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### Unraveling the Tax Treaty

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## UNRAVELING THE TAX TREATY

*Rebecca M. Kysar\**

*Coordination among nations over the taxation of international transactions rests on a network of some 2,000 bilateral double tax treaties. The double tax treaty is, in many ways, the roots of the international system of taxation. That system, however, is in upheaval in the face of globalization, technological advances, taxpayer abuse, and shifting political tides. In the academic literature, however, scrutiny of tax treaties is largely confined to the albeit important question of whether tax treaties are beneficial for developing countries. Surprisingly little consideration has been paid to whether developed countries, like the United States, should continue to sign tax treaties with one another, and no formal revenue or economic analyses of the treaties has been undertaken by the United States government. In fact, little evidence or theory exists to support entrance into tax treaties by the United States, and examination of investment flows indicates the treaties likely lose significant U.S. revenues. Additionally, the treaties enable taxpayer abuse, stagnate domestic policy, and thwart reforms of the antiquated international tax system.*

*Although tax treaties may have, at one time, served salutary purposes, modern circumstances call into question the relinquishment of taxing jurisdiction by source countries. I suggest that nations unravel the jurisdictional provisions from the treaties, abandoning or scaling them down, possibly through the new multilateral instrument. Rather than assessing antiquated notions of worldwide efficiency, the challenge for the international tax system going forward will be to attempt some degree of coordination while also imparting flexibility to advance national interests in setting revenue policy. This solution aims to thread that needle.*

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## INTRODUCTION

Coordination among nations over the taxation of international transactions rests on a network of some 2,000 bilateral double tax treaties. The double tax treaties are, in many ways, the roots of the international system. That system, however, is in upheaval in the face of globalization, technological advances, abuse by treaty beneficiaries, and shifting political tides. Yet serious examination of the worthiness of tax treaties is largely confined to the albeit important question of whether tax treaties are beneficial for developing countries. Surprisingly little to no consideration has been paid to whether developed countries should continue to sign tax treaties with one another. In fact, little evidence or theory exists to support entrance into a tax treaty by countries like the United States. And in many cases, tax treaties may be detrimental to their interests. The recent 2017 tax legislation makes these concerns even more pronounced.

Although tax treaties may have, at one time, served salutary purposes, modern circumstances call into question their necessity. In short, tax treaties do not fulfill their purported objectives. Instead of alleviating double taxation, a dubious goal in and of itself for many reasons, the treaties are the means to achieve double non-taxation. This is because the tax treaties allocate taxing jurisdiction to the country of the taxpayer's residence, which often fails to impose tax. Moreover, there is little evidence substantiating the claim that the treaties increase foreign direct investment. This is especially the case for a country like the United States, which does not benefit from the comity considerations that the treaty system imparts. Functions such as information exchange may provide benefits but can be achieved through standalone treaties that do not allocate taxing jurisdiction.

Rather than meet their intended goals, tax treaties inflict harm. Although recent scholarship laments the revenue losses imposed by the treaty system on developing countries,<sup>1</sup> even developed countries may lose revenue losses if they are net capital-importing. Although the United States was a capital exporter at the dawn of the treaty age, its role has since shifted. In fact, data that I have collected suggests the United States is currently losing a great deal of revenue through the treaty system. It perhaps seems surprising that these concerns have not been

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<sup>1</sup> Kim Brooks & Richard Krever, *The Troubling Role of Tax Treaties*, in TAX DESIGN ISSUES WORLDWIDE, SERIES ON INTERNATIONAL TAXATION 51 (Geerten M.M. Michiels & Victor Thuronyi eds., 2015); see, e.g., Allison Christians, *Tax Treaties for Investment and Aid to Sub-Saharan Africa: A Case Study*, 71 BROOK. L. REV. 639 (2005); John Avery Jones, *Are Tax Treaties Necessary?*, 53 TAX L. REV. 1, 2 (1999); Richard Vann, *International Aspects of Income Taxation*, in TAX LAW DESIGN AND DRAFTING (Victor Thuronyi ed., 1996); Alex Easson, *Do We Still Need Tax Treaties?*, 54 BULL. INT'L TAX'N 619 (2000); Tsilly Dagan, *The Tax Treaties Myth*, 32 N.Y.U. J. INT'L L. & POL. 939 (2000); Lee Sheppard, *How Can Vulnerable Countries Cope With Tax Avoidance?*, 69 TAX NOTES INT'L 410 (2013).

explored by policymakers in the United States but, as this Article argues, is less so when one considers the limited process and political economy dynamics to which such treaties are subject.<sup>2</sup>

Furthermore, the treaty system impedes fundamental reform of the international tax system. In the aftermath of recent tax legislation, many commentators have judged policies based on their compatibility with tax treaties.<sup>3</sup> I argue that such criticism is misplaced; tax reform will continue to be in tension with tax treaties precisely because the premise underlying the treaties has proven unworkable. Although some may condemn the unilateral steps taken by the United States and other countries to tax income at source, the harm that follows will likely prove to be minimal given domestic methods to alleviate “double taxation.”

Moreover, incremental change that comes from the sovereign exercise of taxing power may spur a more rational approach to international taxation; one that is unlikely to occur from the top down due to the composition of various constituencies that comprise the current global tax players. This bottom-up rebuilding of the international tax regime is likely a necessary step on the way to true international tax reform. Although there will be a temporary disruption to the international tax order, and one which will certainly pose transition costs, such adjustments are inevitable in the transition to the modern global and digital economy.

One way to ease the transition would be to employ an ordered mechanism to discard or scale down those treaty provisions that do the most harm—the ones that allocate taxing jurisdiction. One possible method is to leverage the new OECD’s multilateral instrument that is currently being used to add anti-avoidance principles, new residency safeguards, and other provisions to existing treaties. Just as the new multilateral instrument can be used to supplement the tax treaties, it can also be used to dismantle their most noxious aspects, while leaving the more useful, or at least less harmful, provisions in place. It could also be used to reduce unnecessary mismatches in tax systems, coordinating definitions of income, residency, and source, without forsaking taxing rights. Rather than assessing antiquated notions of worldwide efficiency, the challenge for the international tax system going forward will be to attempt some degree of coordination while also

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<sup>2</sup> The process by which tax treaties are enacted stands in stark contrast to trade agreements, which are subject to full consideration in the Senate *and* House. See Rebecca M. Kysar, *On the Constitutionality of Tax Treaties*, 38 YALE J. INT’L L. 1 (2012).

<sup>3</sup> See H. David Rosenbloom and Fadi Shaheen, *The BEAT and the Treaties* (Aug. 21, 2018), available at [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3229532](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3229532); Reuven Avi-Yonah & Bret Wells, *The BEAT and Treaty Overrides: A Brief Response to Rosenbloom and Shaheen* (Aug. 17, 2018), available at [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3232974](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3232974).

giving credence to national interests in setting revenue policy.<sup>4</sup> This solution aims to thread that needle.

In Part I, this Article traces the history of the international tax and the bilateral tax treaty system up through the recent 2017 U.S. tax legislation. Part II explores the stated and unstated purposes of tax treaties, concluding that they ultimately fall short from the perspective of the United States. Part III examines harmful effects of the treaty regime, including revenue losses, loss of autonomy over revenue policy, the hindrance of tax reform, and tax avoidance. Part IV offers process and political economy reasons for why U.S. treaty policy seems so misaligned with the national interest. Part V looks at ways in which the new multilateral tax treaty can be utilized to shed the most harmful treaty provisions while retaining, and perhaps building, others.

## I. BACKGROUND OF THE INTERNATIONAL TAX AND TREATY SYSTEM

### A. *The Pre-Tax Treaty Era*

The primary predicament underlying international taxation is whether income should be taxed by the country in which the taxpayer resides (the “residence country”) or by the country where the income is earned (the “source country”).<sup>5</sup> International tax rules endeavor to resolve this dilemma by deciding which country gets to tax the income.

Deferring to either the source or residence country alleviates double taxation; the difference is over which country gets the revenue.<sup>6</sup> Typically, creditor, or capital-exporting, countries will favor residence-based taxation while debtor, or capital-importing countries, favor source-based taxation. For instance, assume that there are two countries, France and Great Britain. A French business borrows money from a bank in Great Britain, and the question becomes whether France, as the source country where the business is located and where the business income is generated, or Great Britain, as the residence country of the bank getting the interest, gets to tax the interest income. If a country is capital-exporting, like Great Britain in this example, it will prefer a residence-based approach because it will get the

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<sup>4</sup> See, e.g., TSILLY DAGAN, INTERNATIONAL TAX POLICY: BETWEEN COMPETITION AND COOPERATION 7 (2017) (arguing that the new international tax system must navigate between competition and cooperation); DANIEL N. SHAVIRO, FIXING U.S. INTERNATIONAL TAXATION (2014) (questioning usefulness of notions of worldwide efficiency); Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policy*, 54 Tax L. Rev. 261 (2001) (same).

<sup>5</sup> Michael J. Graetz & Michael M. O’Hear, *The ‘Original Intent’ of U.S. International Taxation*, 51 Duke L. J. 1021, 1033 (1997). See, e.g., Ke Chin Wang, *International Double Taxation of Income: Relief through International Agreement, 1921-1945*, 59 HARV. L. REV. 73, 81-82 (1945).

<sup>6</sup> Adam H. Rosenzweig, *Thinking Outside the (Tax) Treaty*, WISC. L. REV. 740 (2012).

revenues. If a country is capital-importing, like France, then a source-based approach yields it greater tax dollars.

The traditional historical account of international taxation emphasizes a 1923 report for the League of Nations by four economists, led by Edwin Seligman, an economist at Columbia University.<sup>7</sup> The 1923 Report rejected source-based taxation as resting upon a fallacy of the “benefits” theory of taxation--an exchange of government services for taxes. Instead, its drafters argued that ability to pay concerns support taxation by the residence country since it is that country that is able to ascertain the worldwide income of its residents, not the country of source. Additionally, the authors of the report had pragmatic concerns over identifying the country of source. Importantly, the four economists recognized that capital importing nations would not fare as well under the residence-based approach and therefore recommended that such division of taxing jurisdiction only made sense where countries had similar economies.<sup>8</sup>

Several years later in 1928, the League of Nations drafted a model bilateral income tax treaty for the relief of double taxation, which was influenced by the 1923 Report, as well as other precedents.<sup>9</sup> The League of Nations treaty was quite generous to the residence country, allocating passive and portfolio income to that country. Although the source country had taxing jurisdiction over business income, such jurisdiction was limited to instances where the enterprise had a permanent establishment. Rates on passive income were also capped under the treaties, leaving residence countries with the ability to tax residual income.

The League of Nations treaty rejected an earlier model treaty, which would have utilized a methodology to split profits between source and residence countries in accordance with criteria such as sales.<sup>10</sup> In so doing, it catered to the mercantilist countries, who wished to tax more income as countries of residence rather than allocating income to where economic activity occurred.<sup>11</sup> The rationale for this framework was premised on the “mercantilist belief that imperial countries were

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<sup>7</sup> *Report on Double Taxation Submitted to the Financial Committee by Professors Bivens, Einaudi, Seligman, and Sir Josiah Stamp*, League of Nations Doc. E.F.S.73 F.19, at 18 (1923) [hereinafter 1923 Report].

<sup>8</sup> *Id.*

<sup>9</sup> Graetz, *supra* note 5, at 1078 (emphasizing the report, along with other sources, such as the early U.S. international tax legislation and the work of the International Chamber of Commerce, as influencing the League of Nations treaty).

<sup>10</sup> Bret Wells & Cym H. Lowell, *Income Tax Treaty Policy in the 21<sup>st</sup> Century: Residence v. Source*, 5 COL. J. TAX L. 1, 6 (2014).

<sup>11</sup> *Id.* at 34. As Wells & Lowell note, the discussion in the archives with regard to the political realities was “amazingly frank.” *Id.* The framers of the treaty all seemed to be aware that capital exporting nations were benefitting from the choice, at the expense of the colonized.

the source of capital and know-how while the colonies were passive suppliers of goods or services with little value-added functionality.”<sup>12</sup>

The 1928 model treaty served as the backbone of the tax treaty network, influencing the model income tax treaties of the Organization for Economic Cooperation and Development (OECD), the United Nations, and the United States. The international tax system evolved such that the default was source-based taxation with treaties as an elective, bilateral mechanism for countries to shift to residence-based taxation.<sup>13</sup> Even today, the more than three thousand bilateral income tax treaties have a fundamental structure based on the League of Nations treaty.<sup>14</sup> This residence-based approach to taxation has since been embraced by the Treasury Department numerous times<sup>15</sup> and, more generally, through the United States’ adherence to the double income tax treaty system.<sup>16</sup>

The world has obviously changed since the 1920s, with a massive growth in international capital flows, the creation of the global economy, and the rise of the multinational corporation. All of these developments increase the stakes at issue but also underscore that the foundations of the international tax system—the categories of source and residence—are inherently malleable concepts. Multinational corporations can avoid taxation by shifting capital income and IP to tax havens and by arbitraging differences in tax systems. The transfer pricing regime that attempts to stop profit shifting is premised on a legal fiction, dividing an economic firm into legal units from various countries, that thus far has proven unenforceable. Finally, competition for investment and capital has created aggressive tax competition, leaving many nations starved for revenue.<sup>17</sup>

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<sup>12</sup> *Id.* at 10.

<sup>13</sup> Rosenzweig, *supra* note 6, at 741-42.

<sup>14</sup> See Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301, 1303 (1996). The UN Model treaty gives more generous taxing rights to source countries, but it is fundamentally based on the OECD Model and its influence has been limited. Sergio Rocha, *International Fiscal Imperialism and the ‘Principle’ of the Permanent Establishment*, 64 BULL. INT’L TAX’N 83, 84 (2014).

<sup>15</sup> U.S. Treasury Dept., *Selected Tax Policy Implications of Global Electronic Commerce*, reprinted in BNA DAILY TAX REPORT L-8 (Nov. 22, 1996); DAVID F. BRADFORD, U.S. TREASURY TAX POLICY STAFF, BLUEPRINTS FOR BASIC TAX REFORM 89-90 (2d ed. 1984); see also THE PRESIDENT’S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY (May 1985).

<sup>16</sup> To be sure, the origins of the international tax system are not neat and tidy. The foreign tax credit rules of the early international tax system, for instance, were swayed by a key Treasury advisor, T.S. Adams, who argued for the primacy of source-based rather than residence-based taxation. Graetz & O’Hear, *supra* note 5, at 1027. Although residence-based taxation has reigned supreme since the dawn of the tax treaty system, this is more of a departure from, rather than a continuation of, the original international tax rules of the United States. *Id.*

<sup>17</sup> Michael J. Graetz, *Foreword—The 2017 Tax Cuts: How Polarized Politics Produced Precarious Policy*, 128 YALE L.J. F. 315 (forthcoming 2018).



It thus is worth examining whether the approach to international tax embodied in the treaty system continues to be relevant. For decades, the international tax system was praised as “remarkably stable and successful”<sup>18</sup> but few would conclude that this continues to be the case.

### *B. Purposes and Features of Tax Treaties*

Tax treaties have stated and unstated purposes. First and foremost among the former, tax treaties are designed to eliminate double taxation.<sup>19</sup> Double taxation occurs when more than one country lays claim to taxing an item of income. Tax treaties attempt to deal with double taxation by either (1) limiting source country taxation on investment income or business income that lacks a significant and continuous presence in the source country (the “permanent establishment” requirement), (2) requiring the residence country to provide an exemption of foreign source income or a tax credit for foreign taxes paid, or (3) coordinating the rules of both countries.<sup>20</sup> Tax treaties further establish competent authority procedures, and more recently, binding arbitration, such that tax authorities commit to resolving issues of double taxation.<sup>21</sup>

Another stated goal of tax treaties is to limit fiscal evasion. Treaties attempt to achieve this through information sharing provisions, which require tax authorities to disclose information to one another regarding taxpayers residing in one country who have tax obligations in the other country. These provisions override domestic confidentiality laws that bar governments from releasing tax

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<sup>18</sup> Graetz & O’Hear, *supra* note 5, at 1026; *see also* Avery Jones, *supra* note 1, at 2.

<sup>19</sup> Almost all tax treaties emphasize their purpose of avoiding double taxation by stating in the recital of the treaty the following: “Convention Between the United States of America and \_\_\_ for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income.” Philip F. Postlewaite & David S. Makarski, *The A.L.I. Tax Treaty Study—A Critique and a Modest Proposal*, 52 BULL. SEC. TAX’N 731, 734 n.2 (1999). The OECD Model Convention makes no explicit mention of avoiding double taxation, but did so until 1977. The preamble to the treaty was changed not to reject that purpose but to account for the fact that the treaty also addressed other concerns as well. INTRODUCTION TO OECD MODEL CONVENTION WITH RESPECT TO TAXES ON INCOME AND ON CAPITAL, Par. 16; Mitchell A. Kane, *International Tax Reform, the Tragedy of the Commons, and Bilateral Tax Treaties* 42 (draft on file with author).

<sup>20</sup> Rosenzweig, *supra* note 6, at 1231. *See, e.g.*, UNITED STATES DEPARTMENT OF THE TREASURY, U.S. MODEL INCOME TAX CONVENTION art. 23 (2016) (hereinafter U.S. Model Treaty) (“[D]ouble taxation will be relieved as follows . . . In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof), the United States shall allow to a resident or citizen of the United States as a credit against the United States tax on income applicable to residents and citizens . . . the income tax paid or accrued to [the other treaty country] by or on behalf of such resident or citizen).

<sup>21</sup> *Id.* at art. 25.

information. This enables the residence country to more readily identify foreign source income of its residents.

In recent years, tax treaties have been critiqued for focusing solely on double taxation rather than double non-taxation, which has plagued the international tax system in recent decades.<sup>22</sup> In response to these concerns, there are efforts to revise the stated purposes of treaties. As a result of the OECD/G20's project against base erosion and profit shifting (BEPS project), a new mechanism has been developed to update automatically existing tax treaties to conform to treaty-related minimum standards and to close gaps with existing rules. The mechanism to achieve these goals is a multilateral instrument, whereby countries choose which off-the-shelf updates they support.<sup>23</sup> Through a novel matching process, if a country's partners in existing tax treaties also choose a particular change, the treaty is automatically updated subject to domestic ratification procedures.

The new instrument provides an option whereby treaty countries can adopt a preamble that commits to the elimination of double taxation "*without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance.*"<sup>24</sup> It implements this language through rules such as minimum standards limiting treaty shopping, a new anti-abuse standard, and rules against hybrid mismatches.<sup>25</sup> Treasury indicated that the United States did not sign the instrument, in part, because its U.S. domestic tax provisions, as well as its negotiating position for a number of years, already limit treaty shopping and abuse. Sixty-eight countries and jurisdictions have, however, signed on to the effort.<sup>26</sup>

Finally, although the treaties themselves, as well as treaty commentaries, refer to the elimination of double taxation as their primary goal, some commentators have emphasized that modern tax treaties have focused primarily on the reduction of withholding taxes.<sup>27</sup> Although addressing double taxation necessarily leads to a reduction in tax liability, the inverse is not true. Thus, tax treaties may simply reduce tax rates without addressing double taxation.<sup>28</sup>

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<sup>22</sup> This dynamic partially stems from tax competition, which distorts the allocation of capital and results in revenue losses worldwide. Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1575, 1576-78 (2000).

<sup>23</sup> ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, MULTILATERAL CONVENTION TO IMPLEMENT TAX TREATY RELATED MEASURES TO PREVENT BASE EROSION AND PROFIT SHIFTING (2017).

<sup>24</sup> *Id.* at art. 6, par. 1. The multilateral instrument further provides that the participating countries can amend their treaties preamble to include a desire "to develop an economic relationship" between the treaty countries or "to enhance their co-operation in tax matters." *Id.* at art. 6, par. 3.

<sup>25</sup> *Id.* at article 7.

<sup>26</sup> Kevin A. Bell, *Five Things to Know About OECD's Multilateral Instrument*, BLOOMBERG (June 16, 2017), <https://www.bna.com/five-things-know-n73014453693/>.

<sup>27</sup> Patrick Driessen, *Is There a Tax Treaty Insularity Complex?*, TAX NOTES 745, 748 (May 7, 2012).

