedy to the injured party.

The United States is not alone in giving its legislature the power to enact statutes in conflict with treaty obligations. Most democratic governments retain that power. For example, the supremacy of the parliament is a fundamental constitutional principle in common law countries, such as Canada and Australia, that follow in the tradition of Great Britain. The tradition in these countries, however, is to adopt legislation that instructs the courts to give priority to treaties over statutes in the event of conflict. In contrast, some countries, including Belgium, France, Germany, Greece, and Spain, have constitutional arrangements that obstruct the override of treaties by legislative action.

In some cases, Congress has specifically provided that new Code provisions are not to prevail over treaty rules.<sup>23</sup> The broadest and most famous of these “savings clauses” was adopted, perhaps out of an abundance of caution, when the Internal Revenue Code was recodified and reenacted in 1954.<sup>24</sup> That provision states that treaty rules in effect on August 16, 1954 (the date

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<sup>21</sup> *Conference Committee Report, H. Rept. 100-1104, Statement of Managers, Technical and Miscellaneous Revenue Act of 1988*, P.L. 100-647, 100th Cong. 2d Sess. (1988) at 16. The pre-1988 language provided that “[i]ncome of any kind, to the extent required by any treaty obligation of the United States, shall not be included in gross income and shall be exempt from taxation under this title.” This language, according to the Conference Committee Report, did not provide operative rules for determining the relationship between the Code and a treaty. It should be interpreted, like the new IRC § 894(a), as simply stating that treaty provisions may override the Code in some cases. Whatever the merits of the position taken by the Conference Committee about the proper interpretation of old IRC § 894(a), there seems little doubt that taxpayers cannot rely on new IRC § 894(a) to support a claim for giving priority to a treaty rule over a Code rule.

<sup>22</sup> See, e.g., *Whitney v. Robertson*, 124 U.S. 190, 195 (1888); *Chae Chan Ping v. U.S.*, 130 U.S. 581, 600 (1889); *Reid v. Cover*, 354 U.S. 1, 18 (1957).

<sup>23</sup> For example, the 1966 tax act, which adopted the effectively-connected rules, contained a savings clause for prior treaty rules.

<sup>24</sup> See IRC § 7852(d)(2) (as amended by TAMRA, 1988).

of adoption of the 1954 Code) are to have priority over Code rules in effect on that date. Thus Congress made clear that the reenactment of the Code was not to have the effect of destroying all tax treaty rights—a result that might be reached through a wooden application of the later-in-time rule by a foolish court.

The 1954 savings clause has no bearing on the priority of statutes adopted after 1954. No similar savings clause was adopted when the Code was again recodified in 1986.<sup>25</sup> It is clear beyond debate, however, that the 1986 recodification did not change the priority of Code provisions that were carried over unchanged from the 1954 Code. For example, the special treaty withholding rates on periodical income continue to apply despite the reenactment of a 30-percent withholding tax in Code sections 871(a) and 881.

In the 1988 tax act (TAMRA), Congress sought to resolve some future claims of conflict between Code rules and treaty rules. It amended Code section 7852(d)(1) to provide as follows:

For purposes of determining the relationship between a provision of a treaty and any law of the United States affecting revenue, neither the treaty nor the law shall have preferential status by reason of its being a treaty or law.

The congressional intent in enacting this seemingly innocuous statement was to encourage U.S. courts to uphold the amendments to the Code made by the 1986, 1987, and 1988 acts against treaty challenges. Congress also hoped, through the legislative history of Code section 7852(d)(1), to induce the courts to resolve unanticipated conflicts between future Code amendments and prior treaties so as to best advance the policy objectives of the Code.

The Senate Finance Committee, in an extended essay on the interrelationship of treaties and statutes under U.S. law, explained the purpose of Code 7852(d)(1) as follows:

The committee believes that a basic problem that gives rise to the need for a clarification of the equality of statutes and treaties is the complexity arising from the interaction of the Code, treaties, and foreign laws taken as a whole . . . . The committee does not believe that Congress can either actually or theoretically know in advance all of the implications for each treaty, or the treaty system, of changes in domestic law, and therefore Congress cannot at the time it passes each tax bill address all potential treaty conflict issues raised by the bill. This complexity, and the resulting necessary gaps in Congressional foreknowledge about treaty conflicts, make it difficult for the committee to be assured that its tax legislative policies are given effect *unless it is confident that where they conflict with existing treaties, they will nevertheless prevail*.<sup>26</sup>

As the passage above suggests, Code section 7852(d)(1) is intended to correct what Congress considered to be an improper reading of prior law by various commentators, including

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<sup>25</sup> Indeed, the 1954 savings clause was inadvertently dropped from the Code and had to be reinstated by TAMRA (1988).

