

**Tax Treaty Overrides:
A Qualified Defense of U.S. Practice**

Reuven S. Avi-Yonah¹

1. Introduction: The Problem of Treaty Overrides

The ability of some countries to unilaterally change, or “override,” their tax treaties through domestic legislation has frequently been identified as a serious threat to the bilateral tax treaty network.² In most countries, treaties (including tax treaties) have a status superior to that of ordinary domestic laws (see, e.g., France, Germany, the Netherlands).³ However, in some countries (primarily the U.S., but also to some extent the U.K. and Australia) treaties can be changed unilaterally by subsequent domestic legislation. This result clearly violates international law as embodied by the Vienna Convention on the Law of Treaties (“VCLT”), which is recognized as customary international law even by countries (like the U.S.) that have not formally ratified it. However, since in the same countries courts are likely to follow domestic law even if it violates international law, both taxpayers and the other treaty partner have little practical recourse in the case of a treaty override beyond terminating the

¹ Irwin I. Cohn Professor of Law, the University of Michigan. I would like to thank...

² See, e.g., OECD Committee on Fiscal Affairs, Report on Tax Treaty Overrides, 2 Tax Notes Int'l 25 (1990) (the “OECD Report”); New York State Bar Assoc., Tax Sect., Legislative Overrides of Tax Treaties, 37 Tax Notes 931 (1987); Anthony Infanti, Curtailing Tax Treaty Overrides: A Call to Action, 62 U. Pitt. L. Rev. 677 (2001); Detlev Vagts, The United States and Its Treaties: Observance and Breach, 95 AJIL 313 (2001); Richard Doernberg, Overriding Tax Treaties: The US Perspective, 9 Emory Int'l L. Rev. 71 (1995); Richard Doernberg, Treaty Override by Administrative Regulation: The Multiparty Financing Regulations, 2 Fla. Tax Rev. 521 (1995); David Sachs, Is the 19th Century Doctrine of Treaty Override Good Law for Modern Day Tax Treaties, 47 Tax Law. 867 (1994); Richard Doernberg, Legislative Overrides of Income Tax Treaties: The Branch Profits Tax and Congressional Arrogation of Authority, 42 Tax Law. 173 (1989).

³ OECD Report, 29.

treaty, which is an extreme and rarely taken step. Therefore, the OECD in 1989 issued a report (the “OECD Report”) urging member countries to refrain from treaty overrides.⁴

How serious of a problem are treaty overrides? This paper argues that the seriousness of the issue has been exaggerated. In practice, most countries, including the U.S. (which was clearly the target of the OECD Report) rarely override treaties, and when they do, in most cases the override can be justified as consistent with the underlying purposes of the relevant treaty. Moreover, treaty overrides can sometimes be an important tool in combating tax treaty abuse. Thus, I believe that if used correctly, treaty overrides can be a helpful feature of the international tax regime, albeit one that should be used sparingly and with caution.

The paper is divided into five parts. After this introduction, part 2 summarizes the conventional negative view of treaty overrides, as embodied in the VCLT and the OECD Report. Part 3 explains the theoretical position of the U.S., which on paper is a broad justification of all treaty overrides, whether or not they are consistent with the purpose of the treaty, and whether or not they are intentional. Part 4 examines the actual practice of the U.S. in treaty overrides, and shows that in practice the U.S. has rarely abused its treaty override rule, but has in fact mostly used it to combat tax treaty abuses. Part 5 concludes by examining the role that treaty overrides can play in

⁴ OECD Report; see also Recommendation of OECD Council adopted October 2, 1989, that member countries “avoid enacting legislation which is intended to have effects in clear contradiction to international treaty obligations.” OECD Report, 33. Significantly, the US refrained from blocking this recommendation.

the international tax regime, and suggesting a “middle way” between the extreme positions taken by the OECD and the U.S.