<sup>28</sup> *Id.*

### C. *The Domestic Rules on International Taxation*

#### 1. Worldwide v. Territorial

Tax treaties lack operative provisions of law. Instead, they mostly function as jurisdictional overlays to the domestic rules of taxation, restricting a state's claim to tax a certain item of income.<sup>29</sup> Tax treaties limit the domestic rules by allocating the right to tax income to one treaty country or by requiring relief from double taxation. Importantly, a tax treaty does not create tax obligations, which are created by the operative domestic law. Additionally, under the "savings" clause of the treaties, the residence countries retain the right to tax worldwide income.<sup>30</sup> Thus, the curtailment of source country jurisdiction only applies to foreign nationals, not to a resident of the contracting state.

The domestic rules of international tax are as varied as the number of countries that employ them, but a few generalizations can be made. Commentators refer to two different types of international tax systems, worldwide and territorial. A worldwide system of taxation subjects foreign earnings to taxation, typically with relief of double taxation through a foreign tax credit. A territorial system of taxation exempts such earnings altogether.

The majority of developed countries have shifted, in recent decades, towards territoriality. In reality, however, the distinction between territorial systems and worldwide systems is blurred, and the systems exist along a continuum.<sup>31</sup> Developed countries with territorial systems, for instance, have anti-profit shifting rules that tax certain types of highly mobile foreign income, which are presumed to be located offshore simply for tax reasons. These foreign systems could thus be more properly described as quasi-territorial. The United States' international tax system, both new and old, also lies on a spectrum, as discussed below.

#### 2. The U.S. Rules—Pre- and Post- 2017

Experts often referred to the former U.S. international tax system as worldwide since it subjected foreign earnings to U.S. taxation. However, the former system never fully taxed these earnings. Taxation could be deferred, even indefinitely, by parking active income in foreign subsidiaries. In contrast, taxation could not be deferred on passive income, which was, and still is, taxed on a current

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<sup>29</sup> Rebecca M. Kysar, *Interpreting Tax Treaties*, 101 IOWA L. REV. 1387, 1411 (2016).

<sup>30</sup> U.S. Model Treaty, *supra* note 20, at art 1(4).

<sup>31</sup> See Mark P. Keightley & Jeffrey M. Stupak, *Corporate Tax Base Erosion and Profit Shifting (BEPS): An Examination of the Data*, CONG. RESEARCH SERV. R44013, at 17 (2015) (discussing the futility of the worldwide and territorial labels); Daniel Shaviro, *The New Non-Territorial U.S. International Tax System*, TAX NOTES (July 17, 2018).

basis under the anti-deferral rules of subpart F and the passive foreign investment company regime. Additionally, the transfer pricing regime attempted to prevent companies from shifting too much income abroad to their foreign affiliates by charging non-arm's length prices. These rules are notoriously ineffective, yet they continue to be relevant under the new system.

Since the taxation of foreign source income by the United States might subject such income to double taxation, the United States has long offered a foreign tax credit for foreign taxes paid on such income. The credit was first enacted in 1918,<sup>32</sup> long before the United States' entrance into its first tax treaty in 1932.<sup>33</sup> The effect of the credit is such that the United States collects residual taxation when its tax rate exceeds the foreign rate. When the foreign rate equals or exceeds the U.S. rate, U.S. tax liability is eliminated.<sup>34</sup>

The new regime has been labeled a territorial system because the foreign income of foreign subsidiaries can escape taxation altogether through the new participation exemption provision so long as the domestic shareholder owns at least 10% of the stock of the subsidiary.<sup>35</sup> Here again, however, the territorial label fails since individuals, branches, and smaller shareholders are still subject to taxation on foreign income. Furthermore, there is a minimum tax regime, called the global intangible low tax income or GILTI regime, which subjects some foreign income of 10% corporate shareholders to a current 10.5% tax (and allows a foreign tax credit offset for 80% of foreign taxes paid).<sup>36</sup> Lawmakers created these worldwide features since a move to pure exemption, as opposed to deferral, would have worsened incentives to shift income abroad.

In addition to the participation exemption and minimum tax regimes, the 2017 tax legislation also enacted two other notable reforms. In the foreign derived intangible income or FDII regime, Congress provided a special low rate on export income.<sup>37</sup> Through the base erosion anti-abuse tax or BEAT regime, the legislation also bolstered source-based taxation by targeting profit stripping by U.S. firms making deductible payments to foreign affiliates. The BEAT subjects such payments to a minimum tax of 10%.<sup>38</sup> Features of these new rules are in arguable tension with bilateral tax treaties, a point which will be treated more fully below.<sup>39</sup>

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<sup>32</sup> Revenue Act of 1918, ch. 18, 40 Stat. 1057 (1919).

<sup>33</sup> See Herbert I. Lazerow, *The United States-French Income Tax Convention*, 39 *FORDHAM L. REV.* 649, n.1 (1971).

<sup>34</sup> Elisabeth A. Owens, *United States Income Tax Treaties: Their Role in Relieving Double Taxation*, 17 *Rutgers L. Rev.* 428, 432 (1963).

<sup>35</sup> 16 U.S.C. § 245A.

<sup>36</sup> 26 U.S.C. §§ 250(a)(1); 951A; 960.

<sup>37</sup> 26 U.S.C. § 250.

<sup>38</sup> 26 U.S.C. § 59A.

<sup>39</sup> See *supra* notes [ ] and accompanying text.

## II. THE PURPORTED PURPOSES OF TAX TREATIES

As mentioned above, there are both stated and unstated purposes of tax treaties. The treaties themselves set forth double taxation relief and the prevention of fiscal evasion as their aims, yet commentators have hypothesized other motivations behind the treaties as well. This section explores how all of these goals go largely unfilled.

### A. *Alleviation of Double Taxation*

#### 1. Availability of Unilateral Relief

The need to alleviate double taxation served as the impetus for the tax treaty regime. The conventional account is that, without tax treaties, multiple countries will lay claim to the same item of income.<sup>40</sup> The predominant explanation for why we care about double taxation is that it “represents an unfair burden on existing investment and an arbitrary barrier to the free flow of international capital, goods, and persons.”<sup>41</sup>

Tsilly Dagan has illustrated, however, that even without tax treaties, countries have incentives and mechanisms to alleviate double taxation unilaterally.<sup>42</sup> Instead, Dagan argues that tax treaties serve “much less heroic goals,” such as easing administrative burdens and harmonizing tax terminology.<sup>43</sup> More nefariously, Dagan contends tax treaties shift revenues from developing to developed countries.<sup>44</sup> The IMF has agreed with Dagan’s view, noting that tax treaties based on the OECD model “significantly constrain the source country’s rights,” and cautions against developing countries entering into such treaties.<sup>45</sup>

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<sup>40</sup> Staff of Senate Comm. on Foreign Relations, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Canada*, 105th Cong. 4 (Comm. Print 1997) (“The traditional objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion.”); COMM. ON FISCAL AFFAIRS, ORG. FOR ECON. COOPERATION AND DEVELOPMENT, INTRODUCTION TO MODEL TAX CONVENTION ON INCOME AND CAPITAL, para 15.2 (2017) (“[A] main objective of tax treaties is the avoidance of double taxation in order to reduce tax obstacles to cross-border service, trade, and investment”).

<sup>41</sup> H. David Rosenbloom & Stanley I. Langbein, *United States Treaty Policy: An Overview*, 19 COLUM. J. TRANSNATIONAL L. 359, 365-266 (1981).

<sup>42</sup> Dagan, *supra* note 1, at 941.

<sup>43</sup> *Id.* at 939.

<sup>44</sup> *Id.*

<sup>45</sup> International Monetary Fund, *Spillovers in International Corporate Taxation*, Policy Paper 12 (May 9, 2014) (footnote omitted), <https://www.imf.org/external/np/pp/eng/2014/050914.pdf>; Mindy Herzfeld, *The Case Against BEPS: Lessons for Tax Coordination*, 21 FL. TAX REV. 1, 16-17 (2017). Predating Dagan’s analysis by several decades were comments by Elisabeth Owens, who,

Using a game theory model, Dagan shows that because countries have incentives to alleviate double taxation unilaterally, a stable equilibrium of alleviation of double taxation would be achieved without tax treaties.<sup>46</sup> These incentives derive from a country's preferences to achieve a certain level of cross-border investment. Dagan concludes that, under a variety of assumptions regarding those preferences, the outcome of unilateral policies is single rather than double taxation.<sup>47</sup>

Dagan concludes tax treaties involve something other than elimination of double taxation. U.S. and global history lends support to Dagan's conclusion since the United States enacted the foreign tax credit almost fifteen years before entering into tax treaties.<sup>48</sup> Today, most countries include in their tax treaties the same mechanism for double tax relief that they provide outside of the tax treaty context.<sup>49</sup>

Dagan instead posits that tax treaties exist to shift revenues from source countries, which are predominantly developing nations, to residence countries, which are predominantly developed nations. How precisely does this work? The lower the tax is in the source state, the higher the residual tax will be in the residence state. For instance, assume Country A, the residence state, taxes income at a 35%

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focusing on the United States, argued that "tax treaties play a very marginal role in relieving double taxation" because "the U.S. has unilaterally provided for the avoidance of double taxation . . . through the foreign tax credit provisions of the Internal Revenue Code." Owens, *supra* note 34, at 430. More recently, commentators have reflected on the diminished role of tax treaties but without much elaboration or normative assessment. Dagan, *supra* note 1, at 8 (making this point); see, e.g., JOSEPH ISENBERGH, INTERNATIONAL TAXATION: U.S. TAXATION OF FOREIGN PERSONS AND FOREIGN INCOME 55:2 (2d ed. 1996) ("Tax treaties are principally concerned with the apportionment of tax revenues between the treasuries of the treaty countries..."); see also PAUL R. MCDANIEL & HUGH J. AULT, INTRODUCTION TO UNITED STATES INTERNATIONAL TAXATION 151 (1977) (concluding that double taxation is eliminated through unilateral measures and that tax treaties serve a more modest function of refining these measures to reflect the relationships of the two treaty countries); Julie A. Roin, *Rethinking Tax Treaties in a Strategic World with Disparate Tax Systems*, 81 VA. L. REV. 1753, 1767 (1995) (arguing that unilateral measures to reduce double taxation has lessened the need for taxpayers to rely on treaty provisions); Pierre Gravelle, *Tax Treaties: Concepts, Objectives and Types*, 42 BULL. FOR INT'L FISCAL DOCUMENTATION 522, 523 (1988) (adopting the view that tax treaties merely "refine[] and improve[]" the domestic mechanisms to alleviate double taxation). The ALI, in contrast, has concluded that "[t]here is remarkably broad and well-established consensus among governments of various political and economic persuasions that it is in their interest to enter into income tax treaties . . ." AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT: INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION II, PROPOSALS ON UNITED STATES INCOME TAX TREATIES 5 (1992). Even the ALI, however, also admitted that many treaty goals can be achieved through domestic legislation, outside of the treaty process. Instead, countries modify their domestic laws only to derive reciprocal dispensations from the other country. *Id.* at 12-13.

<sup>46</sup> DAGAN, *supra* note 4, AT 7.

<sup>47</sup> *Id.* at 13-36.

<sup>48</sup> Steven Dean, *Philosopher Kings and International Tax*, 58 HASTINGS L.J. 911, 944 (2007).

<sup>49</sup> DAGAN, *supra* note 4, at 37.

rate with a credit for foreign taxes paid. If a Country A resident earns \$100 income in Country B, the source state, that is taxed at a 30% withholding rate, then Country B will receive \$30 of tax revenue and Country A will receive only \$5 of revenue. If instead a treaty lowers the Country B withholding tax to 15%, Country B will receive \$15 of tax revenue, and Country A will receive \$20 of revenue.<sup>50</sup>

Why would Country B forgo its revenues? It aims to increase inbound foreign investment by lowering the tax burden on it. Additionally, because the benefits are reciprocal, it may receive more revenues with the treaty than without it, depending upon the balance of investment flows between the two countries.

Thus, tax treaties would tend to make the most sense when countries are in relatively symmetrical positions regarding their investment flows into the other country. In such cases, the taxes the countries lose from their position of lowering taxes as a source country will be offset by the increased revenues they get to collect from their own residents in their capacity as a residence country. This is assuming that the other purported benefits of treaties occur, such as investment, administrative, and enforcement efficiencies.<sup>51</sup>

As this Article discusses further below,<sup>52</sup> the story of the symmetrical tax treaty is largely fictitious, calling into question whether the traditional account supporting the entrance into such obligations continues to hold true. Now that the U.S. is a major capital importer, it is puzzling that its treaty policy has stood still as its trade flows have reversed.<sup>53</sup>

## 2. Double Taxation Relief Through Harmonization?

If alleviation of double taxation is provided unilaterally through foreign tax credits, deductions, or exemption, even in the absence of the tax treaty regime, then it is possible that the treaties serve to alleviate double taxation when these measures fail, for instance by coordinating tax terms. Tax treaties, however, by and large do not resolve such matters. If a country taxes domestic source income, then one function of a tax treaty might be to ensure that what constitutes domestic (as opposed to foreign) source income is understood by all parties.<sup>54</sup> In fact, treaties serve no such purposes, instead leaving the definition of source to the domestic rules. Although some treaties contain resourcing rules that may state that an item of income is treated as foreign source if a treaty partner is permitted to tax it, these

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<sup>50</sup> Kysar *supra* note 29, at n. 18.

<sup>51</sup> DAGAN, *supra* note 4, at 45-46.

<sup>52</sup> See *supra* notes [ ] and accompanying text.

<sup>53</sup> H. David Rosenbloom, *Toward a New Tax Treaty Policy for a New Decade*, 9 AM. J. TAX POL. 77, 83 (1991) (calling into question the wisdom of adhering to prior trade policy since it can no longer be assumed that U.S. investors abroad outnumber foreign investors in the United States).

<sup>54</sup> Owens, *supra* note 34, at 430.

are not always comprehensive.<sup>55</sup> This amounts to a significant amount of double taxation that is left to be resolved through the treaty's administrative solutions, such as the mutual agreement procedure and, increasingly, binding arbitration. Although such dispute resolution procedures might be important, they need not be accompanied by the shifting of tax jurisdiction between countries and could instead be set forth as standalone agreements.<sup>56</sup>

Treaties also do not resolve conflicts of characterization, again leaving a significant amount of double taxation in place.<sup>57</sup> This is because the treaties defer to the domestic rules to assign character of income. For instance, suppose the residence country characterizes income as royalties, thereby concluding that such income is exempt from source country taxation under the treaty and is taxable by the residence country. Further suppose the source country characterizes the income as compensation from personal services, in which case it is rightly subject to taxation by the source country under the treaty. This produces a conflict, which the treaties do not resolve.<sup>58</sup>

Double taxation may also occur because the treaties do not contain a uniform and ascertainable definition of "covered taxes," or the taxes for which the treaty country must provide relief from double taxation. In the U.S. Model Treaty, for instance, Article 2 states that the treaty applies to "federal income taxes imposed by the Internal Revenue Code," and also covers "identical or substantially similar taxes that are imposed after the date of [the signing of the treaty] in addition to, or in place of, the existing taxes." The term "covered taxes" is notoriously difficult to interpret and, in recent years, has become subject to intense debate.<sup>59</sup>

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<sup>55</sup> The U.S. Model Treaty currently has a general re-sourcing rule that is fairly comprehensive. It is intended to ensure that a U.S. resident can obtain a foreign tax credit when a treaty partner taxes the item of income in question. Technical Explanation of the 2006 U.S. Model Income Tax Convention, Art. 23(3). Many treaties in force, however, have far less comprehensive re-sourcing rules. New York State Bar Association Tax Section, Report on Treaty Re-Sourcing Rules 22-33 (Nov. 24, 2014), at [https://www.nysba.org/Sections/Tax/Tax\\_Section\\_Reports/Tax\\_Reports\\_2014/Tax\\_Section\\_Report\\_1313.html](https://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Reports_2014/Tax_Section_Report_1313.html).

<sup>56</sup> Brooks & Krever, *supra* note 1, at 166.

<sup>57</sup> *Id.* at 168.

<sup>58</sup> See *Boulez v. Commissioner*, 83 T.C. 584 (1984) (holding that payments to a music conductor were compensation for services, a category that did not get benefits under the relevant treaty, rather than royalties, which would have been tax-free under the treaty). Article 3(2) provides that if a term is not defined by the treaty, then the country that is applying the treaty should use its tax law to supply the term's meaning, "unless the context otherwise requires." One interpretation of Article 3(2) is that only the source state can invoke it since it is the one typically applying the treaty. Avery Jones, *supra* note 1, at 18. The residence state, however, could take the position that it should apply its domestic laws in interpreting whether it must give relief for double taxation. In such cases, double taxation might ensue.

<sup>59</sup> Fadi Shaheen, *Destination-Based Cashflow Taxes and Tax Treaty Compatibility* (draft on file with author); Richard Collier & Michael P. Devereux, *The Destination-Based Cash Flow Tax and Double*



Avoidance of double taxation is also often not achieved because transactions involve jurisdictions beyond those mentioned in the tax treaties.<sup>60</sup> Moreover, treaties address only juridical rather than economic double taxation, thereby allowing some double taxation to occur.<sup>61</sup>

Tax treaties could resolve many of the above such matters, but the treaty language is often very general and its structure interstitial. This lack of specificity and comprehensiveness is most certainly a conscious choice by the treaty parties, who are reluctant to grant double tax relief in close cases. For the most part, these are, however, precisely those cases not granted relief under domestic law, and so one is left to wonder what tax treaties accomplish that is not already achieved under the statutes.

### 3. Double Taxation as Red Herring

Even if tax treaties were necessary to accomplish the avoidance of double taxation, it is unclear whether that goal should be pursued. To achieve double taxation relief would require more complete coordination, which may be undesirable given the centrality of taxation to the governmental function. As Daniel Shaviro has argued outside of the treaty context, nations may be reluctant to forfeit their independence in this area.<sup>62</sup> Additionally, defining source “correctly” is, in many contexts, a fool’s errand. Economically speaking, multiple and overlapping jurisdictions generate income.<sup>63</sup> Finally, Shaviro argues that the principle of taxing all income once will likely not enhance global efficiency. This is because countries vary in their tax rates; therefore taxing income once, and only once, does not yield

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*Tax Treaties*, Oxford University Centre for Business Taxation Working paper series (July 2017), at [https://www.sbs.ox.ac.uk/sites/default/files/Business\\_Taxation/Docs/Publications/Working\\_Paper\\_s/Series\\_17/WP1706.pdf](https://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Docs/Publications/Working_Paper_s/Series_17/WP1706.pdf). Most recently, whether the new BEAT, enacted in the 2017 U.S. tax legislation, falls within the scope of Article 2 has become an area of live concern given that regime’s only partial creditability of foreign tax credits. See *supra* notes [ ] and accompanying discussion.

<sup>60</sup> EMILY FETT, TRIANGULAR CASES: THE APPLICATION OF BILATERAL INCOME TAX TREATIES IN MULTILATERAL SITUATIONS (2014).

<sup>61</sup> Yariv Brauner, *Treaties in the Aftermath of BEPS*, 41 BROOK. J. INT’L L. 974, 986 (2016). Juridical double taxation is when the same taxpayer has to pay tax twice on the same income. Economic double taxation occurs when different taxpayers have to pay tax twice on the same income. See also Wei Cui, *Minimalism about Source and Residence*, 38 MICH. J. INT’L L. 245 (2017) (arguing that the invocation of double taxation overlooks the economic incidence of taxes).

<sup>62</sup> DANIEL N. SHAVIRO, FIXING U.S. INTERNATIONAL TAXATION 113-14 (2014).

<sup>63</sup> *Id.* See also Hugh J. Ault & David F. Bradford, *Taxing International Income: An Analysis of the U.S. System and its Economic Premises*, in TAXATION OF THE GLOBAL ECONOMY 11, 30 (Assaf Razin & Joel Slemrod, eds., 1990) (contending that “source” lacks economic content). But see Mitchell A. Kane, *A Defense of Source Rules in International Taxation* (defending the coherence of source although not necessarily on economic grounds).

any locational neutrality in investment decisions.<sup>64</sup> Instead, taxpayers will decide where to conduct activity based on where the lowest tax rate can be obtained. In the real world, because of differences in tax regimes, double taxation of income may even *increase* global efficiency, if, for instance, this would create neutrality between a taxpayer facing a 20% rate in Country A versus a 40% rate in Country B.<sup>65</sup>

Shaviro, however, goes on to conclude that the avoidance of double taxation may nonetheless be a worthy goal of bilateral tax treaties if the treaty countries have the same tax rates and equal cross-border capital flows.<sup>66</sup> The avoidance of double taxation creates economic surplus by establishing neutrality between single-country and cross-country income. Because the countries are similarly situated, the concessions made by Country A in the above example in forgoing taxation of Country's B residents are balanced by Country B's similar concessions regarding its own residents.