<sup>26</sup> Senate Finance Committee, *Report 100-445, Technical and Miscellaneous Revenue Act of 1988*, P.L. 100-647, 100th Cong. 2d Sess. (1988) at 382 (emphasis added).

the Internal Revenue Service. Relying on an often quoted passage from *Cook v. United States*,<sup>27</sup> the Service appeared to take the position that unanticipated conflicts between the Code and a treaty should be resolved in favor of the treaty in almost all cases.<sup>28</sup> Some commentators have agreed with this interpretation of *Cook*.<sup>29</sup> In *Cook*, the Supreme Court stated that a “treaty will not be deemed to have been abrogated or modified by a later statute unless such purpose on the part of Congress has been clearly expressed.” When an unanticipated conflict between a statute and a treaty arises, there will almost never be a clear statement of legislative intent to override in the statute or its legislative history, absent a residual override clause. The Senate Finance Committee report notes that the quoted language of *Cook* is dicta. The uncontroversial holding of the case is that the mere reenactment of a statute should not ordinarily change priorities under the later-in-time rule.

The later-in-time rule only applies to override a tax treaty when there is an actual conflict between a newly enacted Code provision and a treaty. General rules of statutory interpretation come into play to minimize potential conflicts. The courts will generally seek to discover a harmonious reading of a treaty and a statute to avoid the application of the later-in-time rule. Congress was not content, however, to leave the resolution of all potential conflicts to the courts.

Congress took several steps in the 1988 tax act to reduce the role of the courts in interpreting treaties. First, by reestablishing the full vitality of the later-in-time rule, it has given itself the first opportunity, in most cases, to decide whether an actual conflict between the Code and a treaty exists and, if there is a conflict, whether it wants the Code or a treaty to prevail. Because Congress is going to address and to some degree determine the issue anyway, tax practitioners who uncover potential treaty conflicts now have an incentive to bring those conflicts to the attention of Congress prior to the enactment of new legislation.

The prior practice of some practitioners was to keep the potential conflict secret. They would then advise clients to play the so-called tax lottery by failing to report income taxable under the Code if there was some basis for claiming treaty protection. If the omitted income items were detected by the tax authorities, the taxpayers would then make their treaty claim. That claim might fail, but it might have enough credibility to avoid the imposition of penalties. The experience with the 1988 tax act itself and with subsequent legislative deliberations over tax changes suggest that Congress has been quite successful in flushing treaty claims into the open.

The second way that Congress reduced the influence of the courts in deciding whether a statute conflicted with a treaty was to make that determination itself at the time the potentially conflicting statute was enacted. Under the current congressional practice, the professional staff of Congress reviews a list of asserted conflicts between the Code and treaties. After that review, Congress may modify the proposed legislation to deal with perceived treaty problems. After concluding that it wants to move forward with the proposed legislation, Congress proclaims in its

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<sup>27</sup> *Cook v. United States*, 288 U.S. 102 (1933).

<sup>28</sup> See Rev. Rul. 80-223, 1980-2 C.B. 217.

<sup>29</sup> See, e.g., Paul McDaniel & Hugh Ault, *Introduction to United States International Taxation*, 168-169 (2d ed. 1981). In the third edition of this book, at 174-175 (1989), the authors softened their position.

various committee reports that U.S. treaties should be interpreted to allow the newly enacted Code rule to operate without a conflict except in enumerated cases.

Some of the Congressional interpretations are unassailable. For example, most, if not all, U.S. courts would probably agree that the foreign-partnership withholding provisions of Code section 1446, enacted in 1988, are compatible with the nondiscrimination clause of U.S. tax treaties, notwithstanding some practitioner claims to the contrary. Other interpretations are aggressive. There is certainly legitimate doubt, for example, whether an impartial arbiter would hold that the commensurate-with-income standard of Code sections 482 and 367(d) is consistent with the arm's length standard allegedly enshrined in most U.S. tax treaties.<sup>30</sup> Whatever their merits, these legislative findings are likely to be given great deference by the courts.