2. The VCLT and the OECD Position

The VCLT, which the U.S. has not ratified but which it accepts as embodying binding customary international law, clearly condemns treaty overrides. Article 26 of the VCLT states that *pacta sunt servanda*: “[e]very treaty in force is binding upon the parties to it and must be performed by them in good faith.”⁵ Moreover, VCLT Art. 27 adds that “[a] party may not invoke the provisions of its internal law as justification for its failure to perform a treaty.”⁶ Thus, it is clear that treaty overrides constitute a violation of international law.

The OECD Report likewise strongly condemns all treaty overrides. It states that “[t]he certainty that tax treaties bring to international tax matters has, in the past few years, been called into question, and to some extent undermined, by the tendency in certain States for domestic legislation to be passed or proposed which may override provisions of tax treaties.”⁷ It defines treaty override as “domestic legislation intended by the legislature to have effects in clear contradiction to international treaty obligations.”⁸ The OECD Report then clarifies that such treaty overrides clearly violate international law (citing the VCLT), although they may still be binding as a

⁵ VCLT Art. 26.

⁶ VCLT Art. 27.

⁷ OECD Report, 26.

⁸ OECD Report, 28.

matter of domestic law.⁹ It goes on to state that there may be little recourse for taxpayers or for the other treaty partner, short of terminating the treaty, which many countries would be reluctant to do.¹⁰

The OECD Report then gives two examples of treaty overrides. Example 1 is a straightforward case of a material breach of the treaty, in which a state introduces a new withholding tax on interest or royalties when these should be exempt from source-based taxation under the treaty. The OECD report states that “[t]he breach being a material one, the treaty partners of State A would be justified in terminating their tax treaty relationship with State A. However, termination could do even more harm economically and endanger the possibility of finding an acceptable solution in the future.”¹¹ It is hard to find an actual example on which this scenario is based.

Example 2 is a more realistic one: State B taxes capital gains from the sale of real property, but under its tax treaties is precluded from taxing capital gains on sales of stock. Taxpayers interpose a State B corporation between themselves and the real property and sell the shares in the corporation instead. State B legislates that the sale of the stock is deemed to be a sale of the real property for purposes of its treaties.¹²

This example is clearly based on the Foreign Investors in Real Property Tax Act of 1980 (FIRPTA), which constituted a treaty override and provides that sales of shares

⁹ OECD Report, 29.

¹⁰ OECD Report, 30-31.

¹¹ OECD Report, 31.

¹² OECD Report, 31.

in “US Real Property Holding Corporations” be subject to tax, even when a treaty prevents taxation of capital gains at source.¹³ The OECD Report condemns the treaty override, stating that “[t]he effect of such legislation is in contravention of State B’s tax treaty obligations, even though the overriding measure is clearly designed to put an end to the improper use of its tax treaties. There may be cases where State B could successfully argue that there is such an improper use and deny the treaty benefits but this must be done under the existing rules.”¹⁴ The OECD Report suggests as remedies a mutual agreement procedure, treaty termination, or treaty renegotiation, and suggests that treaty partners should be open to “an adequate and quick revision of the treaties.”¹⁵

The OECD Report concludes that despite the legitimacy of countering treaty abuse, “the Committee remains strongly opposed to overriding legislation...The Committee on Fiscal Affairs strongly urges Member countries to avoid any legislation which would constitute a treaty override.” The solution, it suggests, is “bilateral or unilateral consultations to address problems connected with treaty provisions.”¹⁶

3. The U.S. Position: Theory

The direct impetus for the OECD Report was a series of treaty overrides by the U.S. in the 1980s, which will be discussed in section 4 below, and an extended defense of

¹³ IRC Sec. 897.

¹⁴ OECD Report, 31.

¹⁵ OECD Report, 31-32.

¹⁶ OECD Report, 32.

the U.S. position on treaty overrides which was included in the legislative history of the Technical Corrections Act of 1988 (the “Senate Report”).¹⁷ The Senate Report explained the enactment of IRC sec. 7852(d), which states that “[f]or 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.”