In reality, however, it is extremely unlikely that the two countries will be identically situated, both in tax rates and investment flows. This is especially true over time. Moreover, even if such homogeneity exists, the existence of tax havens likely creates imbalance between the two countries since it is likely that one country's rules allow for more or less income-shifting to such havens.<sup>67</sup> It is thus unclear what goal the avoidance of double taxation is serving, even in the treaty context. Indeed, the heterogeneity of treaty countries may explain the above observation—that treaties do not in fact ameliorate double taxation. Doing so would serve no efficiency goal nor would it be of equal desirability to each country.

Another recent debate in the academic literature exposes what little work the concept of double taxation accomplishes in the treaty network. Recent proposals for reforming the U.S. international tax system deviate from the model of full creditability of foreign taxes under a worldwide system. Shaviro, for instance, has proposed a reduced rate for foreign source business income and the allowance of a deduction, rather than a credit, for foreign taxes paid. Part of Shaviro's rationale stems from the conclusion that the foreign tax credit's 100% marginal reimbursement rate (MRR) problematically makes taxpayers insensitive to foreign tax rates.<sup>68</sup> This is against the national interest because the United States government ends up footing the bill for higher taxes abroad. Shaviro's approach is similar to other proposals, such as Option Z and that of the former Obama

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<sup>64</sup> SHAVIRO, *supra* note 62, at 114.

<sup>65</sup> *Id.*

<sup>66</sup> *Id.* at 115.

<sup>67</sup> *Id.* at 115-116.

<sup>68</sup> Daniel N. Shaviro, *Rethinking Foreign Tax Creditability*, 63 NAT'L TAX J. 709 (2010); *see also* Michael J. Graetz & Itai Grinberg, *Taxing International Portfolio Income*, 56 TAX L. REV. 537, 568-74 (2003) (reaching similar conclusions for foreign taxes on passive income).

administration.<sup>69</sup> It also has been partially implemented in the 2017 legislation through the GILTI regime, which allows foreign tax credits of only 80%.

It is an open issue whether these proposals or the GILTI regime comply with Article 23 of the treaties, which require either exemption or a credit for foreign taxes, but there is a persuasive argument that incarnations of them do. Although historically, the foreign tax credit is dollar for dollar, Fadi Shaheen argues that as a formal matter, and in furtherance of the purpose of the credit, it is acceptable to divide a dollar of foreign source income and allow credits on only a portion so long as the other portion is exempted.<sup>70</sup> Option Z would have followed this approach explicitly, providing that foreign source income was 60% taxable with foreign tax credits and 40% exempt.<sup>71</sup> GILTI is a variation of this approach, albeit more generous, since it is taxing only 50% of foreign source income while allowing 80% of foreign tax credits. Shaheen's argument is that, under both the U.S. and OECD model treaties, these types of proposals are treaty-compliant so long as the exempt piece and the creditable piece of the income add up to at least 100%.

Mitchell Kane agrees with Shaheen's general conclusion that so long as the income can be separated into exempt and creditable portions, a mixture of these two approaches is treaty-compliant. Kane goes further to add that treaties prevent the resident country from causing its residents' foreign source income to be taxed at a higher rate than domestic source income (taking into account both countries' taxes). This means that if the source country imposes a higher tax than the residence country, then the residence country cannot impose any residence-based tax. If the source country taxes at a lower rate, than the residence country can tax the shortfall, but only up to its rate on domestic source income.<sup>72</sup>

Drawing upon League of Nations documents, Kane's argues that double taxation does not really mean double taxation.<sup>73</sup> Instead, in the treaty sense, the benchmark simply means whether the overall tax burden exceeds that that would have been imposed by the residence country on domestic source income. Tax treaties, in other words, are about capping rates rather than double taxation per se. In pursuing this goal, they strive towards a particular result rather than a particular method.<sup>74</sup>

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<sup>69</sup> Shaviro himself notes these similarities. Daniel Shaviro, *Response to Comments on Fixing International Taxation*, 9 JRSLM. REV. LEGAL STUD. 132, 140-41 (2014).

<sup>70</sup> Fadi Shaheen, *How Reform-Friendly are U.S. Tax Treaties?*, 41 BROOK. J. INT'L L. 1243, 1250-51 (2016).

<sup>71</sup> STAFF OF THE J. COMM. ON TAXATION, 113<sup>TH</sup> CONG., JCX-15-13, TECHNICAL EXPLANATION OF THE SENATE COMMITTEE ON FINANCE CHAIRMAN'S STAFF DISCUSSION DRAFT OF PROVISIONS TO REFORM INTERNATIONAL BUSINESS TAXATION (Comm. Print 2013).

<sup>72</sup> Kane, *supra* note 19.

<sup>73</sup> Kane, *supra* note 19, at 47.

<sup>74</sup> *Id.*

Under this framework, what obligation to credit foreign taxes does the residence country have when it imposes a lower rate on foreign source income than it does on domestic source income? Kane admits this is a question that the treaty drafters did not specifically contemplate, but using the above framework, this set of facts should reduce the burden of juridical double taxation and the corresponding obligation arising under Article 23. In such cases, Kane reasons that a partial credit, rather than a dollar for dollar credit, will satisfy Article 23 so long as the overall tax burden does not exceed that imposed on domestic source income.

Both Kane's and Shaheen's analysis seem to suggest that Article 23's central concern is aggregate tax burden rather than the method of double tax relief, albeit Kane's conclusion is more explicit in this regard. If double taxation seems like a normatively empty goal, does aggregate tax burden fare any better? It would seem, after all, that investors care about the overall level of tax they are paying rather than whether income is technically taxed once, twice, or multiple times. Double taxation could lead to better tax results than single taxation, if for instance two countries imposed 10% tax and a single country imposed a 30% tax.

It seems rational, then, that countries should care more about overall taxation rather than double taxation. It also seems in the countries' interest to preserve a mixture of double tax relief methods, as Kane concludes. From the perspective of the residence country, worldwide taxation with full foreign tax credit relief cuts off tax competition since the source country cannot set the tax burden on the foreign source income, whereas under an exemption system, the source country can do so. But the former system also makes its investors insensitive to local tax rates and may overly burden its residents. From the perspective of the source country, it may prefer residence country exemption since it gets to set the tax rates, however the source country may enjoy the ability to increase revenues without the foreign resident facing an increased tax burden, as is possible under the credit system.<sup>75</sup>

In Kane's view, both residence and source countries would prefer a treaty that preserves policy mixture so that they can balance these various and competing goals rather than a system that forces them into pure credit or pure exemption approaches. And, under Kane's view, the former system is indeed what we have. Kane is likely right that a hybrid approach to international taxation makes the most sense strategically and indeed is reflected in the treaties and nearly all international tax systems. But a further question arises as to whether the treaty is doing any work here.

If it is in the unilateral interest of both nations to have a mixed system, then that is likely what will arise without tax treaties. Indeed, the flexibility of the treaties, as interpreted by Kane and Shaheen, means that neither nation has settled

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<sup>75</sup> *Id.*

upon which degree of rate competition versus revenue collection they would prefer, instead leaving it up to the domestic policies of the residence country. The source country, in other words, remains beholden to the policy choices of the treaty partner.

One concession that the source country does obtain, at least under Kane's view, is that overall taxation will be capped at the residence country's tax rate on domestic source income. Query, however, whether this is any sort of meaningful promise. Overall taxation still depends on the domestic rates of the residence country; nothing in the treaty prevents very high taxation so long as the residence country also imposes such rates on domestic source income. There are political and practical constraints, however, on the ability of the residence country to tax foreign source income more heavily than domestic source income.

In fact, it is generally the opposite that we worry about—that foreign source income goes *undertaxed* by the residence country. This outcome results because there are convincing reasons a residence country would prefer to more lightly tax foreign source income than domestic source income. While location-specific rents, as well as a robust labor market, might support a high U.S. tax rate on domestic source income, such factors likely do not support taxation of foreign source income at the same levels.<sup>76</sup> In other words, it is efficient for a country to tax foreign source income at a lower rate than domestic source income because it can exercise its market power more with respect to the latter, thereby making the former more tax-elastic. On the other hand, the residence country should prefer to impose *some* degree of taxation on a resident company's foreign source income since doing so discourages profit-shifting and also brings in revenues.<sup>77</sup>

Perhaps because of this balancing act, every tax system unilaterally seems to tax foreign source income of resident companies more lightly than domestic source income. In the old worldwide system, the United States' tolerance of deferral effectively created a disparity in the rates on domestic and foreign source income, favoring the latter. Under the new system, that choice is more explicit, with foreign source income obtaining a 50% deduction. And in pure territorial systems, active foreign source income is exempt. Thus, it seems that this purported goal for tax treaties—to constrain the top rate residence countries can impose on foreign source income—would likely be achieved in the absence of the treaties. Although Kane and Shaheen's careful work is helpful in detailing how tax treaties can accommodate this type of tax reform, we have yet to find a good reason for tax treaties in the first place.

Finally, without the concept of double taxation as a guide for setting jurisdictional limits, there does not seem to be any basis to have strict reciprocity

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<sup>76</sup> Daniel Shaviro, *The Crossroads Versus the Seesaw*, 69 TAX L. REV. 1, 10 (2015).

<sup>77</sup> Shaviro, *supra* note 31.

of rates through a bilateral solution. Domestic legislation could instead achieve lower withholding rates.

### *B. The Prevention of Fiscal Evasion*

The other stated purpose of tax treaties is the prevention of fiscal evasion. Traditionally, this rationale supported the exchange of relevant information. Article 26, which implements this principle, however, is ineffective. In both the U.S. and OECD Model treaties, a party does not have to provide information “which is not obtainable under the laws or in the normal course of the administration” or “which would disclose any trade, business, industrial, commercial, or professional secret or trade process.”<sup>78</sup> For many years, countries like Luxembourg and Switzerland took the position that these carve-outs specifically allowed bank secrecy to trump information exchange.<sup>79</sup>

More generally, a treaty is an odd mechanism to induce banking havens to share information. The United States may care very deeply about wanting information from a banking haven, but there is no reciprocal desire on the haven’s side. They therefore have no incentive to fulfill their agreement.<sup>80</sup> Moreover, when evasion spans multiple countries, the bilateral format of the income tax treaty does little to solve the problem.<sup>81</sup>

To the extent exchange of information by international agreement is desirable, there are other means to achieve it. Tax information exchange agreements (TIEAs) based on a 2002 OECD model agreement allow countries to exchange information on taxpayers without also reallocating taxing jurisdiction. In their first decade, over 500 TIEAs were entered into.<sup>82</sup> Newer tools, like domestic legislation and implementing bilateral agreements, can also be utilized to yield information exchange. In 2010, for instance, the United States enacted the Foreign Account Tax Compliance Act (FATCA) to stop tax evasion by its residents. FATCA requires foreign banks and financial institutions to provide information on U.S. taxpayers and their financial accounts. The novel feature of FATCA is a 30% withholding tax on U.S. source income paid to taxpayers that have not provided information regarding their residency or identity of their owners.

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<sup>78</sup> U.S. Model Treaty, *supra* note 20, at art. 26; ORG. FOR ECON. COOPERATION & DEV., MODEL CONVENTION WITH RESPECT TO TAXES ON INCOME AND ON CAPITAL, art. 26 (2014) (hereinafter OECD Model Treaty).

<sup>79</sup> Lee Sheppard, *Don’t Ask, Don’t Tell, Part 4: Ineffectual Information Sharing*, 63 TAX NOTES INT’L 1139 (2009).

<sup>80</sup> *Id.*

<sup>81</sup> *Id.*

<sup>82</sup> Org. For Econ. Cooperation & Dev., *Tax Information Exchange Agreements*, <http://www.oecd.org/tax/exchange-of-tax-information/taxinformationexchangeagreementstieas.htm> (listing such agreements)

FATCA requirements, in most cases, violated the financial institution's countries' internal laws. Intergovernmental agreements (IGAs) became necessary to implement FATCA. According to Treasury, the United States has agreed upon 113 IGAs since 2010.<sup>83</sup> Subsequent to FATCA, the OECD developed the Common Reporting Standard (CRS) based on the IGAs. It is an automatic information exchange, which over 100 countries have agreed to implement, and allows other countries to implement FATCA-like obligations with non-US counterparties.<sup>84</sup>

Clearly, FATCA has been a watershed act, and, along with the rise of other instruments, calls into question the continuing relevance of Article 26. Although IGAs, in their current form, lack reciprocal commitments by the United States, IGAs have done much to eliminate bank secrecy worldwide and have also influenced a global information exchange network. The information exchange world has clearly moved beyond double income tax treaties.

### *C. Double Non-Taxation*

In accordance with the BEPS plan, the purpose of treaties has since grown to encompass the principle of double non-taxation, supporting devices like limitation on benefits provisions and the unilateral override provisions in the new U.S. model treaty.<sup>85</sup> Although these developments combat treaty abuse and double non-taxation, they are effectively solving problems created by the treaties themselves and therefore cannot be invoked to justify the existence of tax treaties, as will be explained below.

What is double non-taxation and why is it problematic? After all, almost every type of taxation distorts economic activity so should not less taxation assist in the free movement of capital? Double non-taxation generally means income that is otherwise typically taxed in one jurisdiction ends up being taxed nowhere. The phenomenon is sometimes referred to in the literature as stateless income or

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<sup>83</sup> U.S. Dept. of Treasury, *Foreign Account Tax Compliance Act*, <https://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx> (listing such agreements). These agreements are at various stages of completion and, in some cases, have only been agreed to in substance.

<sup>84</sup> Org. For Econ. Cooperation & Dev., *Major Enlargement of the Global Network for the Automatic Exchange of Offshore Account Information as Over 100 Jurisdictions Get Ready for Exchanges* (May 7, 2018), at <http://www.oecd.org/tax/major-enlargement-of-the-global-network-for-the-automatic-exchange-of-offshore-account-information-as-over-100-jurisdictions-get-ready-for-exchanges.htm>.

<sup>85</sup> For example, the new model treaty denies treaty benefits to beneficiaries of "special tax regimes," or special tax preferences put in place by some countries. See Allison Christians, *Kill-Switches in the U.S. Model Tax Treaty*, 41 BROOK. J. INT'L L. 1043 (2016).

homeless income.<sup>86</sup> The OECD describes double non-taxation as leading to “a reduction of the overall tax paid by all parties involved as a whole, which harms competition, economic efficiency, transparency and fairness.”<sup>87</sup> One primary concern with double non-taxation is the creation of a race to the bottom, whereby all jurisdictions are worse off due to tax competition. Another concern is the preference of cross-border income as contrasted with wholly domestic income, a concern expressed in the State Aid cases.<sup>88</sup>

Resolving the phenomena is difficult as a conceptual matter because the problem results from the sovereignty of countries over their own tax systems. Since tax treaties, in their current incarnation, never require taxation of income but instead function as devices that limit taxing jurisdiction, it is unclear how they can ever solve the problem of double non-taxation. Instead, tax treaties tend to create double non-taxation because they allow taxpayers to combine reduced treaty rates on source-based withholding taxes with favorable domestic tax rules.<sup>89</sup> In order to fix double non-taxation, domestic law must be utilized, and, at best, tax treaties can be designed to not make the situation worse.<sup>90</sup>

What features, then, of tax treaties give rise to double non-taxation? This stems from the grand bargain struck between source and residence countries, with the residence countries obtaining the right to tax “residual” income after a minimal amount of income has been allocated to the source country.<sup>91</sup> As Brett Wells and Cym H. Lowell have stated, “our treaties were premised on the concept of allocating income to prevent double taxation, but the result is that they have achieved double non-taxation.”<sup>92</sup> The two demonstrate that the phenomenon of double non-taxation (or “homeless income”, in their words) arises from the League of Nations’ choice to adopt a residence-based approach rather than one based on profit-splitting.

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<sup>86</sup> Bret Wells & Cym Lowell, *Tax Base Erosion and Homeless Income: Collection at Source is the Linchpin*, 65 TAX L. REV. 535 (2011); Edward D. Kleinbard, *The Lessons of Stateless Income*, 65 TAX L. REV. 99 (2011).

<sup>87</sup> Org. for Econ. Cooperation and Development, *Action Plan on Base Erosion and Profit Shifting* 15 (2013).

<sup>88</sup> Ruth Mason, *Tax Rulings as State Aid FAQ*, 154 TAX NOTES 451 (2017).

<sup>89</sup> Christians, *supra* note 85, at 1046.

<sup>90</sup> David Rosenbloom has made a similar point, arguing that international tax arbitrage exploits the differences in domestic laws. H. David Rosenbloom, *The David R. Tillinghast Lecture International Tax Arbitrage and the ‘International Tax System,’* 53 TAX L. REV. 137, 164-65 (2000). Tax treaties, in Rosenbloom’s view, are always elective and to the benefit of the taxpayer. In that regard, treaties do not have the leverage to combat tax arbitrage. *Id.*

<sup>91</sup> This term has been defined as the “portion of income earned by all parties to cross-border transactions (‘combined income’) that remains after a routine return has been allocated to each of the related parties for the functions and risks that it performs (‘residual income’).” Wells & Lowell, *supra* note 10, at 5.

<sup>92</sup> Wells & Lowell, *supra* note 10, at 5.



The question that the tax treaties were originally trying to resolve was how to allocate income between a parent company, typically located in a mercantilist country like England (the “residence” country, in today’s terminology), and its supply, manufacturing, and shipping subsidiaries, typically located in British Commonwealth countries like India (the “source country”). The subsidiaries would pay “base erosion payments,” such as interest, royalties, service fees, and leasehold payment to the parent, which would be deductible against their colonial income tax. In this manner, residual profits were stripped out of the source country, leaving it only the ability to tax routine profits.<sup>93</sup>

Under these facts, the income is being taxed by the mercantilist country. With the interposition of a holding company situated in a tax haven, however, the residual profits could be shifted to a jurisdiction that does not tax such income through base erosion payments. Although the colonial country could assert that the arm’s length principle allocates it a certain portion of the profit, typically transfer pricing methods are limited to the income that should be received by the source country, thereby failing to police the income allocated to the holding company.<sup>94</sup> As Wells and Lowell note, this planning strategy primarily stems from several elements bound up in the tax treaty framework: the decision to allocate residual income to the residence country, with the source country only taxing local operations; the interposition of a holding company that is not treated as a permanent establishment and is entitled to receive residual income (and thereby treated as situated in the residence country); and the deployment of one-sided transfer pricing.<sup>95</sup>

In pursuing the approach ultimately adopted by the League of Nations treaty, the four economists were aware of the danger that holding companies in tax havens posed.<sup>96</sup> They recognized that such subsidiaries allowed the allocation of income to a country that was neither a source or residence country, thus creating the potential for electivity into a low-taxed regime. Perhaps, though, they glossed over these concerns because they assumed the residence country would ultimately find ways to tax such income. As it turns out, however, income shifted to holding companies has gone largely untaxed by the residence country. Tax competition has spurred residence countries in this direction, less they face expatriation by their multinational corporations to a country that does not tax such income.<sup>97</sup>

For instance, even under its former worldwide system, the United States allowed deferral on income allocated to subsidiaries in tax havens. Although various outbound regimes, such as controlled foreign corporation rules, and

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<sup>93</sup> Wells & Lowell, *supra* note 10, at 11.

<sup>94</sup> *Id.* at 12.

<sup>95</sup> *Id.* at 12-13

<sup>96</sup> 1923 Report, *supra* note 7, at 49.

<sup>97</sup> Wells & Lowell, *supra* note 10, at 36.

inbound regimes (such as earnings-stripping and thin capitalization rules) have attempted to tax such income, tax competition has also caused countries to rationally tolerate profit shifting. Arguably, the new tax regime instituted by the United States, with BEAT and GILTI, will strengthen taxation of previously untaxed earnings. In previous work, however, I have argued that the new law largely keeps base erosion and profit shifting incentives intact.<sup>98</sup> CBO estimates that nearly 80% of profit shifting is maintained under the new regime. Congressional Budget Office.<sup>99</sup> The effect on profit shifting is likely even smaller, however, since CBO does not take into account investor reactions to the instability of the FDII regime in response to WTO challenges, investor reactions to the political instability of the legislation in general, and tax competition from other countries.<sup>100</sup> Furthermore, commentators and treaty partners have critiqued the new provisions for violating the tax treaties. As a result, U.S. lawmakers may face future pressures to curtail the regimes on a bilateral basis.