A third way that Congress recaptured authority over treaties from the courts was through the adoption of the treaty-position disclosure rules of Code section 6114 and the complimentary penalty provisions of section 6712. The main purpose of the disclosure rules is to prevent taxpayers having treaty claims of dubious or unclear merit from escaping taxation "in the dark of the night." Taxpayers that conceal their income on the ground that they considered the income to be exempt under some tax treaty will face the penalties of section 6712.<sup>31</sup> Prior to the adoption of section 6114, tax advisors had an incentive to screen from public view the dubious treaty claims being made by their clients, thereby reducing the risk of remedial action by Congress. The disclosure rules, like the revitalized later-in-time rule, have induced more public discussion in timely fashion of potential treaty conflicts.

A fourth way that Congress has recaptured from the courts its ability to make treaty policy is its statement of intent to remedy treaty breaches by revising the Code retroactively to reverse an unintentional override that results in a treaty violation.<sup>32</sup> In effect, it has set itself up as its own court of appeals to review its earlier override decisions. Of course, it has retained the ultimate authority to determine whether a treaty violation has actually occurred.

Many commentators argue that the actions taken by Congress to prevent the courts from overturning statutes in favor of tax treaties have caused the United States to breach its obligations under international law. The treaty override issue is discussed in detail in section § 2.2.2, below.

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<sup>30</sup> As interpreted in the regulations, there is not much left of commensurate-with-income standard.

<sup>31</sup> The tough rule would be to deny the benefits of a treaty to anyone not making timely claim of an alleged treaty right.

<sup>32</sup> IRC § 904(g)(10) (carving out a treaty exception to the resourcing rules for U.S.-owned foreign corporations) was adopted in 1988 to reverse an inadvertent treaty override included in the 1984 tax act. See Senate Finance Committee, *Report 100-445* (1988) at 383 ("If conflicts requiring reversal of the later-in-time rule are found after enactment of this bill, retroactive liberalization will be appropriate.").

## § 2.2. Revision and Termination of Treaties

A tax treaty has the traditional life cycle of a private contract. In the initial stage, described in § 2.1.2, above, the treaty is brought into being. The second and third stages of that life cycle are discussed here. Section 2.2.1 describes the bilateral measures that are sanctioned by an article of the treaty itself or by customary international law for revising a treaty that has become outdated in some respects. Section 2.2.2 discusses in some detail the unilateral actions that the United States has taken on occasion to change the legal effects of its bilateral tax treaties. Section 2.2.3 describes the procedures that should be followed on the rare occasion that a tax treaty is to be terminated.

### § 2.2.1. Bilateral Revision Procedures

Tax treaties generally do not include specific provisions governing the modification of the treaty. Changes in a treaty are typically accomplished either by negotiating an entirely new treaty and terminating the old one or, more commonly, by entering into a formal protocol that amends the treaty. For all practical purposes, a protocol is simply a new treaty. The procedures for ratifying a protocol are the same as for ratifying a treaty. Under U.S. domestic rules, a protocol must be submitted to the Senate for its Advice and Consent, and formal documents of ratification must be exchanged.

The political obstacles to agreeing on a protocol to amend an existing treaty are sometimes formidable. In entering into a tax treaty in the first instance, both sides to the negotiation may view themselves as having much to gain from a successful negotiation. In the case of a protocol to modify an existing treaty, however, only one side may have a substantial gain. Indeed, if one of the Contracting States is seeking the protocol to prevent residents of the other Contracting State from obtaining unintended benefits under the treaty, that other Contracting State may view itself as having only potential losses if the proposed protocol is adopted.

As an alternative to formal amendments of a tax treaty, the Contracting States may agree informally to an interpretation of the treaty that has the effect of an amendment. For example, the competent authorities of the Contracting States might agree that an anti-avoidance measure proposed by the two countries is consistent with the treaty, notwithstanding weighty legal arguments that might be made for the contrary position. Even in the absence of formal agreement by the competent authorities, the Contracting States might achieve an informal revision of their treaty if one of the Contracting States simply acquiesces to conduct by the other Contracting State that might be considered a breach of the treaty.