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The U.S. position on treaty overrides, as embodied in the Senate Report, can be summarized as follows. Under the U.S. Constitution, "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."¹⁸ This “Supremacy Clause” was intended to ensure the supremacy of both U.S. federal laws and treaties to state laws, and was one of the major innovations in the Constitution.

On its face, the Supremacy Clause says nothing about the relationship between treaties and federal laws, and it is not at all clear whether it should ever have been interpreted as the basis for treaty overrides. However, the U.S. Supreme Court has for a long time held otherwise, deciding that under the Supremacy Clause treaties and laws are equal and therefore the principle of *lex posterior* (i.e., a later law abrogates a prior contrary law) prevails.¹⁹ In 1888, in a case that discussed the relationship

¹⁷ Senate Report 100-445, 100th Cong., 2nd Sess., Tit. I, XII H. 1 (Relationship with Treaties), explaining sec. 112(aa) of S. 2238 (IRC sec. 7852) (the “Senate Report”).

¹⁸ U.S. Const. art. VI, cl. 2.

¹⁹ 1 W. Blackstone, Commentaries *89.

between a treaty that gave most favored nation status and a later statute imposing tariffs, the Court held that in resolving a clear conflict between a treaty and a federal statute, "[t]he duty of the courts is to construe and give effect to the latest expression of the sovereign will."²⁰ And in 1957 the Court made its position even clearer, stating that "[a]n Act of Congress, which must comply with the Constitution, is on a full parity with a treaty, and ... when a statute which is subsequent in time is inconsistent with a treaty, the statute to the extent of conflict renders the treaty null."²¹

The general U.S. rule is therefore that any statute that is later in time than a treaty, and that conflicts with it in some way, is a treaty override. This rule could have led to hundreds of tax treaty overrides each year, given the frequency of U.S. tax legislation. But even the Senate Report does not go so far, explaining that the courts generally strive to construe statutes to avoid treaty overrides: "[t]he cardinal rule is that repeals by implication are not favored. Where there are two acts upon the same subject, effect should be given to both if possible.... [T]he intention of the legislature to repeal must be clear and manifest."²² The same principle applies in the case of a treaty and a later statute: "When the two relate to the same subject, the courts will always endeavor to construe them so as to give effect to both, if that can be done without violating the language of either."²³ "A treaty will not be deemed to have been abrogated or

²⁰ *Whitney v. Robertson*, 124 U.S. 190, 195 (1888).

²¹ *Reid v. Covert*, 354 U.S. 1, 18 (1957).

²² *Posadas v. National City Bank*, 296 U.S. 497, 503 (1936).

²³ *Whitney v. Robertson*, 124 U.S. at 194.

modified by a later statute unless such purpose on the part of Congress has been clearly expressed."²⁴

However, the Senate Report also makes clear that when a clear conflict does exist, a treaty override will result: "Prior judicial efforts to find consistency between earlier and later statutes and treaties illustrate the difficulties of determining when application of the general later-in-time rule should result in giving effect only to the later provision; however, these difficulties cannot be permitted to obscure the fact that if an actual conflict does exist concerning a matter within the scope of both an earlier treaty and a later statute, as properly construed, the later statute prevails."²⁵

Moreover, this result obtains even where there is no evidence in the law or its legislative history that a treaty override was intended. The Senate Report's statement in this regard fully sets out the theory underlying the U.S. position, and it is thus worth quoting in full:

Notwithstanding Congress' intent that the [1986 Tax Reform] Act and income tax treaties be construed harmoniously to the extent possible, conflicts other than those addressed in this bill or in the Act ultimately may be found or alleged to exist. Similarly, conflicts between treaties and other acts of Congress affecting revenue are likely to be found or alleged to exist in the future, either with respect to existing or future treaties and statutes. The bill provides that for purpose 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 a law. In adopting this rule, the committee intends to permanently codify (with respect to tax-related provisions) present law to the effect that canons of construction applied by the courts to the interaction of two statutes enacted at different times apply also in construing the interactions of revenue statutes and treaties enacted and entered into at different

²⁴ *Cook v. United States*, 288 U.S. 102, 120 (1933).