Tax treaties, however, do seem to be inching closer to addressing double non-taxation.<sup>101</sup> As stated in the official press release of the new model treaty, Treasury has taken the position that tax treaties “should eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance.”<sup>102</sup> To further this relatively modest goal, the new model treaty contains somewhat unique “kill-switch” provisions that turn off treaty benefits if income is subject to low or no taxation.<sup>103</sup> For instance, the special tax regime provisions deny treaty benefits on deductible interest or royalties to related persons that face low or no taxation under a preferential tax regime.<sup>104</sup> In this manner, the rules preserve source taxation when the residence country forgoes taxation of the item of income. The treaty also provides that treaty benefits with

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<sup>98</sup> See Rebecca M. Kysar, *Critiquing (and Repairing) the New International Tax Regime*, 128 YALE L.J.F. 339 (2018).

<sup>99</sup> *The Budget and Economic Outlook: 2018-2018*, 124 & 127 (2018), at <https://www.cbo.gov/system/files/115th-congress-2017-2018/reports/53651-outlook.pdf>. For instance, AbbVie Inc., a biopharmaceutical company recently reported a tax rate of 9%, decreased from around 22% in years prior to the 2017 tax legislation. Michael Erman & Tom Bergin, *How U.S. Tax Reform Rewards Companies that Shift Profits to Tax Havens*, REUTERS (June 18, 2018), at <https://www.reuters.com/article/us-usa-tax-abbvie/how-u-s-tax-reform-rewards-companies-that-shift-profit-to-tax-havens-idUSKBN1JE12Q>.

<sup>100</sup> Kysar, *supra* note 98.

<sup>101</sup> Reuven S. Avi-Yonah & Gianluca Mazzoni, *Are Taxes Converging?: Review of A Global Analysis of Tax Treaty Disputes* (draft Oct. 25, 2017), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3059090](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3059090).

<sup>102</sup> U.S. Model Treaty, *supra* note 20, at Introduction.

<sup>103</sup> As Allison Christians has noted, these type of “kill-switch” provisions, whereby treaty benefits are turned off under certain circumstances, are rare but not unprecedented. Christians, *supra* note 85, at 1059-69.

<sup>104</sup> U.S. Model Treaty, *supra* note 20, at arts. 11(2)(c), 12(2)(a), and 21(2)(a).

regard to dividends, interest, royalties, and other income may be denied if a treaty partner either (a) reduces its tax rates to below the lesser of 15 percent or 60 percent of the general statutory rate or (b) switches to a territorial regime. Other changes to both the U.S. and OECD model treaties attempt to minimize double non-taxation. These include addressing exempt permanent establishments, revisions to the limitation on benefits provisions, rules on expatriated entities, and the new general anti-abuse rule adopted in the multilateral treaty.

Reuven Avi-Yonah has argued that the international tax regime embraces a principle that income should be taxed once, and only once.<sup>105</sup> He has pointed to these recent treaty developments as further indication that the world is converging upon this “single tax principle.”<sup>106</sup> Ample room for double non-taxation under the treaties still exists, however. There is much uncertainty as to the definition of what constitutes a “special tax regime” if such regimes are not explicitly identified during the treaty negotiations. Moreover, if such a regime is implemented through administrative practice, the United States might not be able to detect it if it cannot access taxpayer-specific rulings.<sup>107</sup>

Finally, it is the treaty regime and its fundamental bargain between source and residence countries that is the primary cause of a great deal of double non-taxation. That treaty partners are now undoing some of the treaties’ contribution to double non-taxation through mechanisms like the unilateral override and anti-abuse provisions cannot be seen as justification of the continued existence of the treaty system.

#### *D. Foreign Direct Investment*

Increased foreign direct investment (FDI) is another cited reason for tax treaties. We would expect foreign direct investment to increase upon entrance into a tax treaty for two reasons. First, if tax treaties really do alleviate double taxation, a proposition of which I am dubious, then we would expect foreign direct

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<sup>105</sup> Reuven S. Avi-Yonah, *Who Invented the Single Tax Principle? An Essay on the History of U.S. Treaty Policy*, 59 N.Y.L. SCH. L. REV. 305, 309 (2014–2015); see also see Hugh J. Ault, *Some Reflections on the OECD and the Sources of International Tax Principles*, 70 TAX NOTES INT’L 1195, 1195 (2013).

<sup>106</sup> Avi-Yonah & Mazzoni, *supra* note 101. This principle has been controversial both descriptively and as a normative goal. H. David Rosenbloom, *The David R. Tillinghast Lecture International Tax Arbitrage and the ‘International Tax System,’* 53 TAX L. REV. 137, 166 (2000) (stating that “[i]nvoking the international tax system does not constitute an explanation, since that system appears to be imaginary.”). See also Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policy*, 54 Tax L. Rev. 261 (2001); Julie Roin, *Taxation Without Coordination*, 31 J. LEGAL STUD. S61 (2002); DANIEL N. SHAVIRO, *FIXING U.S. INTERNATIONAL TAXATION* (2014).

<sup>107</sup> Christians, *supra* note 85, at 1075.

investment between the two countries to increase. Second, the treaties may enhance the treaty country's reputation among the global economy, a benefit that would expand as the country's treaty network expands.<sup>108</sup>

Empirical evidence on whether tax treaties bring in foreign direct investment, however, is mixed.<sup>109</sup> Several older studies looked at changes in FDI on a jurisdictional basis as countries entered into tax treaties and concluded that there was no increase in FDI. Newer studies have looked at whether a greater number of tax treaties is correlated with higher FDI and have found a positive relationship between the two.<sup>110</sup> It is difficult to confirm causation, however, "since treaties may precede investment not because they spur the latter but because they may be concluded only when there is an expectation of such investment."<sup>111</sup> In the United States, for instance, this is a built-in feature of treaty policy.<sup>112</sup>

One other study has reached both conclusions—that the number of treaties that a source country has signed with the United States is positively correlated with FDI from the United States while also concluding that there is a *negative* correlation between new and existing treaties with the United States and such FDI.<sup>113</sup> One explanation for this is that a large network of treaties increases profit shifting through the source country by means of treaty shopping. On the other hand, new and existing treaties that are renegotiated may reduce FDI and reinvested earnings because of the information sharing and tax cooperation features of tax treaties.<sup>114</sup>

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<sup>108</sup> DAGAN, *supra* note 4, at 108 (providing an excellent summary of the literature on FDI and tax treaties).

<sup>109</sup> See Ronald B. Davies, *Tax Treaties and Foreign Direct Investment: Potential versus Performance*, 11 INT'L TAX & PUB. FIN. 775 (2004) (finding no effect on FDI from U.S. treaties); Bruce A. Blonigen & Ronald B. Davies, *The Effects of Bilateral Tax Treaties on U.S. FDI Activity*, 11 INT'L TAX & PUB. FIN. 601 (2004) (same); Bruce A. Blonigen & Ronald B. Davies, *Do Bilateral Tax Treaties Promote Foreign Direct Investment?*, in 2 HANDBOOK OF INTERNATIONAL TRADE 526 (E. Kwan Choi & James C. Hartigan eds., 2005) (finding a positive effect on FDI from old treaties but a slight negative effect from new treaties); Paul L. Baker, *An Analysis of Double Taxation Treaties and their Effect on Foreign Direct Investment*, 21 INT'L J. ECON. BUS. 341 (2014) (finding no effect on FDI flows); Peter Egger, *The Impact of Endogenous Tax Treaties on Foreign Direct Investment: Theory and Evidence*, 39 CAN. J. ECON. 901 (2006) (finding a negative effect on FDI); Eric Neumayer, *Do Double Taxation Treaties Increase Foreign Direct Investment to Developing Countries?*, 43 J. DEV. STUD. 1495 (2007).

<sup>110</sup> Julian di Giovanni, *What Drives Capital Flows? The Case of Cross-Border M&A Activity and Financial Deepening*, 65 J. INT'L ECON. 127 (2005); Eric Neumayer, *Do Double Taxation Treaties Increase Foreign Direct Investment in Developing Countries?*, 43 J. DEV. STUD. 1501 (2007).

<sup>111</sup> International Monetary Fund, *Spillovers in International Corporate Taxation* 26 (2014), at <https://www.imf.org/external/np/pp/eng/2014/050914.pdf>.

<sup>112</sup> *Id.*

<sup>113</sup> Joseph P. Daniels, Patrick O'Brien & Marc V. von der Ruhr, *Bilateral Tax Treaties and US Foreign Direct Investment Financing Modes*, 22 INT'L TAX & PUB. FIN. 999 (2015).

<sup>114</sup> *Id.*

The FDI effect is likely to be particularly muted in the case of developed countries like the United States since the treaty is not needed to signal regime stability to investors in that context. Moreover, if tax treaties are increasing FDI because of treaty shopping, developed countries may not benefit from that effect given the relatively higher rates of taxation imposed by such countries.

Furthermore, investment in the United States may also be more inelastic than other jurisdictions. This may be the case if demand for U.S. assets is robust enough to support withholding.<sup>115</sup> For instance, although the United States taxes real property, foreign ownership of U.S. real assets remains robust.<sup>116</sup> The strong U.S. market for goods and services may mean that foreign demand could support higher withholding rates on outbound flows.<sup>117</sup>

Finally, although the U.S. statutory withholding rate of 30% is quite high, it is unclear anyone actually pays it, even without a treaty, given the portfolio interest exemption and availability of derivatives that are not subject to withholding tax.<sup>118</sup> In this sense, the reduced treaty rates do little work. If treaties did not exist, then surely the domestic withholding rate would be set much lower, thereby alleviating concerns of over-taxation. In all likelihood, the reason that the 30% rate has held so long is that it is a way for the United States to preserve its negotiating position.<sup>119</sup>

#### *E. Comity Considerations*

Related to the issue of increased foreign direct investment, it is also posited that countries enter into tax treaties for comity reasons.<sup>120</sup> Tax treaties solidify relationships between countries and create communication channels between their taxing authorities.<sup>121</sup> For developing countries especially, entering into the “club” of tax treaties improves a nation’s standing in the international arena, serving as a “stamp of approval.”<sup>122</sup> Signing a tax treaty signals that the country “is willing to

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<sup>115</sup> Driessen, *supra* note 27, at 749

<sup>116</sup> *Id.*

<sup>117</sup> Driessen, *supra* note 27, at 749.

<sup>118</sup> David R. Tillinghast, *Tax Treaty Issues*, 50 U. Miami L. Rev. 455 (1996).

<sup>119</sup> Avery Jones, *supra* note 1, at 3.

<sup>120</sup> Christians, *supra* note 1, at 706-707 (“It has been suggested that tax treaties may signal a stable investment and business climate in which treaty partners express their dedication to protecting and fostering foreign investment. . .[T]ax treaties may serve largely to signal that a country is willing to adopt the international norms regarding trade and investment, and hence, that the country is a safe place to invest.”).

<sup>121</sup> Brauner, *supra* note 61, at 988.

<sup>122</sup> Dagan, *supra* note 4, at 113.

adopt the international norms,” which may have positive effects in non-tax areas as well.<sup>123</sup>

Although such benefits might accrue to a developing country attempting to gain a seat at the table, they are less likely to sway the position of the United States, whose existing trade relationships and agreements with other countries dwarf the impact of tax treaties. Moreover, an established tax administration that is willing to robustly enforce tax norms, like the IRS, produces a more effective signaling effect to other nations.<sup>124</sup> Comity considerations should therefore be relatively minor in factoring into the decision of whether the United States should enter into tax treaties.

#### *F. Certainty and Predictability*

Tax treaties are also said to signify a stable and certain legal regime. Many would argue that the current international tax regime is fairly harmonized, and this is partly due to the existence of the treaty network. The OECD Model has been incredibly influential, and the more than 3,000 tax treaties in existence are based upon it.<sup>125</sup> One scholar has noted that “[o]ne can pick up any modern tax treaty and immediately find one’s way around, often even down to the article number.”<sup>126</sup> As a result, tax treaties are quite similar to one another.

To the extent that standardization of international tax rules has occurred, however, we see it outside of the tax treaty context as well—in the domestic laws of nations.<sup>127</sup> For instance, in the United States, a foreign person will be taxed on U.S. business income if it is “effectively connected” to a “U.S. trade or business.” Tax treaties attempt to clarify and harmonize this concept by narrowing source country jurisdiction over “business profits” that are “attributable to a permanent establishment.”<sup>128</sup> The treaty standard, however, appears to be no clearer than the domestic one, causing many to conclude that it is essentially equivalent to the domestic standard.<sup>129</sup> Indeed, some of the U.S. tax treaties explicitly define the term

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<sup>123</sup> Richard Vann, *International Aspects of Income Tax* 8, in *TAX LAW DESIGN AND DRAFTING* (Victor Thuronyi, ed., 1998).

<sup>124</sup> Brooks & Krever, *supra* note 1, at 167-68.

<sup>125</sup> Yariv Brauner & Pasquale Pistone, *Introduction*, in *BRICS AND THE EMERGENCE OF INTERNATIONAL TAX COORDINATION* 3 (Yariv Brauner & Pasquale Pistone eds., 2015).

<sup>126</sup> Avery Jones, *supra* note 1, at 2.

<sup>127</sup> See Reuven S. Avi-Yonah, *Tax Competition, Tax Arbitrage, and the International Tax Regime*, no. 4 (2007) (contending that a coherent international tax regime exists in both tax treaties and the domestic law of all nations).

<sup>128</sup> U.S. Model Treaty, *supra* note 20, at 7.

<sup>129</sup> See, e.g., Lee A. Shepard, *Why Do We Need Treaties?*, *TAX NOTES* 825-826 (Nov. 19, 2016); Reuven S. Avi-Yonah & Oz Halabi, *Double or Nothing: A Tax Treaty for the 21st Century* 1–2 (Univ. of Mich. Law Sch. Scholarship Repository, Law & Econ. Working Paper No. 66, 2012), [http://repository.law.umich.edu/cgi/viewcontent.cgi?article=1176&context=law\\_econ\\_current](http://repository.law.umich.edu/cgi/viewcontent.cgi?article=1176&context=law_econ_current).

“business profits” in a way that references the domestic law.<sup>130</sup> The Service has drawn upon domestic law to interpret what constitutes a “permanent establishment,” referencing concepts that are also used to determine the domestic standard.<sup>131</sup> This is the case for other treaty terms as well.<sup>132</sup>

As stated earlier, the treaties generally defer to domestic law to answer vexing and central questions as to the residency of the taxpayer, what type of income is at issue, and the definition of income taxes.<sup>133</sup> Tax treaties are primarily jurisdictional devices and mostly lack operative provisions of law that would more meaningfully harmonize the tax regimes of various nations.<sup>134</sup> Even as jurisdictional devices, however, the treaties merely “state general taxing principles” whereas “Code provisions are tailored to specific situations.”<sup>135</sup>

The extent to which tax treaties harmonize international law is thus limited. This may be due to various reasons. For one, tax law is an area of law that has to address nearly all economic activities and encompasses all business entities and individuals, all while aiming to meet critical revenue-raising and redistribution goals.<sup>136</sup> Given the complexities of these tasks, an intricate body of domestic law has arisen. Even still, the statutory text does not often address the specific fact pattern in question and thus reliance upon non-textual sources is necessary to fill interpretive gaps.<sup>137</sup> Plain meaning interpretation also often seems inappropriate in the tax setting given the self-containing nature of tax law, which creates specialized tax terms that do not have analogues in everyday conversation.<sup>138</sup> The highly detailed character of the domestic law means that treaty-makers may be unable to incorporate concepts directly; instead they intentionally leave gaps in the treaty so that domestic law can fill in the details.<sup>139</sup>

Another reason for the gaps in treaties is the connection between taxation and state sovereignty.<sup>140</sup> Treaties often defer to domestic law so that nations can retain some control over tax policy. Although international law always implicates

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<sup>130</sup> Yariv Brauner & Allison Christians, *The Meaning of ‘Enterprise,’ ‘Business’ and ‘Business Profits’ under Tax Treaties and Domestic Law* 19, in *THE MEANING OF ‘ENTERPRISE,’ ‘BUSINESS’ AND ‘BUSINESS PROFITS’ UNDER TAX TREATIES AND EU TAX LAW* (Guglielmo Maisto, ed., 2011).

<sup>131</sup> Kysar *supra* note 29, at 1413-1414.

<sup>132</sup> Brauner & Christians, *supra* note 130, at 21 (“In general, the *terms* ‘business, enterprise, and business profits’ as used in the U.S. tax treaties are not autonomous but derive their meaning from domestic tax law provisions.”).

<sup>133</sup> See *supra* notes [ ] and accompanying text. Kysar *supra* note 29, at 1411-12.

<sup>134</sup> Kysar *supra* note 29, at 1411.

<sup>135</sup> KLAUS VOGEL ET AL., *UNITED STATES INCOME TAX TREATIES* 26 (1989).

<sup>136</sup> Kysar *supra* note 29, at 1414.

<sup>137</sup> Michael Livingston, *Congress, the Courts, and the Code: Legislative History and the Interpretation of Tax Statutes*, 69 *TEX. L. REV.* 819, 829–30 (1991).

<sup>138</sup> *Id.* at 828-29.

<sup>139</sup> Kysar *supra* note 29, at 1416.

<sup>140</sup> *Id.* at 1416.

sovereignty concerns, these issues are particularly strong in the tax context given that taxation implicates the revenue function of a nation, which in turn provides public goods and national defense.<sup>141</sup> Taxation is also a key component of a nation's fiscal policy, which allows it to affect growth, prices, and unemployment.<sup>142</sup>

It is also important to note that, unlike in the trade context where multilateral cooperation can contribute simultaneously to worldwide and national efficiency, international tax is predominantly a zero sum game.<sup>143</sup> For all of these reasons, we should expect a significant degree of retention of sovereignty in the tax treaty context. In fact, we do see this, both implicitly, through ambiguity in the treaties, and explicitly, through incorporation of the domestic tax laws.<sup>144</sup> Accordingly, the degree to which tax treaties can provide certainty through the harmonization of tax concepts and terms is limited.

As for stability, the network of more than 3,000 treaties provides some benefits in this regard. Indeed, as Tsilly Dagan has noted, the treaty system creates a lock-in effect, which makes transition to a different system more difficult.<sup>145</sup> There is, however, a serious cost to this stability, the dangers of which have become apparent. Long after the system proves useful, it will continue.

### G. Ancillary Functions

Tax treaties also may serve ancillary goals such as the prevention of non-discrimination or the resolution of tax disputes between the governments. Both of these goals can be accomplished via other means, however. Tax treaties require competent authorities to endeavor to resolve cross-border tax disputes and, increasingly, provide for mandatory arbitration. As was the case with information exchange, there is no need to couple this goal with the divvying up of taxing jurisdiction.<sup>146</sup> Other international agreements, like the approach taken by the European Union, can serve the same purpose.<sup>147</sup>

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<sup>141</sup> See Diane M. Ring, *What's at Stake in the Sovereignty Debate?: International Tax and the Nation-State*, 49 VA. J. INT'L L. 155, 157 & 167 (2008) (noting the "particular strength to the claims for tax sovereignty").

<sup>142</sup> *Id.* at 168-69.

<sup>143</sup> See generally Michael J. Graetz, *The David R. Tillinghast Lecture: Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261 (2001).

<sup>144</sup> Kysar, *supra* note 29, at 1417.

<sup>145</sup> Tsilly Dagan, *Tax Treaties as a Network Product*, 41 BROOK J. INT'L L. 1081 (2016).

<sup>146</sup> Brooks & Krever, *supra* note 1, at 166-67.

<sup>147</sup> See, e.g., EC, 90/436/EEC: Convention on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises—Final Act—Joint Declarations-Unilateral Declarations, [1990] O.J., L. 225/10; EC, Protocol amending the Convention of 23 July 1999 on the elimination of double taxation in connection with the adjustment of profits of associated enterprises, [1999] O.J. C. 202/1. Brooks & Krever, *supra* note 1, at 166-67.