### § 2.2.2. U.S. Treaty Overrides

The legitimacy of a statutory rule that “overrides” a treaty rule that may conflict with it must be determined on a case by case basis.<sup>33</sup> Some override rules are clearly permissible under

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<sup>33</sup> For discussion of the effects of an override under international law, see Michael J. McIntyre, “A Defense of Treaty Overrides,” 1 *Tax Notes Int'l* 611 (December 1990) and “More on Tax Treaty Overrides,”

the applicable international norms. For example, the override of treaty objections to the U.S. information-reporting rules imposed on foreign taxpayers simply removed opportunities for dilatory action by noncomplying taxpayers. Other overrides can be defended, but not conclusively. For example, the Treasury Department and its critics make good arguments about the legitimacy under U.S. treaties of earnings stripping rules. Congress has conceded that in a few cases its override legislation constitutes at least a technical violation of international law.<sup>34</sup> None of the tax statutes giving primacy to a Code rule over a treaty rule constitutes a material breach of U.S. treaty commitments.

The term “treaty override” has two related but distinct meanings in the tax literature. Some commentators use the term to describe a statutory provision that nullifies a privilege or benefit that a taxpayer or a government is entitled to obtain under a treaty.<sup>35</sup> Legislation classified as an override under this definition violates international law. Whether a particular piece of legislation constitutes an override under this meaning of the term is sometimes a matter for debate.

Especially among U.S. tax specialists, the term “treaty override” is often given a broader, less normative, meaning. Under this second meaning, a statutory provision is a treaty override if it is to apply notwithstanding the treaty claims that might be made against its application. The merits of the treaty claims are not relevant in classifying a provision as an override. In this report, the term “treaty override” is used in this second sense. Some legislation referred to here as a treaty override may be perfectly legal under international law. Some legal treaty overrides may represent sound tax policy, and some may not.

Prior to the 1980s, Congress had exercised its constitutional power to override tax treaties on relatively rare occasions, and the early override legislation did not create much conflict with U.S. treaty partners.<sup>36</sup> Recent tax acts and some proposed legislation, however, have contained many treaty overrides, and several of these overrides have been greeted with hostility by U.S. treaty partners. Part of the hostility is due to concerns for the integrity of the treaty process, although there have also been substantive objections to the results reached by the overrides.

The United States does not breach a treaty by adopting in good faith a treaty interpretation that is favorable to it, even if that interpretation is quite aggressive and is contested by affected taxpayers or by treaty partners. Most of the override legislation would seem to be merely an attempt by Congress to impose on private parties its interpretation of treaty provisions. All such

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2 *Tax Notes Int'l* 35 (January 1990).

<sup>34</sup> The override allowing the United States to tax gain from sale of real property holding companies is the common example of a technical violation. In this context, a technical violation is a violation of the letter of the treaty that falls short of a material breach.

<sup>35</sup> See, e.g., “OECD Committee on Fiscal Affairs Report on Tax Treaty Overrides,” 2 *Tax Notes Int'l* 25 (January 1990) at 28 (“[T]he type of treaty override primarily addressed in this note is the enactment of domestic legislation intended by the legislature to have effects in clear contradiction to international treaty obligations.”).

<sup>36</sup> By acquiescing (without duress) to an override, a treaty partner may be sanctioning the interpretation of a treaty implicit in the override. See *Vienna Convention on the Law of Treaties*, Article 31(3)(b).

interpretative overrides are consistent with the requirements of international law, absent some evidence of bad faith or some binding precedent to the contrary. Unfortunately, the distinction between an interpretative override and a substantive override is not always clear, with the result that an override viewed as interpretative by the United States may be viewed as a treaty breach by its treaty partners.

The override of treaties under the later-in-time rule in the case of unforeseen conflicts between a treaty and a statute is also sanctioned under international law as long as the United States acts promptly to rectify any treaty breaches that may occur. Congress has pledged itself to amend the Code to retroactively eliminate inadvertent breaches of U.S. treaties.<sup>37</sup>

To give rise to a remedy under international law, a breach of a treaty must be material. In the language of Article 60 of the Vienna Convention on the Law of Treaties, a material breach requires an unsanctioned repudiation of the treaty or “the violation of a provision essential to the accomplishment of the object or purpose of the treaty.”<sup>38</sup> Under this standard, it is difficult to demonstrate that the alleged breaches of tax treaties by the United States are material, although some commentators have so asserted. Of course, a violation of a treaty may be objectionable on moral grounds even if the breach is not material.