²⁵ Senate Report, *supra*.

times. The committee does not intend this codification to alter the initial presumption of harmony between, for example, earlier treaties and later statutes. Thus, for example, the bill continues to allow an earlier ratified treaty provision to continue in effect where there is not an actual conflict between that treaty provision and a subsequent revenue statute (i.e., where it is consistent with the intent of each provision to interpret them in a way that gives effect to both). Nor does the committee intend that this codification blunt in any way the superiority of the latest expression of the sovereign will in cases involving actual conflicts, where that expression appears in a treaty or a statute. . . .

Although the committee believes that the bill's provision regarding the equal status of treaties and statutes merely codifies present law, the committee believes that this provision, and the bill's disclosure provision, are necessary technical corrections to the Act for several reasons. The committee is concerned that the relationship of the tax laws and treaties is misunderstood. The internal tax laws of most countries provide some sort of regime for taxing either the foreign income of domestic persons, the domestic income of foreign persons, or both. Either type of income, then, is potentially subject to two autonomous tax systems each of which is at best designed to mesh with other tax systems only in broad general terms. Double taxation of the same income, or taxation of certain income by neither system, can potentially result. Income tax treaties, in the committee's view, are agreements that provide the mechanism for coordinating two identified tax systems by reference to their particular provisions and the particular tax policies they reflect, and which have as their primary objectives is a desirable goal that serves to improve the long term environment for commercial and financial dealings between residents of the treaty partners.

The committee believes that when a treaty partner's internal tax laws and policies change, treaty provisions designed and bargained to coordinate the predecessor laws and policies must be reviewed for purposes of determining how those provisions apply under the changed circumstances. The committee recognizes that there are cases where giving continued effect to a particular treaty provision does not conflict with the policy of a particular statutory change. In certain other cases, however, a mismatch between an existing treaty provision and a newly-enacted law may exist, in which case the continued effect of the treaty provision may frustrate the policy of the new internal law. In some cases the continued effect of the existing treaty provision would be to give an unbargained-for benefit to taxpayers or one of the treaty partners. At that point, the treaty provision in question may no longer eliminate double taxation or prevent fiscal evasion; if not, its intended purpose would no longer be served.

The committee recognizes that some would prefer that existing treaties be conformed to changing U.S. tax policy solely by treaty renegotiation. However, the committee notes that in recent years, U.S. tax laws have been constantly changing. Moreover, once U.S. tax policy has changed, the existence of an unbargained-for benefit created by the change would have the effect of making

renegotiation to reflect current U.S. tax policy extremely difficult, because the other country may have little or no incentive to remove an unbargained-for benefit whose cost is borne by the United States.

The committee recognizes that the parties to the treaty can differ as to whether the continued effect of a treaty provision in light of a particular statutory change provides such an unbargained-for benefit or otherwise frustrates the basic objectives of tax treaties. Remedies may be available in the case of what one party views as a breach of international law. However, the committee believes that under the constitutional system of government of the United States, where tax laws must be passed by both Houses of Congress and signed by the President, and where it is the role of the courts to decide the constitutionality of the laws and what the laws mean, it is not the role of taxpayers, the Judicial branch, or the Executive branch to determine that constitutionally valid statutes that actually conflict with earlier treaties ought not to be given effect either because of views of international law or for any other reason.

The committee is concerned that there are some who assert that treaties receive preferential treatment in their interaction with statutes. The committee is further concerned that whatever support is found for this view is based on misinterpretations of authoritative pronouncements on the subject. For example, before original introduction of this technical corrections legislation, the Internal Revenue Service announced that new Code section 367(e)(2), discussed above, which imposes corporate-level tax in certain liquidations, would not apply where it "would violate a treaty non-discrimination provision" (Notice 87-5, 1987-1 C.B. 416). Eventually, the Internal Revenue Service withdrew its notice on a prospective basis, and concluded that no treaty conflict existed (Notice 87-66, 1987-2 C.B. 376). The committee is concerned that the language used in the original notice may have suggested an erroneous inference that, had section 367(e)(2) actually created a conflict in a particular case, it would have been given no effect under the terms of the original Notice. Normal application of the later-in-time rule would not permit this result.