Tax treaties also are said to accelerate international investment through their nondiscrimination clauses, which require that the treaty partners tax domestic and foreign investors similarly.<sup>148</sup> These clauses appear in every U.S. tax treaty in force, as well as the model U.S. and OECD tax treaties.<sup>149</sup> Again, nondiscrimination could also be accomplished without the loss of taxing rights, perhaps through investment treaties or domestic legislation.<sup>150</sup> Indeed, major multilateral and regional trade agreements already contain mandates against tax discrimination.<sup>151</sup> The nondiscrimination principle as articulated in tax treaties was originally intended only to mirror existing obligations under the commercial treaties and, as a result, was not expected to have a meaningful impact.<sup>152</sup>

The General Agreement on Tariffs and Trade (GATT) and its later WTO-enforced incarnations limit export subsidies (in addition to tariffs on imports). Export subsidies can include income tax incentives, and these agreements have been used against several U.S. tax regimes.<sup>153</sup> Some trade treaties limit their reach to other income tax provisions, but it is possible they could also prohibit income tax benefits such as accelerated depreciation or tax credits to machinery and equipment that is produced domestically.<sup>154</sup>

Although there is overlap between tax and trade treaties in how they treat discrimination, the concepts are framed differently and have variances in scope.<sup>155</sup> There are arguments, however, that trade treaties may be more effective means than tax treaties against tax discrimination. The WTO is a more representative body than

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<sup>148</sup> Ruth Mason & Michael Knoll, *What is Tax Discrimination?*, 121 YALE L.J. 1014 (2012). U.S. Model Treaty, *supra* note 20, at art. 24; OECD Model Treaty, *supra* note 78, at art. 24.

<sup>149</sup> See RICHARD E. ANDERSEN, ANALYSIS OF UNITED STATES INCOME TAX TREATIES ¶ 20.01 (2011); U.S. Model Treaty, *supra* note 20, at art. 24.

<sup>150</sup> Brooks & Krever, *supra* note 1, at 167.

<sup>151</sup> Mason & Knoll, *supra* note 148, at 1018.

<sup>152</sup> See, e.g., U.S. Treasury Dep't, *Memorandum Explaining Article XXI of the 1945 U.S.-U.K. Treaty* ("It will be observed that this article extends to all taxes, both Federal and local. Such extension, however, is in keeping with several commercial treaties (such as that with Norway, of 1928, and that with Germany, of 1923) to which the United States is now a party. It has no practical effect, since our domestic taxation does not discriminate as between United States citizens and British nationals residing in the United States."); Mary C. Bennett, *Nondiscrimination in International Tax Law: A Concept in Search of a Principle*, 59 TAX L. REV. 439, 444 (2006).

<sup>153</sup> David Kamin et al., *The Games They Will Play: Tax Games, Roadblocks and Glitches Under the 2017 Tax Overhaul*, 103 MINN. L. REV. \_\_\_\_ (forthcoming 2019). See, e.g., Paul R. McDaniel, *Trade Agreements and Income Taxation: Interactions, Conflicts, and Resolutions*, 57 TAX L. REV. 275 (2004).

<sup>154</sup> Michael J. Graetz & Alvin C. Warren, *Income Tax Discrimination and the Political and Economic Integration of Europe*, 115 YALE L.J. 1186, 1195 (2006); Reuven S. Avi-Yonah, *Treating Tax Issues Through Trade Regimes*, 26 BROOK. J. INT'L L. 1683 (2001).

<sup>155</sup> Note that neither trade or tax treaties explicitly prohibit discrimination against domestic companies' income from foreign production; instead the double tax relief provisions address this issue. Graetz & Warren, *supra* note 154, at 1196.

the OECD, has a larger jurisdiction, and the trade agreements contain more binding dispute resolution mechanisms.<sup>156</sup> That being said, international trade agreements are currently suffering from serious political scrutiny and instability.

Another issue with tax discrimination is that it is a notoriously ambiguous and, at times, narrow concept.<sup>157</sup> Under the “nationality paragraph” of Article 24, the treaties bar the source country from taxing foreign enterprises operating in that country in a way that is “more burdensome” than nationals of the source state in “the same circumstances.”<sup>158</sup> Its scope is limited since the treaties define “similar circumstances” as excluding U.S. nationals that are taxed on a worldwide basis. This preserves the ability of the United States, for instance, to impose gross basis withholding taxes on nonresident aliens since they are not in the same circumstances as a nonresident U.S. citizen (who gets taxed on a net basis).<sup>159</sup> In the case of corporations, this carve-out means the nondiscrimination principle has very limited impact in the United States because a corporation that is incorporated abroad is, by definition, not in the same circumstances as a corporation that is incorporated in the U.S.<sup>160</sup> Other countries may define corporate residency on the basis of other factors, such as place of management, in which case nondiscrimination may have more impact.<sup>161</sup>

Under the permanent establishment paragraph of Article 24, a country is prohibited from subjecting the permanent establishment (essentially the fixed place of business) of a resident of the other country to “less favorable” taxation than its own residents “carrying on the same activities.”<sup>162</sup> The permanent establishment paragraph has no such carveout for residency, but it is often a struggle for courts and the Service to determine whether foreign residents are “carrying on the same activities” as residents of the permanent establishment country.<sup>163</sup> Although one U.S. court has found that a U.S. tax provision violated this paragraph, Treasury and the Service have traditionally taken a very narrow view of this phrase.<sup>164</sup> For instance, in assessing thin capitalization rules, which deny certain interest deductions for payments to related foreign persons, the position of the United States has been that these rules do not violate nondiscrimination because they also deny

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<sup>156</sup> Avi-Yonah, *supra* note 154, at 1689-90. For an opposing view, see Robert M. Green, *Antilegalistic Approaches to Resolving Disputes Between Governments: A Comparison of the International Tax and Trade Regimes*, 23 YALE J. INT’L L. 79 (1995).

<sup>157</sup> Ruth Mason and Michael S. Knoll, *What is Tax Discrimination?*, 121 YALE L.J. 104, 1017 (2012).

<sup>158</sup> U.S. Model Treaty, *supra* note 20, at art. 24.

<sup>159</sup> Bennett, *supra* note 152, at 445.

<sup>160</sup> *Id.*

<sup>161</sup> *Id.*

<sup>162</sup> U.S. Model Treaty, *supra* note 20, at art. 24(2).

<sup>163</sup> *Id.* at 448.

<sup>164</sup> *Id.* at 448-49.

deductibility to related domestic tax-exempt entities.<sup>165</sup> This defense is arguably unconvincing since the nonresident, for-profit lender should be compared to a resident, for-profit lender.<sup>166</sup> European courts, in contrast, have given the paragraph more robust interpretations.<sup>167</sup>

Given the uncertainty surrounding the nondiscrimination principle and the large divide between countries in interpreting it, query whether it would be more effective to enact it as a domestic provision, or, as previously mentioned, through our trade treaties given the greater consensus, and means to achieve consensus, in that area. These routes may be a more forceful means at ensuring equal treatment of investments. Regardless, it does not appear that the nondiscrimination principle in treaties is providing a great deal of reciprocal protection, and in any case, nondiscrimination could be incorporated into tax agreements that do not cede jurisdiction over the tax base.

### III. DISADVANTAGES OF TAX TREATIES

The above discussion concludes that the rationales for tax treaties are opaque and ultimately unconvincing. Meanwhile, the disadvantages they bring to the United States government are potentially significant, as this Part explores.

#### A. *Loss of Revenues*

Scholars have argued that the reciprocal nature of tax treaties disadvantages developing countries by allocating taxing jurisdiction, and hence shifting revenues, from the country where the income is earned, typically the developing country, to the country of the taxpayer's residence, typically the developed country.<sup>168</sup> This literature points to the asymmetry of the countries' investments flows as the source of the treaty process's unfairness toward developing nations. Proponents of this view also cite economic evidence, discussed above, that tax treaties have no effect, or even a negative effect, on foreign direct investment, meaning that the developing country has sacrificed revenues for little to no advantage in capturing investment.<sup>169</sup>

The common account is that treaties between developed nations do not cause similar revenue shifts since the countries are similarly situated. Yet

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<sup>165</sup> H.R. Rep. 101-386, at 568 (1989) (Conf. Rep.).

<sup>166</sup> See, e.g., AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT, INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION II, PROPOSALS ON UNITED STATES INCOME TAX TREATIES 258-59 (1992).

<sup>167</sup> *Id.* UBS AG v. HM Revenue and Customs Commissioners, [2005] S.T.C. (SCD) 589, aff'd [2006] EWHC 117 (Ch), [2006] S.T.C. 716 (Eng.).

<sup>168</sup> See sources cited *infra* note 1.

<sup>169</sup> See, e.g., Brooks & Krever, *supra* note 1, at [pincite].

conclusions from the developing country literature can be extended to treaties that the United States enters with other developed nations when the investment flows between those countries differ, as is often the case in the modern era.

The treaty policy of the United States has remained relatively static since the 1960s, even though the United States has swung from being the world's most important net capital exporter to being a net capital importer due to the massive increase of foreign investment into the United States.<sup>170</sup> The change means that the United States, in many cases, will lose revenue as a result of entering into the treaty whereas before it was likely to gain revenues.<sup>171</sup> In spite of the variances of capital flows, both historically and between nations, tax treaties remain markedly similar to one another and to their predecessors.<sup>172</sup> This dynamic stands in contrast to the bilateral investment treaty context, where the United States has recognized its status as a capital importer and has taken a more balanced approach towards weighing its investors' interests against state sovereignty rather than protecting just the former.<sup>173</sup>

To be fair, the United States may be a net exporter of certain types of capital and capital flows may reverse rather quickly.<sup>174</sup> That being said, the United States has been a net importer in the aggregate for decades so it is surprising that its basic negotiating positions on tax treaties have not changed, in contrast to bilateral investment treaties. One possible explanation is that under the latter, the United States is often sued as a source country, thus compelling it to reexamine its negotiating stances *ex ante*.

It may also be possible that, although the United States runs a deficit in the aggregate, it runs surpluses with treaty countries. Given the massive influx of capital into the United States in recent decades, however, this would be

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<sup>170</sup> See Rosenbloom, *supra* note 53, at 83-84.

<sup>171</sup> There have been no studies estimating the revenue impact of U.S. tax treaties and how they have changed across time as the United States' capital flows have changed. A Dutch nonprofit has attempted to calculate lost revenue for certain developing countries with regard to treaties entered into with the Netherlands. ACTIONAID, *MISTREATED: THE TAX TREATIES THAT ARE DEPRIVING THE WORLD'S POOREST COUNTRIES OF VITAL REVENUE* (2016). Another working paper attempts to assess the costs and benefits of tax treaties, using Ukraine as a case study. Oleksii Balabushko, *The Direct and Indirect Costs of Tax Treaty Policy: Evidence from Ukraine*, WORLD BANK GROUP POLICY RESEARCH WORKING PAPER 7982 (2017), at <http://documents.worldbank.org/curated/en/534391488205311904/pdf/WPS7982.pdf>.

<sup>172</sup> See e.g., Reuven S. Avi-Yonah, *Double Tax Treaties: An Introduction*, in *THE EFFECT OF TREATIES ON FOREIGN DIRECT INVESTMENT* 99, 101 (Karl P. Sauvant & Lisa E. Sachs eds., 2009) (noting that about 75% of tax treaty terms are identical to one another).

<sup>173</sup> Anthea Roberts, *Triangular Treaties: The Extent and Limits of Investment Treaty Rights*, 56 *HARV. INT'L L. J.* 353, 361 (2015)

<sup>174</sup> Philip D. Morrison, *Talking Past Each Other on Tax Treaty Policy and Subpart F*, 69 *TAXES* 1001, 1003 (1991).

surprising.<sup>175</sup> Frustratingly, the Joint Committee of Taxation makes no revenue estimates for tax treaties nor does it include them in the tax expenditure budget. This is because the treaties are Article II treaties and bypass the normal budget process.<sup>176</sup> The executive branch has also chosen not to provide formal economic analyses of tax treaties.<sup>177</sup>

Although I do not purport to undertake such a formal analysis here, I have examined a set of data regarding trade, capital, and financial flows in an attempt to shed some modest insight into whether treaties make economic sense for the United States. Scholars have long pointed out that investment flow imbalances cause differences in revenue flows under tax treaties, but, to my knowledge, there has been no attempt to look at those flows in any detail, particularly on a system wide basis.

[Note to readers: the below data collection and analysis is preliminary.]

First, I surveyed the bilateral balance of payments data from the Bureau of Economic Analysis, which consists of flow data for any given quarter since 2003. Of the sixty-six countries listed on the IRS website as having tax treaties with the United States, this data included that of sixteen countries.<sup>178</sup> Of those sixteen countries, U.S. residents were net borrowers from current, capital account, and financial-account transactions in thirteen countries over the time span from 2003 to 2017, amounting to net borrowing of approximately \$11 trillion or an average \$735.2 billion per year.<sup>179</sup> They were net lenders in only three countries.<sup>180</sup> For financial-account transactions alone over this time span, U.S. residents were net borrowers in eleven and net lenders in five,<sup>181</sup> amounting to net lending of approximately \$3.9 trillion or an average \$260.3 billion per year. We could roughly estimate, then, that a supermajority of these sixteen tax treaties are losing revenues.

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<sup>175</sup> See Rosenzweig, *supra* note 6.

<sup>176</sup> See Kysar, *supra* note 2.

<sup>177</sup> Driessen, *supra* note 27, at 746. Recently, but sporadically, JCT has added some general economic information regarding trade flows in their explanations of tax treaties but this is by no means comprehensive. See, e.g., Joint Committee on Taxation, *Explanation of the Proposed Income Tax Treaty Between the United States and Hungary*, JCX-32-11, at 16-19 (May 20, 2011).

<sup>178</sup> These countries are Belgium, France, Germany, Italy, Luxembourg, the Netherlands, the United Kingdom, Canada, Mexico, Venezuela, Australia, China, India, Japan, South Korea, and South Africa.

<sup>179</sup> These countries were France, Germany, Italy, Luxembourg, the United Kingdom, Canada, Mexico, Venezuela, China, India, Japan, South Korea, and South Africa.

<sup>180</sup> These countries were Belgium, the Netherlands, and Australia.

<sup>181</sup> The U.S. was a net lender in Belgium, the Netherlands, Mexico, Venezuela, and Australia with respect to financial transactions. It was a net borrower with respect to France, Germany, Italy, Luxembourg, the United Kingdom, Canada, China, India, Japan, South Korea, and South Africa in such transactions.

Second, I studied the U.S. Department of Treasury Annual Survey of Portfolio Holdings, which consists of stock data at particular points in a given year since 2003, with additional data in 1994, 1997, and 2001 as well. The Annual Survey lists both the value of foreign holdings of U.S. securities and the value of U.S. portfolio holdings of foreign securities. Of the sixty-six countries listed on the IRS website, two countries did not have sufficient security holdings to list. The rest were examined. Notably, the Treasury data revealed the U.S. had inflows of capital greater than outflows with respect to the tax treaty countries in every year in which data was collected except two (2006 and 1994). From 2003 to 2017, the net flows were negative by \$22.14 trillion or an average of \$1.476 trillion per year. Once again, it would seem that the U.S. is losing revenues from the tax treaty system as a whole.

I also looked at the relative flows of each country for the year 2017. Of the countries examined, thirty-six had inflows greater than outflows, meaning there were more holdings by that country's residents of U.S. securities than U.S. holdings of those country's securities. Twenty-eight countries had outflows greater than inflows, meaning that U.S. investors held more of those countries' securities than vice versa. Notably, the amount of inflows, in total, exceeded outflows by \$4.54 trillion for that year.

There are, of course, caveats to this analysis. First, bilateral economic flows cannot tell us the revenue picture in its entirety. Any formal analysis should account for increased investment as a result of the treaty, for instance. Second, even for the flow data, these are just snapshots in time, reflecting only the current economic position of the United States via its treaty partners. That being said, because the treaties are so entrenched, one can see the danger of committing to them given the fact that economic flows can reverse rather quickly and dramatically. This highlights the difficulty of tax treaties more generally. Third, we could imagine that the breakdown of flows differs between income types, which may be relevant in calculating revenue losses from the treaties. For instance, if the U.S. is a capital exporter for royalties, then perhaps it is gaining from the treaties even if it is capital importing with respect to other types of income, like interest. This is because the treaty restricts source country jurisdiction over royalties but generally does not alter the treatment of interest, which is generally exempt under the U.S. portfolio interest rules.<sup>182</sup>

Revenue losses can also come about because of the interaction between the domestic law and the treaty or the disparity in tax systems.<sup>183</sup> For instance, one could imagine that two similarly situated countries would sign a tax treaty, reasoning that any rate reduction they provide on source income from the other country's residents would be counterbalanced by an increase in domestic taxes

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<sup>182</sup> 26 U.S.C. § 871

<sup>183</sup> See Roin, *supra* note 45, at 1767.

through the residual taxation of foreign source income of its own residents, who are now also receiving the benefit of lower rates in the other country. If, however, a country does not tax on a worldwide basis, the calculus is different. Its residents may enjoy the lower foreign rate, unencumbered by residual taxation. The territorial regime means that the lower foreign tax treaty rates will not effectuate an increase in domestic revenues. This bargain may still be in the country's interest, but the benefits are flowing to its residents rather than to government coffers.<sup>184</sup>

The 2017 changes to the U.S. international tax system are likely to complicate the revenue picture of U.S. tax treaties. For one, the partial transition to a territorial system means that the United States is forgoing residual taxation as a residence state on foreign income earned by closely held corporations.<sup>185</sup> Yet this is counterbalanced by the new minimum tax regime that is imposed on such income. The reduction of the corporate rate all the way to 21% means that no residual taxation will be paid on foreign income so long as U.S. corporations are taxed at a 13.125% rate abroad.<sup>186</sup>

This picture is further exacerbated by the fact that the blending of tax credits is allowed to reduce tax liability under residual taxation for individuals and others who do not receive the benefits of territoriality. Treaties allow taxpayers to cross credit income that receives favorable treaty rates with high taxed income, thereby minimizing the limitation on foreign tax credits under U.S. law.<sup>187</sup> This dynamic will also occur under the new minimum tax regime, leading to further revenue losses.

On the flipside, because the U.S. is no longer recouping residual taxation on a significant amount of foreign income, we could expect that some countries will push for more tax treaties with the United States since the reductions in source taxation that they agree to will benefit U.S. investors rather than the U.S. Treasury. Presumably, this strengthens the case for increased foreign direct investment. Still, some countries may worry that a move to territoriality may instead trigger an undesirable race to the bottom, requiring a reciprocal exemption system. It also may make the residents of the other treaty country more cost-conscious with respect to

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<sup>184</sup> The United States' transition to a partial territorial regime will mean that its treaty agreements may produce less revenue than before, a point that will be revisited below. *See supra* notes [ ] and accompanying text.

<sup>185</sup> *See* Eric M. Zolt, *Tax Treaties and Developing Countries*, 72 TAXL. REV. \_\_\_ (forthcoming 2018) (noting that despite the reduction of source-country revenues through tax treaties, residence countries have been reluctant or unable to capture their share of the lost revenues).

<sup>186</sup> *See* Tax Cuts and Jobs Act Conference Report to Accompany H.R. 1, Rep. No. 115-466, at n. 1526 and accompanying text (Dec. 15, 2017).

<sup>187</sup> *See* Roin, *supra* note 45, at 1772-75 (explaining this phenomenon under the normal foreign tax credit rules).

foreign taxes since they no longer enjoy a 100% marginal reimbursement rate in the form of foreign tax credits, thus harming the source countries ability to tax.<sup>188</sup>

Overall, it is puzzling that tax treaties do not take into account differences in investment flows, disparities in tax systems, and various ways in which the model treaty may diverge from the national interest. Despite the enormous economic and legal changes that have developed since the model tax treaties were first developed, far from becoming more heterogeneous, tax treaties seem to be converging.<sup>189</sup> Moreover, despite the fact that Elisabeth Owens called for formal analysis of the costs and benefits of tax treaties nearly sixty years ago, there has been virtually no progress on that front.<sup>190</sup> I explore possible reasons for these phenomena below.<sup>191</sup>

### *B. Stagnation of Domestic Policy and International Tax Norms*

Another problematic effect of tax treaties is the stagnation of domestic policy and international tax norms. Over two decades ago, John Avery Jones cited the proliferation of treaties as problematically locking in both domestic and treaty policy.<sup>192</sup> Tax treaties cannot be easily changed because they are so numerous.<sup>193</sup> And, unless countries are willing and able to override tax treaties, domestic policy is stymied.<sup>194</sup> The problem has only worsened since Avery Jones raised the issue, with the number of treaties having more than doubled since then.