Virtually all of the U.S. treaty overrides represent attempts by Congress to prevent taxpayers from avoiding taxes that the United States is conceded to have the authority to levy under its treaties. In effect, the United States has read into each of its treaties a general anti-avoidance clause authorizing it to adopt reasonable<sup>39</sup> statutory measures to prevent the use of the treaty for tax-avoidance purpose. Actions reasonably designed to limit international tax avoidance are consistent with the object or purpose of a tax treaty.<sup>40</sup>

Treasury Department officials undoubtedly would meet with considerable resistance if they attempted to include an explicit anti-avoidance clause in all U.S. tax treaties. Many governments would be concerned that the United States would give a very expansive reading to a general anti-avoidance clause, using it to justify substantive overrides. And some U.S. treaty partners are rather tolerant of tax avoidance, as long as the taxes being avoided are those assessed by a foreign government. Of course, it is not clear that Congress or the Treasury Department would favor an explicit anti-avoidance clause in tax treaties because of their fears that it might be abused by U.S. treaty partners.

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<sup>37</sup> TAMRA did retroactively reverse an unintentional override resulting from the 1984 tax act.

<sup>38</sup> The United States is not a signatory to the Vienna Convention, but it is bound by it to the extent it codifies customary international law.

<sup>39</sup> There is such a provision in the nondiscrimination clause of the Australia and New Zealand treaties. U.S. courts have routinely read an anti-avoidance clause into some Code provisions. the leading case is *Gregory v. Helvering*, U.S. (1935).

<sup>40</sup> See OECD Commentary to Article 1, para. 24 (“The main problem seems to be whether or not general principles such as “substance-over-form” are inherent in treaty provisions. . . . [I]t is the view of the wide majority that such [domestic anti-avoidance] rules, and the underlying principles, do not have to be confirmed in the text of the convention to be applicable.”

Treaty overrides, to the extent that they violate international law, create friction between the United States and its treaty partners. Even overrides that are technically legal under international law may undermine, to some extent, the comity upon which the network of international tax agreements ultimately rests. By enacting override legislation, moreover, the United States may stimulate its trading partners to enact measures that are harmful to U.S. interests. Such action may also reduce the ability of the United States to have a positive influence on the development of international tax rules. The negative consequences of treaty overrides appear so far to be small, but there is a significant downside risk for the long term.

Whatever the costs and benefits of particular overrides, it seems clear that some internationally sanctioned mechanism ought to be developed that would reduce or even eliminate the pressures that have led to overrides. That mechanism should provide for consultations between Contracting States on the interpretation of treaties so as to limit potential abuses from overly aggressive interpretative overrides. It should also allow for orderly adjustments of minor provisions of treaties to deal with tax avoidance problems and changing economic circumstances. To be effective, the mechanism must provide for some form of binding arbitration to settle disputes that the Contracting States are unable to resolve through bilateral negotiations.

### § 2.2.3. Termination of Treaties

In general, a tax treaty continues in effect indefinitely. Most treaties provide, however, for termination procedures. Article 29 of the U.S. Model Treaty (2006) provides that the a Contracting State may terminate a tax treaty at any time if proper notice of termination is given to the other Contracting State. It contemplates that the treaty rules affecting withholding at source would cease to be in effect six months after one of the Contracting States gives formal notice of its intent to terminate. Other provisions of the treaty would terminate at the start of the first taxable year following the end of that six-month period. Most U.S. treaties, however, provide that a new treaty will continue in force for at least five years; after that period, the Contracting States could terminate the treaty by following notice rules similar to those in the U.S. Model Treaty (2006).<sup>41</sup>

Under customary international law, as codified in Article 60 of the Vienna Convention on the Law of Treaties (1996), a Contracting State may terminate a treaty at any time in the event of a “material breach” of the treaty by the other Contracting State. A material breach occurs, according to the Vienna Convention, when one of the Contracting States violates “a provision essential to the accomplishment of the object or purpose of the treaty.” The United States has never terminated a tax treaty or had one of its tax treaties terminated by the other Contracting State on the ground that a material breach occurred.<sup>42</sup>

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<sup>41</sup> See, e.g., U.S./Australia treaty, Art. 29 (2001); U.S./Belgium treaty, Art. 31 (1987); U.S./Canada treaty, Art. XXXI (2007); U.S./Mexico treaty, Art. 30 (2002); U.S./Spain treaty, Art. 30 (1990).

<sup>42</sup> The author is not aware of any tax treaty that has been terminated on that ground that a material breach has occurred. With several thousand tax treaties in existence, however, it is difficult to be certain that such a termination has never occurred. Other types of treaties have been terminated for a material

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breach, although such terminations do not appear to be common. For a general discussion of the topic, see Ian Brownlie, *Principles of Public International Law* (5th edition, 1998) at 622-623.