Other examples exist where the committee is troubled with erroneous inferences that have apparently been drawn from language used by the Executive branch. For example, in Revenue Ruling 80-223, 1980-2 C.B. 217, the Service considered the issue of whether foreign tax credit provisions enacted in the Tax Reduction Act of 1975 (sections 901(f) and 907) prevailed over conflicting provisions in earlier treaties that provide for foreign tax credits determined pursuant to the foreign tax credit provisions of the Code in effect as of dates specified in such treaties. The analysis stated the following:

In *Cook v. United States*, 288 U.S. 102 (1933), subsequent inconsistent legislation was held not to supersede an earlier treaty provision because neither the committee reports nor the debates on the subsequent legislation mentioned the earlier treaty. It is, therefore, necessary to examine the legislative history

underlying the enactment of sections 901(f) and 907 of the Code for a clear indication from Congress as to whether it intended these sections to supersede any provision of treaties entered into prior to the enactment of these sections.

The committee believes it would be erroneous to assert that the absence of legislative history mentioning a treaty was sufficient to reach the result in *Cook*. That case dealt with the question of how to construe an anti-bootlegger provision (section 581 of the Tariff Act of 1930) that first became law in an act (the Tariff Act of 1922) passed early on during Prohibition. Section 581 of the 1930 Act was a verbatim reenactment of section 581 of the Tariff Act of 1922. The scope of section 581 of the 1922 Act had been limited by a U.S.-Great Britain treaty made in 1924. The case came before the Supreme Court as Prohibition was in the last stages of being written out of the Constitution. The Court reached its conclusion on the stated ground that the treaty limit continued to apply under the 1930 Act, because section 581, "with its scope narrowed by the Treaty, remained in force after its re-enactment in the Act of 1930." 288 U.S. at 120. Properly construed, therefore, the committee believes that *Cook* stands not for the proposition that Congress must specifically advert to treaties to have later statutes given effect, but that for purposes of interpreting a reenacted statute, it may be appropriate for some purposes to treat the statute as if its effect was continuous and unbroken from the date of its original enactment.

Similarly the committee believes it would be erroneous to assert that an income tax statute such as the Tax Reduction Act of 1975 prevails over treaties only if treaty interactions are mentioned in the statute or legislative history. On the other hand, the committee believes that any such mention, if made, would be dispositive.

In view of what the committee believes is the correct treatment of treaty-statute interactions, then, the committee finds it disturbing that some assert that a treaty prevails over later enacted conflicting legislation in the absence of an explicit statement of congressional intent to override the treaty; that it is treaties, not legislation, which will prevail in the event of a conflict absent an explicit and specific legislative override. The committee does not believe this view has any foundation in present law. Moreover, the committee believes that it is not possible to insert an explicit statement addressing each specific conflict arising from a particular act in the act or its legislative history; for in the committee's view, it is not possible for Congress to assure itself that all conflicts, actual or potential, between existing treaties and proposed legislation have been identified during the legislative process of enacting a particular amendment to the tax laws. In the absence of a clear statement that legislation prevails over prior treaties, dubious tax avoidance schemes, in the committee's view, have been suggested. See, e.g., Tax Notes, March 9, 1987, at 1004, improperly suggesting that the failure to clarify the relationship between the Subchapter S Revision Act of 1982 and earlier treaties allows foreigners to own and operate U.S. business tax-free.

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 notes that the United States has over 35 income tax treaties, some of extreme complexity, plus additional treaties bearing on income tax issues. In addition, the application of United States tax law to complex business transactions exacerbates these complexities. 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 that 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.