Of course, stagnation may not be a problem if the treaty regime locks in beneficial policy. Although tax treaties may have initially served some valid purposes, they, however, more recently have contributed to the breakdown of the international tax system. As discussed above, instead of easing double taxation, treaties have contributed to double non-taxation.<sup>195</sup> This problem has grown exponentially with the rise of digital technology and immensely valuable (and easily shifted) intellectual property. Moreover, their requirements have increasingly come into conflict with possible solutions to the problems plaguing the international tax system. Recent U.S. tax reform has brought this problem into the spotlight.

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<sup>188</sup> Shaheen, *supra* note 70, at 1291.

<sup>189</sup> See Elliott Ash & Omri Y. Marian, *The Making of International Tax Law: Empirical Evidence Using Natural Language Analysis* (June 28, 2017 draft), at [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2994217](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2994217).

<sup>190</sup> Owens, *supra* note 34, at 452-53. See also Roin, *supra* note 45, at 798 (labeling tax treaties tax expenditures and calling for examination of their costs).

<sup>191</sup> See *supra* notes [ ] and accompanying discussion.

<sup>192</sup> Avery Jones, *supra* note 1, at 4.

<sup>193</sup> *Id.*

<sup>194</sup> Unlike the United States, not all countries can override international agreements through domestic legislation. Kysar, *supra* note 2.

<sup>195</sup> See *supra* notes [ ] and accompanying text.



## 1. The Destination-Based Cash Flow Tax and Potential Treaty Conflicts

In 2016, Republicans began to set forth their platform to overhaul the international tax provisions. Their initial plan was to replace the corporate income tax with a destination-based cash flow tax (“DBCFT”). The DBCFT would have essentially been a modified VAT, with a deduction for wages.<sup>196</sup> Like a VAT, the tax would also have been border-adjusted, meaning that it excludes exports and taxes imports without deduction for costs.<sup>197</sup> Its features meant that the DBCFT would have treated debt and equity equally, removed taxes on investment returns, and removed incentives to profit shift and offshore activities.<sup>198</sup> Taxing on a destination basis (where sales occur) offers advantages relative to taxing on an origin basis (where value is created). In general, the residency of customers is more fixed than that of corporations, and thus taxing a business on this basis likely reduces tax avoidance. Additionally, ascertaining where products or services are invented is an economic fiction that has proven impossible to execute, leading to the shifting of profits through transfer pricing games.

There are reasons to think that a destination-based approach should at least supplement revenue collection given the rise of the multinational corporation. However, the plan was critiqued, in part, for its incompatibility with the tax treaty regime if the DBCFT was considered a “covered tax” under the treaties.<sup>199</sup> If so, the treaties’ permanent establishment requirement, which essentially requires a physical presence in the source country before that country can exercise taxing jurisdiction over business profits, would forbid the imposition of a destination-based tax that taxes where goods are sold. In short, the very feature that makes the DBCFT attractive is the same trait that makes it incompatible with the treaties—taxing at destination versus origin.

In addition to the conflict with the permanent establishment limitation, the DBCFT also implicated other treaty provisions. In order to include all imports, the DBCFT should be levied on intangibles that produce royalties and other types of deductible payments that can substitute for royalties since their exclusion would invite tax abuse. If the DBCFT is considered an income tax, however, then such inclusion would constitute a treaty override because it would violate the treaty provisions that forbid withholding on such payments.<sup>200</sup> The DCBFT also might

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<sup>196</sup> House Tax Reform Task Force, *A Better Way, Our Vision for a Confident America: Tax 27-29* (June 24, 2016), at [http://abetterway.speaker.gov/\\_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf](http://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf).

<sup>197</sup> *Id.* at 28.

<sup>198</sup> William G. Gale, *Understanding the Republicans’ Corporate Tax Reform*, BROOKINGS INSTITUTE (Jan. 10, 2017), at <https://www.brookings.edu/opinions/understanding-the-republicans-corporate-tax-reform/>.

<sup>199</sup> Reuven S. Avi-Yonah & Kimberly Clausing, *Problems with Destination-Based Corporate Taxes and the Ryan Blueprint*, 8 COLUM. J. TAX L. 229 (2017).

<sup>200</sup> Avi-Yonah & Clausing, *supra* note 199.

arguably violate the nondiscrimination provision of the treaties by advantaging exporters over importers.<sup>201</sup> Furthermore, if the DBCFT is not an income tax and therefore outside the treaty's scope, treaty partners would be under no obligation to provide foreign tax credits to their residents who pay the tax.<sup>202</sup>

A further issue results from the fact that U.S. corporations may no longer be U.S. residents under the treaty because, under the DBCFT, they would no longer be "liable to tax . . . by reason of . . . domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature."<sup>203</sup> Accordingly, foreign taxpayers may no longer benefit from the treaty provision that reduces withholding on dividends, among other complications.<sup>204</sup>

Another challenge is that if the United States were to enact the DBCFT, then its treaty partners may no longer have incentives to maintain or renegotiate treaties.<sup>205</sup> This is because the United States would be giving up its jurisdiction to tax income as the residence country; therefore, why should a source country provide relief from its withholding tax? On the other hand, if the United States was no longer taxing worldwide income, the source country's reduction of withholding tax would flow to the investor rather than the United States Treasury, therefore perhaps strengthening the source country's ability to attract investment.<sup>206</sup> The source country may also feel increased pressure to reduce its taxation of direct investment income considering the favorable tax treatment U.S. investment would receive.<sup>207</sup>

Another concern would be the potential for tax arbitrage between the DBCFT, which would not tax income, and a treaty partner's income tax system that allows for interest deductions.<sup>208</sup> This arbitrage opportunity may induce treaty partners to terminate their treaties in order to impose higher withholding taxes on interest and dividends to U.S. residents.<sup>209</sup> Congress may attempt to stave off such terminations by imposing its own withholding tax on interest and dividends to non-residents, but this may itself violate the nondiscrimination provision since the United States may not be taxing investment income of its own residents.<sup>210</sup> Even if

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<sup>201</sup> *Id.* at 246; See also Reuven Avi-Yonah, *The International Implications of Tax Reform*, 69 TAX NOTES 913 (1995); Reuven Avi-Yonah, *From Income to Consumption Tax: Some International Implications*, 33 SAN DIEGO L. REV. 1329 (1996).

<sup>202</sup> Shaheen, *supra* note 59.

<sup>203</sup> U.S. Model Treaty, *supra* note 20, at art 4.

<sup>204</sup> Shaheen, *supra* note 59.

<sup>205</sup> Avi-Yonah & Clausing, *supra* note 199, at 246. David A. Weisbach, *A Guide to the GOP Tax Plan – The Way to a Better Way*, 8 COLUM. J. TAX L. 171, at 214-15 (2017); see also Stephen E. Shay & Victoria P. Summers, *Selected International Aspects of Fundamental Tax Reform Proposals*, 51 U. MIAMI L. REV. 1029, 1074-76 (1997).

<sup>206</sup> Shay & Summers, *supra* note 205, at 1075

<sup>207</sup> *Id.*

<sup>208</sup> *Id.*

<sup>209</sup> *Id.*

<sup>210</sup> *Id.*

the provision was upheld, the United States may wish to condition any treaty exemptions of the new discriminatory tax on reciprocal exemption from the treaty partner, a perhaps undesirable bargain for a country with reciprocal trade flows with the United States and a large tax base.<sup>211</sup>

In short, the enactment of the DBCFT would cause chaos in the international tax community. The myriad issues presented by the tax have caused some to predict that its enactment could lead to the collapse of the treaty regime.<sup>212</sup> Moreover, this problem is not specific to the DBCFT. Other significant new taxes in other countries pose classification challenges for tax treaties. In the past few years, The Indian Equalization Levy, the UK Diverted Profits Tax, the Australian Diverted Profits Tax, the Netherlands Excessive Severance Tax, and the Belgian Fairness Tax—are all hybrid taxes of some nature and serious questions have arisen over their relationship with the treaty system.<sup>213</sup> Together, these taxes and the U.S. reforms, discussed below, are part of a larger debate over taxing on a destination basis versus an origin basis.<sup>214</sup>

More recently, the European Commission has proposed levying a turnover tax on the digital revenues, which would almost exclusively hit U.S. technology companies. The EU Council Legal Service issued an opinion that the digital services tax is not an indirect tax,<sup>215</sup> which also makes it harder to contend that tax treaties are not in conflict with it since tax treaties demand certain requirements of direct taxes. The digital services tax is fundamentally flawed because it focuses only on digital companies, but it is also likely to suffer from design problems because its proponents have attempted to enact it within the treaty-based context of a permanent establishment, stretching this concept to the point of disbelief.<sup>216</sup>

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<sup>211</sup> Shay & Summers, *supra* note 205, at 1075

<sup>212</sup> Avi-Yonah & Clausing, *supra* note 199, at 247.

<sup>213</sup> Ismer and Christoph Jescheck, *The Substantive Scope of Tax Treaties in a Post BEPS World: Article 2 OECD MC (Taxes Covered) and the Rise of New Taxes*, INTERTAX 45.5, 386-87 (2017). See also M. Tenore, “Taxes Covered”: *The OECD Model (2010) versus EU Directives*, 66 BULLETIN FOR INTERNATIONAL TAXATION 162 (2012).

<sup>214</sup> Itai Grinberg, *Comments at AEI event on The Future of Corporate Taxation in a Digital World* (Apr. 19, 2018), at <http://www.aei.org/events/the-future-of-corporate-taxation-in-a-digital-world/>.

<sup>215</sup> Mehreen Khan, *EU Lawyers Question Brussels Digital Tax Plan* (Oct. 9, 2018), at <https://www.ft.com/content/88e0a81a-cbf0-11e8-b276-b9069bde0956>. In contrast, Wei Cui argues that countries should be able to freely design digital taxes so that they fall outside the scope of the treaty. Cui reasons that a treaty is a contractual agreement and parties can choose its scope. Cui also argues that, even if double taxation is an important goal (of which he is skeptical), tax treaties cannot be successful at this goal if they generate allocations that are in tension with countries’ desires. Wei Cui, *The Digital Services Tax: A Conceptual Defense* 26 (Oct. 26, 2018 draft), at [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3273641&download=yes](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3273641&download=yes).

<sup>216</sup> Wei Cui argues that countries should be able to freely design digital taxes so that they fall outside the scope of the treaty. *Id.*

Justifying the tax by using the notoriously vague concept of value creation will set no reliable architecture for the new tax.<sup>217</sup>

We might search for a procedural solution to all of this. If the DBCFT presents difficulties of treaty interpretation, and was clearly not contemplated in the treaty's design, then the states should endeavor to resolve the issue by mutual agreement. Going forward, a clause could be inserted in Article 2 of the treaties to cover significant new taxes if the parties reach a mutual agreement to this effect. The hybrid nature of these taxes requires further clarification from the treaty partners, and asking courts and arbitrators to fill these significant gaps may be beyond their institutional capacity. Yet even if an administrative solution was achievable, the complexities resulting from the mapping of these taxes onto the treaty system expose the latter's rigidity. International movement towards destination-based taxes or increased taxation at source is preferable, but this is antithetical to the fundamental deal cut in tax treaties. As a result, the substance of the proposals have suffered, and the treaty regime makes the likelihood of such a shift more remote.

## 2. The BEAT

### a. Potential Treaty Conflicts

Although Republicans abandoned the DBCFT, the 2017 tax legislation that was enacted also poses significant challenges to the tax treaty system. Among the changes to the tax law is the new inbound base erosion regime, which is designed to prevent earnings stripping from companies that have been able to erode the base by making deductible payments to related foreign parties.

The originally proposed inbound regime was the House excise tax.<sup>218</sup> The excise tax subjected income from deductible items, including royalties and cost of goods sold, to an excise tax, which was designed to prompt taxpayers to elect to treat such payments as effectively connected income. The Ways and Means committee report made clear that the new tax was necessary to supplement transfer pricing principles, which were not sufficient to stop inbound base erosion.<sup>219</sup>

There is a strong argument that the proposed House excise tax would have breached treaty obligations because the tax was designed to hit multinationals without a permanent establishment, in violation of Article 7 of the treaty.<sup>220</sup> The

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<sup>217</sup> Michael Devereux, *The Digital Services 'Sutton' Tax*, [http://business-taxation.sbsblogs.co.uk/2018/10/23/the-digital-services-sutton-tax/?dm\\_i=17AR,5XL76,ELTIXU,N8496,1](http://business-taxation.sbsblogs.co.uk/2018/10/23/the-digital-services-sutton-tax/?dm_i=17AR,5XL76,ELTIXU,N8496,1).

<sup>218</sup> H.R. 1, Sec. 4303.

<sup>219</sup> H. Rep. 115-409, at 400.

<sup>220</sup> Reuven Avi-Yonah, *Guilty as Charged: Reflections on TRA17*, 157 TAX NOTES 1131, 1133-34 (Nov. 20, 2017).

excise tax also was vulnerable to the criticism that it was an indirect way to impose withholding taxes on royalties, contrary to Article 12 of the treaties. Additionally, the tax also arguably violated the arm's length standard of Article 9 of the treaties because it would have applied to cost of goods sold between the related parties regardless of what parties dealing at arm's length would have agreed to do.

The end result of the excise tax would have also been to tax foreign-earned income, with no foreign tax credit or double tax relief. Such criticism forced the House to revise the proposal to allow a partial foreign tax credit. This was the case even though the United States would have been crediting residence country taxes as the source country, when traditionally foreign tax credits are offered by the residence country for source country taxes.<sup>221</sup> This revision reduced the revenue estimate of the proposal.<sup>222</sup>

In part because of its tension with the tax treaties, Congress abandoned the House excise tax, instead enacting the BEAT, a new and separate tax.<sup>223</sup> The BEAT functions as an alternative minimum tax, adding back in certain deductible payments to foreign related parties (but not U.S. related parties) to constitute a "modified taxable income" base.<sup>224</sup> The BEAT liability is the excess of 10% of that base over the taxpayer's regular tax liability. Notably, although it functions similar to the now repealed corporate alternative minimum tax, the BEAT does not allow foreign tax credits in the calculation of the base.<sup>225</sup>

Importantly, the BEAT also allows parties to circumvent it because it exempts cost of goods sold, including imbedded royalties.<sup>226</sup> In contrast, the House excise tax would have left less room for circumvention because it would have applied to cost of goods sold. Unfortunately, *because* the House tax applied to cost of goods sold, it likely would have violated the arms' length principle of the treaties.

The alternative minimum tax structure of the BEAT is an attempt to accommodate tax treaties, but a group of EU Ministers asserted that the BEAT regime could be viewed as discriminating against foreign companies in violation of

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<sup>221</sup> *Id.* at 1135.

<sup>222</sup> The original revenue estimate for the excise tax was \$154.5 million over the budget window period. Joint Committee on Taxation, *Estimated Revenue Effects of H.R. 1, The 'Tax Cuts And Jobs Act,' Scheduled For Markup By The Committee On Ways And Means On November 6, 2017* (Nov. 2, 2017), at <https://www.jct.gov/publications.html?func=startdown&id=5026>. This was revised to \$94.5 million after revisions to the excise tax, including the provision for foreign tax credits. *Estimated Revenue Effects of H.R. 1, The "Tax Cuts and Jobs Act," As Ordered Reported By The Committee On Ways And Means On November 9, 2017* (Nov. 11, 2017), at <https://www.jct.gov/publications.html?func=startdown&id=5034>.

<sup>223</sup> Rosenbloom & Shaheen, *supra* note 3, at 2.

<sup>224</sup> 26 U.S.C. § 59A.

<sup>225</sup> The corporate AMT limited foreign tax credits instead of disallowing them completely. *Id.*

<sup>226</sup> Kysar, *supra* note 98.

bilateral tax treaties.<sup>227</sup> Article 24(5) of our double tax treaties provides that treaty partners cannot tax residents of the other treaty country more heavily than its own residents.<sup>228</sup> Arguably, the BEAT violates this nondiscrimination clause because a foreign-owned U.S. entity will be subject to the BEAT regime whereas a U.S.-owned U.S. entity will not be. One counter-argument is that the BEAT applies regardless of who *ultimately* owns the corporation.<sup>229</sup> Thus, the BEAT applies to payments from a U.S. entity to a foreign entity that is owned by the U.S. entity (a CFC), which indicates that the intent was to protect the U.S. tax base rather than to discriminate against foreign-owned U.S. parties.<sup>230</sup>

Another arguable path to treaty violation is Article 24(4), which commands that foreign residents be entitled to deductions “under the same conditions” as U.S. residents.<sup>231</sup> The BEAT regime, however, is arguably not equivalent to the denial of a deduction, and interest, royalties, and other items remain fully deductible. Instead, the BEAT merely subjects the tax benefit conferred by such deductions to the 10% tax; denying a tax deduction would increase the tax on the item by 21%, not 10%.<sup>232</sup> Additionally, the base erosion rules are perhaps sanctioned under Article 24(4) because they are necessary to arrive at an appropriate arm’s length result within the meaning of Article 9 of the treaties, although this argument seems less forceful since the BEAT applies even when arm’s length prices are charged.<sup>233</sup>

The BEAT may also violate Article 23, which requires treaty partners to grant a foreign tax credit for income tax of the treaty partner “in accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof.”<sup>234</sup> Since the BEAT offers no foreign tax credit, it may be inconsistent with

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<sup>227</sup> Stephanie Soong Johnston, *EU Finance Ministers Warn Against Proposed U.S. Tax Measures*, TAX ANALYSTS WORLDWIDE TAX DAILY (Dec. 11, 2017).

<sup>228</sup> The model tax treaty provides: “Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned Contracting State to any taxation or any requirement connected therewith that is more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned Contracting State are or may be subjected.” U.S. Model Treaty, *supra* note 20, at art. 24(5).

<sup>229</sup> Although a harsher result applies to foreign companies that were formerly U.S. companies, such disparate treatment is likely within the savings clause of the treaties, which allows the United States to tax its residents, and former residents, under its own domestic law. U.S. Model Treaty, *supra* note 20, at art. 1(4) & art. 4(1); *see also* Bret Wells, *Get With The Beat*, 158 TAX NOTES 1023 (Feb. 19, 2018).

<sup>230</sup> Reuven S. Avi-Yonah, *BEAT It: Tax Reform and Tax Treaties* (Jan. 10, 2018), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3096879&download=yes](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3096879&download=yes).

<sup>231</sup> U.S. Model Treaty, *supra* note 20, at art. 24(4).

<sup>232</sup> Avi-Yonah, *supra* note 230.

<sup>233</sup> Wells, *supra* note 229.

<sup>234</sup> U.S. Model Treaty, *supra* note 20, at art. 23

the “general principle” of Article 23.<sup>235</sup> It is possible, however, that the BEAT is not a “covered tax” under Article 2 of the treaty and therefore not subject to the requirements of Article 23 (although still subject to Article 24).<sup>236</sup> If the BEAT did not fall within this category of “covered taxes,” then a treaty partner could not object to the disallowance of foreign tax credits.

As discussed above, what constitutes a covered tax is a difficult question, and the status of many new taxes is in doubt.<sup>237</sup> Relevant to the BEAT context, however, is that the United States has previously taken the position that the AMT was covered by the treaties and the two taxes are structurally similar.<sup>238</sup> Another counter to the argument that the BEAT falls outside the treaties’ scope is that Congress chose to enact it as part of subtitle A (“Income Taxes”) of the Code.<sup>239</sup> In favor of BEAT’s non-coverage, however, is the fact that it denies deductions for payments to related foreign persons, therefore falling outside the definition of an “income” tax.<sup>240</sup>

#### b. Overrides and Implications of Treaty Conflicts

If the BEAT is a covered tax, then should it not simply constitute a treaty override? There is current scholarly debate over how easily Congress can override treaties, which has implications for the issue of whether treaties stymie domestic reform. If Congress can readily override treaties, then perhaps we need not worry. If it cannot, then perhaps the concern is more justified.