The committee further believes that codification of this rule, together with the disclosure requirements in the bill, will lead to the early discovery of now-unknown treaty conflicts and to their appropriate resolution. If any case actually arises in which proper application of the canons of construction ultimately reveals an actual conflict, the committee expects that full legislative consideration of that conflict will take place to determine whether application of the general later-in-time rule is consistent with the spirit of the treaty (namely, to prevent double taxation by an agreed division of taxing jurisdiction, and to prevent fiscal evasion) and the proper expectations of the treaty partners.²⁶

Why does the Senate Report use such strong language? Part of the explanation may lie in the unique constitutional arrangements in the U.S.. Tax treaties, like other treaties, are negotiated by the Executive Branch (specifically, the International Tax Counsel and the Treasury's Office of Tax Policy), reviewed by the Senate Foreign Relations Committee (not the Finance Committee, which authored the Senate Report) and ratified by the Senate. Tax laws, on the other hand, must originate in the House of Representatives, are considered by the House Ways and Means Committee and the Senate Finance Committee, passed by the House and Senate and signed by the President, frequently with minimal involvement by the Treasury.

²⁶ Senate Report, *supra*.

It is thus plausible to assume that the Office of Tax Policy, which is in charge of negotiating tax treaties, would usually prefer that there be no treaty overrides, given that these make the task of negotiating future treaties harder. Thus, Treasury and the IRS, as well as the courts, may be inclined to minimize treaty overrides by interpreting away potential conflicts, and by stressing the need for Congress to be explicit. The Ways and Means and Finance Committees, on the other hand, want to retain their full authority over tax laws, and thus prefer to emphasize treaty overrides.

The U.S. theoretical position on treaty overrides is hard to defend. It implies that every statute that conflicts with an earlier treaty should prevail, whether or not there is a policy reason for the override, and whether or not the override was intentional. Given this broad statement, it is understandable that the OECD went out of its way to condemn all treaty overrides the following year, and it is remarkable that the U.S. Treasury, which participates in full in OECD activities, did not block the adoption of the OECD Report and Council Recommendation (which, like all OECD measures, require consensus by all members).

However, when we now turn to U.S. practice, it turns out that it is very different (and much more defensible) than U.S. theory.

4. The U.S. Position: Practice

When does the US actually resort to treaty overrides? The answer is rarely, and when it does so deliberately, an argument can be made that it is justified in doing so.

Consider four recent cases from the period 1986-1997: the branch profits tax, the earnings stripping rule, the multiparty financing regulations, and the reverse hybrid rule.

The branch profits tax (BPT) was enacted in 1986 to equalize the position of foreign investors who operate in the US through a subsidiary and through a branch.²⁷ Before 1986, investors who operated through a subsidiary were subject to tax on the subsidiary's income and also to a withholding tax on dividends, whereas investors who operated through a branch were only subject to a tax on the branch income because distributions from the branch were not a dividend and not subject to withholding tax. Under the branch profit tax, distributions from a branch were made subject to withholding tax. But a problem arose: Many U.S. tax treaties forbade taxing distributions from foreign corporations resident in a treaty country to their foreign shareholders even if the distribution came out of earnings of a U.S. branch, and arguably the branch profits tax violated the spirit of this rule (although not its letter). So did the U.S. resort to treaty override? It did not. Instead, it announced that the BPT will not apply to residents of those treaty countries until the treaties were renegotiated to permit the BPT. In fact, by now most U.S. treaties have been so renegotiated, and other countries have adopted the BPT in their own laws.

²⁷ IRC 884.

But this left the U.S. in a difficult position, because while treaties were slowly renegotiated, it could collect the BPT on some branches but not on others. At the time, there were no limitation on benefits provisions in U.S. treaties, leading to a concern that there would be widespread treaty shopping (i.e., setting up a corporation in a treaty jurisdiction just to benefit from the treaty). So the U.S. inserted a limitation on benefits provision into the BPT rule in the Code and made that an explicit treaty override.²⁸ Was it justified? I believe that an underlying assumption of treaties is that they are only intended to benefit bona fide residents (otherwise, any treaty becomes a “treaty with the world”). Thus, I think the override was justified because it is consistent with the underlying purpose of the treaties. But countries like the Netherlands that later negotiated much longer limitation on benefits provisions that were full of loopholes may have had reason to be miffed, because they derive revenue by letting their treaties be used for treaty shopping.

Next, consider the earnings stripping rule, adopted in 1989.²⁹ That rule is a “thin capitalization” provision, i.e., it is intended to prevent foreign parents from eliminating the tax base of their U.S. subsidiaries (or branches) through interest deductions by capitalizing them mostly with debt rather than equity. When the rule was adopted the U.S. was very worried (in light of the contemporaneous OECD Report) it will appear to be a violation of the non-discrimination provision in tax treaties if it applied only to foreign related parties. Thus, to avoid even the appearance of a treaty override, the U.S. instead applied the rule to all “tax exempt related

²⁸ IRC 884(d).

²⁹ IRC 163(j).

parties”, i.e., to domestic tax exempts as well as foreigners. But this was an obvious ruse, since no domestic tax exempts are ever related (i.e., control over 50%) to domestic taxable subsidiaries.³⁰ Nor do I believe the ruse was necessary, because in fact most countries have a thin capitalization rule and apply it explicitly to foreigners. I thus believe thin capitalization is an accepted customary international law exception to non-discrimination, which is necessary because the source country has the primary right to tax active business income and without thin capitalization that base can easily disappear. What is striking, though, given the broad justification of overrides the previous year, is how reluctant the U.S. was to override treaties.

Third, the multiparty financing regulations, which were adopted in 1995 on the basis of broad Congressional authorization in IRC 7701(l). These regulations provide that where taxpayers use conduits for treaty shopping, the IRS has the authority to disregard the conduit even when the conduit is in a treaty jurisdiction and there is no limitation on benefits provision in the treaty (or the LOB article does not apply). The regulations embody the principle developed by the courts in treaty shopping cases like *Aiken Industries*, where in the case of back to back loan via a treaty country, the court held that the conduit did not have the requisite control of the funds to qualify for treaty benefits.³¹ Again, I believe that since the underlying assumption of treaties (embodied in Article 1) is that they are only intended to benefit bona fide residents,

³⁰ In fact, Germany tried to defend its thin capitalization rule in the ECJ (which uses a far broader definition of discrimination) by a similar ruse, and the court easily dismissed the ruse. *Lankhorst-Hohorst GmbH v Finanzamt Steinfurt*, Case C-324/00, 2002 E.C.R. 11779 (December 12, 2002).

³¹ *Aiken Industries v. Commissioner*, 56 T.C. 925 (1971). But treaty shopping cannot just be left to the courts, as illustrated by *SDI Netherlands v. Commissioner*, 107 T.C. 161 (1996), in which the Tax Court approved blatant treaty shopping for royalties.

the override was justified because it is consistent with the underlying purpose of the treaties.

Finally, consider the reverse hybrid rule, adopted by the U.S. as a treaty override in 1997.³² The rule was adopted in response to a transaction in which a Canadian parent set up a limited liability company (LLC) in the U.S. and capitalized it with what was for Canadian purposes equity but for U.S. purposes was treated as debt. The LLC was treated as a branch by the U.S. but as a subsidiary by Canada. The result was that from a U.S. perspective the tax on the branch was offset by interest deductions on the debt with a reduced rate of withholding tax under the treaty, but from a Canadian perspective the income was treated as exempt dividends from a controlled subsidiary. Hence double non-taxation. The U.S. could have (and indeed later did) renegotiate the treaty, but this takes time, and a lot of revenue was being lost. Hence the treaty override, which Canada did not object to, which denied treaty benefits to such a “reverse hybrid”. Fundamentally, I believe the override was justified because the purpose of tax treaties is to prevent double taxation and not enable double non-taxation; reductions of tax at source should be premised on taxation by the residence jurisdiction.