As mentioned above, under the U.S. Constitution, treaties and statutes are both “supreme law” and, as discussed above, the Court has held that, when there is a conflict between the two, the one enacted “later in time” will prevail.<sup>241</sup> David Rosenbloom and Fadi Shaheen argue that a Supreme Court case, *Cook v. United States*, stands for the proposition that Congress must clearly express treaty overrides, otherwise “a treaty will not be deemed to have been abrogated or modified by a later statute.”<sup>242</sup> This is surely correct as a restatement of the reasoning of *Cook*, but *Cook* should be read as a rule of statutory interpretation, only applicable if there is a question as to how the statute should be constructed. The Court itself cabined its reasoning as to resolving “any doubt as to the construction of the statute.” In essence, the *Cook* doctrine can be seen as a variation on the *Charming Betsy* canon, which is used to construe statutes as to avoid treaty

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<sup>235</sup> *Id.*

<sup>236</sup> U.S. Model Treaty, *supra* note 20, at art. 2.

<sup>237</sup> See *infra* notes [ ] and accompanying text. Ismer & Jescheck, *supra* note 20, at 386-87.

<sup>238</sup> Rosenbloom & Shaheen, *supra* note 3.

<sup>239</sup> *Id.*

<sup>240</sup> *Id.*

<sup>241</sup> *Whitney v. Robertson*, 124 U.S. 190, 195 (1888).

<sup>242</sup> Rosenbloom & Shaheen, *supra* note 3 (citing *Cook v. United States*, 288 U.S. 102 (1933)).

violations.<sup>243</sup>

Moreover, the *Cook* Court was also applying the doctrine in a rather narrow set of circumstances—interpreting the reenactment of a statute that preceded a later enacted treaty. The reenactment was identical to the statute that was later superseded by the treaty, and the Court held that the later in time rule privileged the treaty. In this unusual set of facts, it can be inferred that Congress’s intent was to not abrogate the treaty. In other words, the circumstances produced clear expression of Congress’s intent. This should not foreclose other ways in which Congress can clearly express its intent to override.

One such way for Congress to do so is through enactment of a statute that clearly conflicts with a prior treaty. In the instant case, the BEAT plainly does not provide a foreign tax credit. Courts should not rewrite the statute to avoid a treaty conflict. Nor should the statute be rewritten to calculate the modified taxable income base to allow deductions for otherwise deductible payments to related persons resident in treaty countries, when this is explicitly forbidden by the statute. Yes, courts are reluctant to find treaty and statutory conflicts, but they do not rewrite statutes to accommodate treaties.<sup>244</sup>

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<sup>243</sup> RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 109 (1987) (stating that Congress construes statutes to avoid treaty violations “where fairly possible”). Admittedly, however, the Court has not been entirely consistent, even within an opinion. In *Trans World Airlines, Inc. v. Franklin Mint Corp.*, the Court referred to the *Cook* doctrine as a “canon of construction against finding repeal of a treaty in ambiguous congressional action”, only to later state that “legislative silence is not sufficient to abrogate the treaty.” *Trans World Airlines, Inc. v. Franklin Mint Corp.*, 466 U.S. 243, 252 (1984). We could reconcile these two statements by stating that explicit legislative statements to abrogate the treaty are necessary when the statute is ambiguous but not when the statute is clear in its conflict.

<sup>244</sup> For further discussion of this point, see Kysar, *supra* note 98. In the Senate Committee on Finance’s markup session, Tom Barthold, Chief of Staff for the Joint Committee on Taxation, responded to a Senator’s question about the interaction between the legislation and the treaties by saying that “[The BEAT] is structured as an alternative tax compared to the income tax. So I think our view is that there is not a treaty override inherent in that design.” [cite] Rosenbloom and Shaheen argue that it is plausible Congress used Barthold’s statement as its working assumption, thus indicating congressional intent not to override. Recent academic analyses suggest that the revenue estimators are indeed a powerful influence upon the legislative process and therefore courts should use their analyses as indicative of Congressional intent. Lisa Schultz Bressman & Abbe R. Gluck, *Statutory Interpretation from the Inside—An Empirical Study of Congressional Drafting, Delegation, and the Canons: Part II*, 66 STAN. L. REV. 725, 764 (2014); Abbe R. Gluck, *Congress, Statutory Interpretation, and the Failure of Formalism: The CBO Canon and Other Ways That Courts Can Improve on What They Are Already Trying To Do*, 84 U. CHI. L. REV. 177, 182 (2017); Clint Wallace, *Congressional Control of Tax Rulemaking*, 71 TAX L. REV. 179 (2017) (proposing a JCT canon of interpretation). These arguments, however, are made in the particularly salient context of revenue scores. It is far from clear whether a mere statement by a JCT official is as influential upon Congress. Moreover, the Supreme Court has recently rejected reliance upon a much more formal JCT publication as indicative of congressional intent—the so called “bluebook.” *United States v. Woods*, 571 U.S. 31 (2013). Since JCT staff are not elected officials, it is perhaps a step



There may be additional arguments for why we should privilege statutes above treaties when enacted later in time in the tax context specifically. Sections 894(a) and 7852(d) of the Code reiterate that treaties and statutes are on equal footing.<sup>245</sup> The legislative history of these sections indicates that Congress wished to codify the last in time rule for tax provisions<sup>246</sup> and specifically rejected the IRS's position that, under *Cook*, a statute must explicitly override a treaty in order for it to take precedence.<sup>247</sup>

I have also previously argued that tax treaties are likely in tension with the Origination Clause, which requires all revenue legislation to originate in the House, because, as self-executing Article II treaties, they omit the House from the treaty process.<sup>248</sup> To quell the House's ability to override treaties, by requiring clear expression of intent for instance, would lay in further tension with the Origination Clause since overrides are one way the House traditionally protects its constitutional prerogative.<sup>249</sup> Although the availability of congressional overrides does not cure the constitutional defect, it does allow the House to participate at least

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too far to simply impute congressional intent from their statements in the record concerning working assumptions on the legislation.

<sup>245</sup> 26 U.S.C. §§ 894(a) & 7852(d).

<sup>246</sup> CONFERENCE REPORT ON H.R. 4333 TECHNICAL AND MISCELLANEOUS REVIEW ACT OF 1988, H.R. REP. NO. 100-1104, at 12 (1988).

<sup>247</sup> See Kathleen Matthews, *Treasury Encouraged by Finance Treaty Override Substitute*, 40 TAX NOTES 662 (1988). Rosenbloom and Shaheen, however, argue that Congress cannot change the rule in *Cook* as a constitutional matter. Rosenbloom & Shaheen, *supra* note 3. There is a strong argument that Congress can enact rules of interpretation in many circumstances. Nicholas Quinn Rosenkranz, *Federal Rules of Statutory Interpretation*, 115 HARV. L. REV. 2085 (2002). In categorizing rules of interpretation that derive from the Constitution, Rosenkranz distinguishes between "constitutional starting point" rules and other rules of interpretation, such as "constitutional default rules" that Congress can opt out of using clear statements and "constitutional mandatory substantive rules" that may not be changed by Congress. *Id.* at 2099. The question thus becomes whether the *Cook* rule that treaties be expressly overridden is constitutionally required no matter Congress's views on the matter. In effect, under Rosenbloom and Shaheen's view, the Court has created a clear statement rule, allowing Congress to override treaties through statutes enacted later in time but only if they expressly do so. This, in turn, is an interpretation of the last in time rule, which is an interpretation of the Supremacy Clause. Under this view, it may be that Congress cannot default out of the judicial scheme. Under my view, however, *Cook* did not create a clear statement rule but instead created an interpretive rule. Using Rosenkranz's typology, the last in time rule may be a constitutional mandatory substantive rule, which cannot be changed by Congress, but the clear expression of intent language in *Cook* and the *Charming Betsy* canon could be viewed as a constitutional starting point rule, which can be changed by Congress. In this manner, perhaps Sections 894 and 7852 accomplished the rejection of any clear expression of intent requirement for tax statutes, at least where the statute clearly rejects treaty principles.

<sup>248</sup> Kysar, *supra* note 2.

<sup>249</sup> See Reuven S. Avi-Yonah, *International Tax as International Law*, 57 TAX L. REV. 483, 493 (2004) ("The most notorious difference between tax treaties and other U.S. treaties is the frequency of treaty overrides (other treaties are overridden, but much less frequently).").

somewhat to formulate revenue policy in an area from which it is otherwise omitted.

Finally, there is some historical precedent for allowing treaty overrides without clear statements in the tax context. Since the enactment of section 7852(d) in 1988 and prior to the enactment of the 2017 tax bill, there have been at least three instances in which Congress has enacted statutes that conflict with the treaties while being silent on the issue in both the statutory text and legislative history. In 2004, Congress enacted an excise tax on nonresident alien “insiders” of an expatriating U.S. corporation. In 2008, Congress imposed a transfer tax on gifts or bequests from an expatriate. In 2010, Congress enacted the net investment income tax, which can apply to foreign source income without foreign tax credit allowances.<sup>250</sup> In none of these cases have courts mandated that the statutes be rewritten to accommodate the treaties.<sup>251</sup>

Should we then conclude that Congress has an easy time overriding treaties and therefore our concerns about stymying tax reform are unfounded? Certainly under Rosenbloom and Shaheen’s view, the concern that tax treaties impede tax reform is more acute since Congress has to affirmatively state their intention to violate international law, which, shall we say, could be awkward. But we have reason to worry about Congress’s agency over domestic reform even if we reject Rosenbloom and Shaheen’s reading of the caselaw.

International law, not U.S. law, determines whether or not international obligations continue; obligations under international law may continue in the face of a congressional override of the treaty. Congress will be reluctant to put the United States in breach of its obligations.<sup>252</sup> This is likely a reason why overrides of tax treaties occur predominantly in the tax treaty abuse context, where they are more justifiable.<sup>253</sup>

There is also reason to indicate that Congress may be less willing to override treaties going forward. It used to be the case that after the treaty overrides of the 80s and 90s, Congress was able to renegotiate the existing tax treaties in order to accommodate the statutory changes. Recently, however, the Senate has been unable to move treaties through the Article II process, and many have been languishing for

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<sup>250</sup> Thomas Bissell, *Treaty Overrides Where the Legislative Intent is Silent*, BLOOMBERG (July 14, 2016), at <https://www.bna.com/treaty-overrides-codes-n73014444693/>.

<sup>251</sup> There is some precedent for the IRS to rewrite statutes to accommodate treaties, however, Congress has rejected its authority to do so, citing the Supremacy Clause and the last in time rule. *See* S. Rep. No. 445, 100th Cong., 2d Sess. 371 (1988) (citing Notice 87-5, 1987-1, C.B. 416).

<sup>252</sup> RESTATEMENT, *supra* note 243, at § 109; *see, e.g.*, Pigeon River Improvement, Slide & Boom Co. v. Charles W. Cox, Ltd., 291 U.S. 138, 160 (1934).

<sup>253</sup> Reuven S. Avi-Yonah, *Tax Treaty Overrides: A Qualified Defense of U.S. Practice*, in TAX TREATIES AND DOMESTIC LAW 65 (Guglielmo Maisto ed., 2006).

years.<sup>254</sup> The possibility of renegotiation thus is much more remote in the current era than in prior eras of treaty overrides. This may have a chilling effect on the amount of treaty overrides Congress is willing to do, and thus the concern for policy stasis is likely to be even greater than before.

Indeed, many legislative proposals are abandoned or narrowed out of concern for treaty conflicts, as this discussion has demonstrated. In part out of concern for incompatibility with international obligations, Congress enacted the less ambitious BEAT, rather than the House's excise tax. Arguably, the inbound tax regime would have been more ambitious in scope, and hence more effective, if this had not been the case.

To conclude, tax treaties, especially in recent years, impede domestic reform. Although Congress may, at times be willing to override the treaties, it likely does so much less often than if such an act were authorized by international law and blessed by our treaty partners. This is a risk inherent to all treaties, to an extent, but is particularly problematic in the tax treaty context, the foundations of which have not been modernized to take into account developments such as the rise of the multinational corporation and electronic commerce. The tax treaty network rests on a foundation of arbitrary and conflicting rules that distort economic activity and spawn tax competition. It also has served to keep that foundation in place, long past its shelf life. International movement toward destination-based taxes, greater source taxation, or even formulary apportionment, would be preferable, but the treaty regime makes the likelihood of such a shift more remote. Although the constitutional structure in the United States allows some relief from this danger, it by no means solves the fundamental problem.

### c. The Danger of Rate Stasis

In addition to impeding structural tax reform, treaties also obstruct domestic policy other ways. Perhaps the most visible feature of tax treaties is the ceiling they impose on withholding rates. An underappreciated consequence of this ceiling is that, unless the United States wishes to tax such income at rates below those set forth by the treaty, domestic rates on outbound income are effectively fixed. The rate ceiling thus hamstring domestic policy such that the government cannot be as reactive to macroeconomic conditions, fiscal crises, or other factors. This presents troubling effects on efficiency and limits the ability to deploy countercyclical responses.<sup>255</sup>

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<sup>254</sup> Diane M. Ring, *When International Tax Agreements Fair at Home: A U.S. Example*, 41 BROOK. J. INT'L L. 1185 (2016).

<sup>255</sup> For arguments that the tax law should change in response to macroeconomic conditions, see Yair Listokin, *Equity, Efficiency, and Stability: The Importance of Macroeconomics for Evaluating Income Tax Policy*, 29 YALE J. REG. 45, 49–50 (2012); Zachary Liscow & William Woolston, *Who's In, Who's Out? Policy to Address Job Rationing During Recessions*, 70 TAX L. REV. 627 (2017).

### C. Tax Abuse Opportunities

A third disadvantage of tax treaties is that they encourage tax avoidance as a result of the ceding of taxing jurisdiction and the interface between the treaties and domestic provisions.<sup>256</sup> Since this was discussed in the context of whether tax treaties fulfill their promise of achieving double non-taxation, I will not discuss it here. But it is a significant downside and one that costs revenue.

## IV. WHY DOES U.S. TREATY POLICY REMAIN IN THE PAST?

### A. Process Deficiencies and Political Economy

If tax treaties have these negative effects and also fail to fulfill their purposes, why has U.S. tax treaty policy remained stagnant for decades? For one, tax treaties suffer from a deficiency in process. Because tax treaties are Article II treaties, the House is entirely cut out of the tax treaty process despite its long constitutional pedigree as the initiator of tax policy on the domestic side.<sup>257</sup> Somewhat puzzlingly, this stands in contrast to trade treaties, with which the House has remained involved through congressional executive agreements. The House's participation in the trade treaty context has been justified, in part, because of its traditional role over revenues, as set forth in the Origination Clause.<sup>258</sup>

The treaty process often flies under the radar. Most of the treaty negotiating process happens behind closed doors, with multinational corporations strategically communicating their policy positions to negotiators.<sup>259</sup> It is not surprising that the paucity in process benefits special interests like these corporations. Each step in the legislative process can potentially derail any proposal. The more robust process means the greater potential for policy failure. When the context is bestowing

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<sup>256</sup> Julie Roin has argued that avoidance as a result of treaty rates is of no concern because the residual taxation of the residence country offsets the reduction of source country tax. Julie A. Roin, *Adding Insult to Injury: The 'Enhancement' of section 163(j) and the Tax Treatment of Foreign Investors in the United States*, 49 TAX L. REV. 269, 281 (1994). This view, however, does not take into account the fact that the residence country may fail to tax the income. Driessen, *supra* note 26, at n.22.

<sup>257</sup> Kysar, *supra* note 2.

<sup>258</sup> Bruce Ackerman & David Golove, *Is NAFTA Constitutional?*, 108 HARV. L. REV. 799, 923 (1995) (noting that the Origination Clause may strengthen the argument that NAFTA is constitutional); Laurence H. Tribe, *Taking Text and Structure Seriously: Reflections on Free-Form Method in Constitutional Interpretation*, 108 HARV. L. REV. 1221, 1261 n.133 (1995) (noting that the Origination Clause may place limits on treaties involving revenues but disagreeing with Ackerman and Golove that House participation justifies the use of congressional-executive agreements).

<sup>259</sup> Driessen, *supra* note 27, at 745.

benefits to special interests (as opposed to the public), a less robust process will accrue to their benefit.<sup>260</sup> Tax treaties reduce the tax bills of multinational corporations and do not increase taxes. Therefore, their relatively easy path to enactment favors such constituents at the expense of the public. Additionally, the resultant lobbying power of the corporations helps to explain why tax treaties exist in their current form—to benefit industry. The lack of process generally benefits policy that would otherwise be controversial in the legislative process.

Thus, a nefarious explanation for why tax treaties look the way they do is that they are simply a less visible way to funnel U.S. revenues to multinational corporations. Seen as tax incentives that do not have the scrutiny of the legislative or budget processes, they are invisible and against the public interest.<sup>261</sup> Perhaps then it is not so puzzling that the United States would remain in treaties that are antithetical to its interest—to be able to deliver benefits to powerful constituencies without some kind of reckoning.

Groups that might normally be opposed to funneling benefits to multinational corporations, such as labor unions, are absent from the tax treaty process, in spite of their engagement over the reach of our international tax system as implemented through domestic law.<sup>262</sup> Domestic policy disfavoring outbound investment is in direct conflict with the lowering of withholding rates through the treaty, yet public debate only focuses on the former. These advocacy groups may overlook tax treaties because the process forecloses open and vigorous deliberation. In fact, their significant participation in trade treaties suggest this might be the case since such treaties, as congressional-executive agreements, are subject to greater process than tax treaties.<sup>263</sup>

The other major deficiency in process is the lack of revenue estimates of tax treaties, or any studies undertaken by Treasury that might justify entrance into particular tax treaties.<sup>264</sup> The lack of consensus on whether tax treaties increase foreign direct investment and the reversal of trade flows that the United States has experienced over the past few decades, which almost certainly impacts the revenue picture of the treaties, makes the omission from the budget process especially troubling.<sup>265</sup>

Not only are there no revenue estimates when the United States enters into treaties, the benefits they funnel to taxpayers also do not show up on the tax

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<sup>260</sup> Kysar, *supra* note 2, at 35.

<sup>261</sup> See Kysar, *supra* note 2; Zolt, *supra* note 185.

<sup>262</sup> Driessen, *supra* note 27, at 751

<sup>263</sup> Oona A. Hathaway, *Treaties' End: The Past, Present, and Future of International Lawmaking in the United States*, 117 *YALE L.J.* 1236, 1274, 1307-1316 (2008).

<sup>264</sup> Driessen, *supra* note 27.

<sup>265</sup> See *supra* notes [ ] and accompanying text.

expenditure budget,<sup>266</sup> which the JCT publishes to account for revenue losses from special tax benefits. Many decades ago, Stanley Surrey famously concluded that such preferences should be highlighted as equivalent to government spending since they constituted revenue losses.<sup>267</sup> Among such preferences Surrey highlighted were certain tax benefits provided by tax treaties.<sup>268</sup> The absence of tax treaties from the tax expenditure budget allows for an easier path to treaty conclusion.<sup>269</sup>

One might try to justify omission of tax treaties from the tax expenditure budget as reflecting difficulties in defining the appropriate baseline. Surrey and McDaniel argued, for instance, that reduction in gross withholding taxes are not tax expenditures because they reflect an approximation of the tax burden if it were applied on a net basis.<sup>270</sup> Of course, if the rate was very low or zero, as is the case for certain types of income under the treaties, then such justification for omission from the budget would not be applicable. Another justification for omission might be that the exercise would prove too challenging for the estimators.<sup>271</sup> Presumably, however, JCT could attempt to produce some average tax rates applicable to net investment income on the domestic front and use this as an approximate baseline.

Moreover, this line of argument does not extend to the regular budget process. In estimating revenues for purposes of the enactment process (if such revenue estimates were produced), the proper baseline is not a normative one but generally follows current law with some prescribed modifications.<sup>272</sup> In that context, the proper revenue baseline should be the 30% withholding rate applicable to net investment income earned by non-U.S. residents.

The paucity in process might also have several other ramifications. As discussed above, treaties do not seem to fulfill their stated or unstated purposes. Enhanced deliberation might help clarify the objectives of tax treaties, or expose the lack thereof.<sup>273</sup> Additionally, the process problem might also help explain why tax treaties are surprisingly uniform in nature, a suboptimal result given the variances in relative trading positions of the U.S. and its tax treaty partners.<sup>274</sup> More

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<sup>266</sup> Steven Dean, *The Tax Expenditure Budget Is a Zombie Accountant*, 46 U.C. DAVIS L. REV. 265, 306-07 (2012).

<sup>267</sup> *Id.*

<sup>268</sup> STANLEY S. SURREY & PAUL R. MCDANIEL, TAX EXPENDITURES 168-70 (1985) (hereinafter SURREY & MCDANIEL, TAX EXPENDITURES); PAUL R. MCDANIEL & STANLEY S. SURREY, INTERNATIONAL ASPECTS OF TAX EXPENDITURES: A COMPARATIVE STUDY 59 (1985).