5. Conclusion: A Middle Way

I believe, therefore, that U.S. treaty override *practice* can usually be defended as consistent with the underlying purpose of tax treaties, which is, as the OECD Report

³² IRC 894©.

states, the prevention of both double taxation and double non-taxation: “Tax treaties aim primarily at the avoidance of double taxation and the prevention of fiscal evasion but also have the objective of allocating tax revenues equitably between to Contracting States. Thus, any interpretation achieving these objectives would be preferable to one leading to double taxation or to an inappropriate double exemption.”³³

This is not to say that all U.S. tax treaty overrides are justified. A blatant example of an unjustified treaty override was a provision enacted in 1986 that specified that for purposes of the alternative minimum tax only 90% of the taxpayer’s U.S. tax on foreign source income could be offset by foreign tax credits. The result was double taxation on the other 10%, in clear violation of the purpose of treaties. Even though Congress did not state so explicitly, U.S. courts have treated this provision as a treaty override.³⁴ Fortunately, the provision was repealed in 2004.

Can a middle road be found between the extreme positions taken by the OECD Report (no treaty override even when clearly required to achieve the purpose of a treaty) and the Senate Report (all treaty overrides, even unintentional, are valid)? I believe the answer is yes, and would suggest two guiding principles.

³³ OECD Report, 30; see also OECD Commentary on Art. 1, containing broad language against tax treaty abuse, and its discussion of partnerships, which is premised on the prevention of double non-taxation.

³⁴ See, e.g., *Kappus v. Commissioner*, 337 F.3d 1053 (DC Cir. 2003) (which happens also to be the only US tax case that cites the VCLT- an unthinkable situation in most countries where treaty interpretation is involved).

First, as the U.S. courts have suggested, there should be no treaty overrides by implication. If Congress intends to override treaties it should clearly say so, signifying that it considered the issue and the potential harm to treaty partners. If there is a loophole not considered by Congress, it should revisit the issue; but it is going too far to assert, as the Senate Report does, that because Congress cannot think of all the potential conflicts, treaty overrides by implication should be permitted. Treaty overrides are serious violations of international law and may injure treaty partners; they should not happen easily or unintentionally.

Second, treaty overrides should be allowed only when consistent with the underlying dual purpose of tax treaties, i.e., to prevent double taxation and double non-taxation. This rule would distinguish the examples given in section 4, all of which strike me as justified overrides, from the unjustified AMT override cited above. It would also distinguish the OECD Report's Example 1, which is clearly unjustified because it changes the treaty bargain and can result in double taxation, from Example 2, in which I believe the override is justified: Given that the treaty bargain was to permit source taxation of real property, it seems perverse to ban a treaty override aimed at a blatant abuse of the treaty, and which leads to double non-taxation..

In fact, the latter example, taken originally from the U.S. FIRPTA legislation in 1980, was also the basis of a more recent treaty override by Australia.³⁵ This may indicate that the U.S. practice of justified treaty overrides is spreading where it is permitted by

³⁵ See Michael Kobetsky, The Aftermath of the Lamesa Case: Australia's Tax Treaty Override, IBFD Bulletin Tax Treaty Monitor 236 (June, 2005).

law, and I would welcome such a development. Tax treaties are too cumbersome to renegotiate every time taxpayers find a new way to abuse the treaty, so the OECD Report solution is inadequate. Moreover, I do not believe the other treaty partner has a justified expectation that the treaty will not be overridden in cases of abuse. Either taxpayers are abusing the expectations of both treaty partners, in which case (as in the reverse hybrid situation) the non-overriding partner will not object; or the treaty partner is profiting from encouraging abuse of its treaties (as in many treaty shopping cases), which is not a legitimate expectation. Thus, even though treaty overrides are a violation of international law, I believe they have a valid role in improving the international tax regime (which itself is in my opinion part of customary international law), and should to the extent stated above be cautiously retained.³⁶

³⁶ See Reuven S. Avi-Yonah, International Tax as International Law, 57 Tax L. Rev. 483 (2004).