<sup>269</sup> Dean, *supra* note 266, at 294.

<sup>270</sup> SURREY & MCDANIEL, TAX EXPENDITURES, *supra* note 268, at 168.

<sup>271</sup> Dean, *supra* note 266, at 290 n. 117.

<sup>272</sup> David Kamin, *Basing Budget Baselines*, 57 WM. & MARY L. REV. 143, 1488-90 (2015); David Kamin & Rebecca Kysar, *Temporary Tax Laws and the Budget Baseline*, 157 TAX NOTES 125, 126 (2017).

<sup>273</sup> Driessen, *supra* note 256, at 748. Misstated purposes also risk misleading the judiciary in their interpretation of the treaty.

<sup>274</sup> See *supra* notes [ ] and accompanying text.

robust process might help to create heterogeneity among the treaties, tailoring them to various national interests.

Finally, although powerful constituencies shape U.S. treaty policy as a matter of political economy, there is reason to be hopeful that there is some room for reform of the process. Although tax treaties have historically been approved as a matter of course, the politically charged environment has made this less likely.<sup>275</sup> Although opponents of tax treaties have blocked them for reasons unrelated to the problems discussed here, perhaps this controversy will shift the burden to proponents to analyze and justify their costs.

### B. *The Lock-In Effect*

Another obstacle to treaty innovation is the fact that the international tax system is comprised of thousands of bilateral treaties. Any changes must generally be made treaty-by-treaty, and, as discussed above, the proliferation of the treaties has created a “network effect” whereby deviation from the script is disapproved in the global community.<sup>276</sup> Tax treaties are based on a common standard that provides more and more benefits the greater the number of adopters.<sup>277</sup> The OECD treaties have positive network externalities along the dimensions of predictability of legal content, enforcement, and the signaling of a credible commitment to a stable regime.<sup>278</sup> But as the network grows, so do its costs.

First, the initiators can exploit the network to extract “cartelistic gains from potential competitors and monopolistic rents from its own users.” Second, there is a strong lock-in effect; the treaty remains in force even when the standard becomes undesirable because it becomes difficult for users to establish a new network. This is because any purveyors of a new standard will have a difficult time recruiting other states to join the new network without a critical mass that can reduce risk and transition costs.<sup>279</sup> At one time, the United States, and other developed nations, may have rationally preferred the treaties’ tilt towards the residence country when they were capital-exporting, but they are now locked into that position long after it no longer makes sense. As a result, the status quo reigns.

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<sup>275</sup> Diane M. Ring, *When International Tax Agreements Fail at Home: A U.S. Example*, 41 BROOK. J. INT’L L. 1185 (2016).

<sup>276</sup> DAGAN, *supra* note 4, at 170; Dagan, *supra* note 145; *see also* See Eduardo A. Baistrocchi, *The Structure of the Asymmetric Tax Treaty Network: Theory and Implications* (Bepress Legal Services Working Paper 1991, Feb. 8, 2007), at <http://law.bepress.com/cgi/viewcontent.cgi?article=9408&context=expresso>. 10-11

<sup>277</sup> DAGAN, *supra* note 4, at 170; Dagan, *supra* note 145.

<sup>278</sup> *See* Baistrocchi, *supra* note 275

<sup>279</sup> DAGAN, *supra* note 46, at 176.

C. Race to the Bottom

Nations may also enter into tax treaties with countries in which trade flows are obviously and persistently asymmetrical in order to receive legitimacy on the international level, although this is unlikely to be the case with established countries like the United States. They may hope to increase foreign direct investment through the reduction in tax burden, although, as discussed above, the evidence on this is mixed.<sup>280</sup> A more nefarious explanation could simply be the exploitation of politically “weak” countries by “strong” ones. Countries could be engaging in a race to the bottom, whereby one country chooses the sub-optimal option of joining the treaty network because it fears others will do so as well, thereby crowding it out of the investment environment.

In particular, source countries may assent to the regime in spite of its favoring residence countries because of a prisoner’s dilemma scenario.<sup>281</sup> If all source countries are competing to attract foreign direct investment, they could be in a better position to agree to not sign treaties and maintain their revenues. Anticipating defection, however, a source country may choose to enter into a treaty because they may be better off if the other source country does not sign the treaty, although still worse off than in a world where the source countries all agreed not to participate in the treaty regime. They also will be better off than if they are the fool who did not sign the treaty when the other one did. We could model this dilemma as follows, with the order of preferences per country noted numerically from 1 (the most preferable) to 4 (the least):

		A		COUNTRY A	
		B		No treaty (Cooperates)	Treaty (Does not cooperate)
COUNTRY B	No treaty (Cooperates)			2	4
	Treaty (Does not cooperate)	1	4	3	3

Under this scenario, the countries are worse off if all join since there is a perhaps only a modest possibility of increasing investment but with fewer revenues.

<sup>280</sup> See *infra* notes [ ] and accompanying text.

<sup>281</sup> See Eduardo A. Baistrocchi, *The Structure of the Asymmetric Tax Treaty Network: Theory and Implications* (Bepress Legal Services Working Paper 1991, Feb. 8, 2007), at <http://law.bepress.com/cgi/viewcontent.cgi?article=9408&context=expresso>.



Yet, this is the likely outcome given that a worse outcome would be if one country joins the treaty network and the other one is left out. Coordination problems, thus may explain why countries with divergent interests enter into tax treaties.<sup>282</sup>

Finally, the world is changing, and developing countries do not seem as eager to sign double tax treaties as they once were.<sup>283</sup> As I mentioned above, even developed countries have started to contemplate self-help regimes around the treaties.<sup>284</sup> Thus, just because tax treaties have evolved as the building blocks of the international tax regime does not mean they will continue to serve that function.

## V. UNRAVELING THE TAX TREATY

In light of the foregoing discussion, how might we reconceptualize the tax treaty? The world seems to be moving away from the prioritization of residence country taxation. The recent U.S. international reform and proposed and enacted taxes in Europe can be seen as strengthening taxation by the “source” country.<sup>285</sup> Furthermore, the double tax treaties have recently been under attack by developing countries, who now question whether it is in their interest to sign them. The pressure that globalization, stateless income, and technology have placed on the antiquated international tax system may cause other countries also to doubt the relevance of tax treaties. As a result, the bargains long reached in the tax treaties may very well be finally upended.

This is because the international tax system, based on antiquated and artificial source rules, is fundamentally at odds with the nature of today’s world economy. Geopolitical, technological, and economic forces, as well as the phenomenon of stateless income, will require policy innovation that is likely to be in tension with the bargains reached long ago in tax treaties. The allocation of taxing rights no longer makes sense for many countries, both developed and developing, but instead serves a small but powerful constituency—the multinational corporation. The new international tax system will likely place more emphasis on source-based taxation, as a response to the fact that residence country taxation has diminished, and contain more destination-based rules, as a response to the ability

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<sup>282</sup> *But see* Yariv Brauner, *An International Tax Regime in Crystallisation — realities, experiences and opportunities*, 56 TAX LAW REVIEW 259 (2003) (stating “...there is a definite proof that developing countries have benefited from the current bilateral tax treaty practice. They have never been forced, nor claimed to have been forced, into concluding a bilateral tax treaty with a developed country. In fact, in most cases the developing countries wish to conclude treaties with the developed countries, which reject their wishes in times...”).

<sup>283</sup> DAGAN, *supra* note 4, at 181 (“Over the course of the last decade, the developing countries that were represented by the OECD have been losing some of their clout as a group.”).

<sup>284</sup> *See supra* notes [ ] and accompanying text.

<sup>285</sup> Although destination-based taxes forgo the concept of origin of income, and hence “source” countries, their practical effect will often be greater source country taxation.

of multinational corporations to more easily game origin-based rules. So far, tax treaties have served to thwart such innovation, but the desperate need for revenues may eventually require it.

Thus, it seems that the tax treaty provisions that allocate taxing jurisdiction should be jettisoned. Yet some of the treaty provisions that do not relate to the allocation of income should be retained, or at least could be kept with little cost. For instance, any shift to destination-based taxation is likely to be incremental. As a result, the rules regarding transfer price enforcement will likely be useful in the interim. The information exchange provisions are less useful with the rise of other international agreements in the area and should yield to those. Their retention does little harm, however, unlike the allocation of income provisions. Nondiscrimination may be more appropriately dealt with by trade treaties, as discussed above, but this may be asking too much of a system that is currently also in a state of upheaval. Moreover, given the flexible interpretation U.S. courts have given nondiscrimination, it may not provide as many obstacles to fundamental reform as the jurisdictional provisions do.

As discussed above, the OECD has completed a multinational instrument that aims to create a streamlined mechanism by which countries can amend their existing tax treaties to include BEPS measures, subject to domestic ratification procedures.<sup>286</sup> The aim is to allow countries to update their treaties without the need for treaty-by-treaty negotiating. This effort is, in some ways, not as ambitious as it first appears. It primarily relates to proposals, like the limitation on benefits and mandatory arbitration provisions, that can be found in existing treaties entered into by the United States. In general, the BEPS process leaves in place treaty rules dividing the tax base between the two countries and does little to update those concepts. Treaties are also only amended if there is a two-sided “match” between treaty partners in choosing which of the new provisions to adopt. Still, one could imagine that the multilateral instrument may eventually extend beyond the BEPS project, inducing the United States to sign on to it.<sup>287</sup>

Somewhat paradoxically, the multilateral instrument, which was designed to breathe new life into the double tax treaty regime, could be used to scale it down. Additionally, although many nations and experts have opposed a multilateral regime for encroaching upon national sovereignty, the new instrument could be leveraged to *restore* sovereignty over tax policy.

Specifically, the multilateral instrument could be used to opt out of those aspects of the tax treaties that reallocate taxing jurisdiction while maintaining the still useful features such as dispute resolution mechanisms and nondiscrimination

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<sup>286</sup> See *supra* notes [ ], and accompanying text.

<sup>287</sup> Yariv Brauner, for instance, has argued that it is difficult to imagine that the multilateral instrument will be abandoned after the BEPS treaty norms have been implemented. Brauner, *supra* note 61, at 1030.

provisions. This would allow countries to examine where it is in their interest to give up source-based taxation and where it is not. Essentially, rather than countries signing on to a system of treaties that are identical to one another, the multilateral instrument could be used to tailor treaties to the particular needs of a set of countries, creating a heterogeneous international tax system.<sup>288</sup>

This new heterogeneity of the tax treaties, although disruptive in many respects, could more fairly reflect the incongruity of trade flows between countries, differences in the elasticities of taxing foreign income between nations, variances in revenue needs, and divergence in gains from comity and reputation. Although this diversification could occur unilaterally, the multilateral instrument provides a mechanism to do so without jettisoning the treaty framework altogether or taking the controversial move of treaty termination. It would also obviate the need for painstaking treaty-by-treaty negotiation. Moreover, it provides a mechanism to automatically update treaties as the circumstances of a nation changes.

Leveraging the multilateral instrument would also allow for intermediate options that a nation could opt into. Instead of abandoning the low treaty rates on withholding, for instance, they could be raised somewhat in between the current treaty rates and the statutory rates. Nations could even specify a range that they would tolerate, and if the treaty partner's range also matches, then the treaty rates could be adjusted to the mid-point of overlap.

Another more moderate option would be to expand upon the permanent establishment concept, allowing for taxation at source without necessarily a physical presence. Although this proposal was rejected in the BEPS effort, it should be revisited. Political interest in digital taxes has increased since then, and an expanded notion of permanent establishment would accommodate these and more destination-based approaches to taxation. Reforming the concept of permanent establishment could also make source country jurisdiction contingent upon administrative capacity of the source country.<sup>289</sup> Since a country without the ability to collect source country taxes is arguably not losing anything from residence country taxation, treaty partners may decide this is an efficient allocation of taxing jurisdiction.

An important aspect of this approach is flexibility. Currently, the multilateral instrument goes a long way in this regard by allowing countries to opt in and out of proposals. Even the minimum standards, which signatories to the instrument are required to meet, can be fulfilled in a variety of manners. Since the

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<sup>288</sup> This prescription is similar to that suggested by Victor Thuronyi with regard to developing nations signing “skinny treaties” that do not yield taxing rights, although my recommendation is broader than his since it applies to developed nations as well. See Victor Thuronyi, *Tax Treaties and Developing Countries*, in TAX TREATIES: BUILDING BRIDGES BETWEEN LAW AND ECONOMICS 441, 445 (Michael Lang et al. eds., 2010).

<sup>289</sup> Brooks & Krever, *supra* note 1, at 170.

multilateral instrument allows nations to pick and choose which treaties are subject to which new provisions, this would allow countries with asymmetric trade flows or different tax systems to opt out of the tax allocation provisions when it is not in their interest. Given the fact that, under asymmetric trade flows, one capital-exporting country will likely benefit from residence-based taxation and the other capital-importing country will lose, it is likely that unilateral rejection of these provisions will be controversial. Once the other country sees that withdrawal is imminent, however, it is likely in their interests to acquiesce to the unilateral withdrawal rather than risk the termination of the entire treaty. The countries may also decide to come to an agreement to scale up source-based taxation. Moreover, the multilateral instrument could provide a means to revisit the treaties if a country's economic circumstances changed.

Rather than the 3000 tax treaties that are nearly identical to one another, we could have a system of bilateral tax treaties that better reflect national interests. Moreover, by deemphasizing residence-based jurisdiction, this type of system may assist in helping to solve the stateless income problem. Finally, because the pared down treaty system would necessarily give way to more domestic solutions, international tax could respond more readily to current economic conditions and tax planning maneuvers. Although some might critique this solution as causing chaos in the international tax sphere, I would argue that we are at least on the precipice of that point already, and an ordered unwinding of the system is preferable to unilateral moves by individual nations that we are beginning to see.

Another advantage of this proposal is that it would give nations the space and flexibility to experiment with new ways to tax cross-border income. As countries have struggled with various methods of taxing stateless income it has become apparent that fitting such new taxes into the old tax treaty model is a fool's errand. Moreover, the time to explore novel approaches to cross-border taxation is now, as the E.U. state aid controversy and other developments have suddenly cast doubt upon the longstanding status quo of preventing double taxation as the sole focus of the international tax system.<sup>290</sup>

If tax treaties are at least partially unraveled, we might ask how and when the new system should be rebuilt. It is my view that even if true multilateral coordination of the tax base is not achieved, abandonment of or scaling down aspects of the current bilateral system is still worthwhile given their harmful effects. Ideally, however, a new system could be put into place as the older treaties are being unraveled. The first best solution would be to for nations to come together to decide on new principles that can accommodate destination-based taxation. Such principles must extend beyond the EU's current sectorial focus of digital taxation

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<sup>290</sup> See Steven A. Dean, *A Constitutional Moment for Cross-Border Taxation* (draft on file with the author) (likening the current political environment in cross-border taxation to a potentially transformative constitutional moment).

and the geographic focus on large U.S. corporations. Multilateral solutions should also strengthen source-based taxation in instances where the residence country is not taxing the income. To the extent an initial allocation of taxing jurisdiction is retained, the multilateral instrument could, for instance, pursue provisions that “throw-back” the tax to a state if the state of initial apportionment does not tax the item.<sup>291</sup>

More modestly, the multilateral instrument could be used to resolve problems of inconsistent tax treatment. For instance, countries could agree to harmonize their tax rules in certain areas or to make adjustments to their domestic rules in order to achieve consistent tax treatment.<sup>292</sup> It could also be used to refine source rules to incorporate more destination-based concepts such as customer base.<sup>293</sup> Domestic double-tax relief systems could then function in a better manner. Likewise, other problems of cross-border arbitrage could be addressed by the multilateral instrument.<sup>294</sup>

If multilateral solutions are not found, domestic law could step in to serve as a coordination device. For instance, domestic law could impart some of the give and take in foreign relations by premising code provisions on reciprocity. This would allow nations to have more control over their revenue policy while also partially tying tax systems together. This would also address one potential objection to ceding more authority to individual nations—that control over international relations would be lost because nations would no longer have the quid pro quo negotiation that the treaty system imparts.

It would also remove some of the arbitrariness in applying different policies to treaty and nontreaty countries, even if the economics or politics of the situation

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<sup>291</sup> Wells & Lowell, *supra* note 10, at 38. Such a system would replicate the “throw-back rules” adopted by several states in the United States. See Walter Hellerstein, *The Quest for ‘Full Accountability’ of Corporate Income*, 63 ST. TAX NOTES 627 (2011).

<sup>292</sup> See Victor Thuronyi, *International Tax Cooperation and a Multilateral Treaty*, 26 BROOK. J. INT’L L. 1641, 1652 (2001). Some multilateral proposals seek to simply replicate the OECD bilateral model treaty on a multilateral basis. See Michael Lang et al., *Draft for a Multilateral Treaty*, in MULTILATERAL TAX TREATIES: NEW DEVELOPMENTS IN INTERNATIONAL TAX LAW (Michael Lang et al. ed., 1998). Tsilly Dagan has also argued for greater coherence in harmonizing the international tax system through focus on such rules, although not through a treaty or instrument per se. DAGAN, *supra* note 4, at [pincite]. Harmonization of tax rules has been done on a small, although not legally binding, scale. See Recommendation of the Council of the OECD on the Tax Deductibility of Bribes to Foreign Public Officials (1996) (representing a political commitment by OECD countries to deny a deduction for bribes).

<sup>293</sup> See Paul Oosterhuis & Amanda Parsons, *Destination-Based Income Taxation: Neither Principled Nor Practical?* (Oct. 27, 2017) (unpublished manuscript) (draft on file with author).

<sup>294</sup> On a more ambitious level, proponents of formulary apportionment may wish to use the multilateral instrument to shift to a such a system. As we have learned with the bilateral system of treaties, however, political might may win over rationality, harming countries with less sway on the international front.

call for uniform treatment between the two. A reciprocal code provision would instead tie foreign relations policy to the desired criteria. For instance, a code provision could re-allocate profits from a foreign related party to a domestic related party if the foreign profits were not subject to meaningful taxation abroad. This would be similar to the new kill-switch provisions in the 2016 U.S. Model treaty but would have the advantages that unilateral decision-making brings.<sup>295</sup> After all, precisely those countries that are reluctant to tax such income may also be reluctant to implement these new treaty provisions. Other destination-based statutory solutions, like destination-based taxes or experimental source rules, could also be utilized to preserve taxation of business income.<sup>296</sup> As these rules are enacted by a powerful country like the United States, other nations may follow suit, creating harmonization without multilateral action.

Another significant advantage domestic law has over treaties is, at least in the United States, greater democratic process and transparency. With regard to statutory changes, both houses of Congress are involved, there is greater opportunity for deliberation, and any changes would be subject to the normal budget process.<sup>297</sup> This has the advantage of bringing scrutiny over policies that benefit multinational corporations at perhaps great cost to the fisc. Although one can make the case that tax treaties allow countries to strategically enact different tax systems for foreign and domestic investors,<sup>298</sup> such differentiation would still be attainable in, and would benefit from, a robust legislative process. Such a solution would also lend itself to greater policy innovation and fiscal flexibility.

## CONCLUSION

To conclude, this Article finds fault with the traditional justifications offered in favor of bilateral tax treaties. Most criticism towards these treaties has been done on behalf of developing nations, but countries like the United States also stands to lose from the status quo. Rather than accommodating tax reform or reflecting differences in tax systems or trade flows, the treaties, by and large, are entrenched and follow a single model. In these respects, the most damaging aspects of the tax treaties are those provisions that allocate taxing jurisdiction. This Article suggests that countries should abandon or scale back these provisions and offers the new multilateral instrument as a possible means to do so. The hope is that this

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<sup>295</sup> See U.S. Model Treaty, *supra* note 20, at arts. 11(2)(c), 12(2)(a), and 21(2)(a).

<sup>296</sup> Such solutions need not wholly embrace destination-based taxation but could instead utilize some of its principles alongside the existing system. This incremental approach would allow for experimentation with a new form of taxation on a platform less risky than, say, the destination-based cash flow tax that would have replaced the corporate income tax.

<sup>297</sup> See Kysar, *supra* note 2.

<sup>298</sup> See Zolt, *supra* note 185, at 14.

process paves the way toward a more dynamic and heterogenous tax treaty. Gone are the days where nations are able to invoke some notion of worldwide efficiency to justify a uniform international tax system. Instead, the system must do its best to coordinate within a world of competing national interests.