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Solving the Problem of Tax-Treaty Shopping through the Use of Limitation on Benefits Provisions

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SOLVING THE PROBLEM OF TAX-TREATY SHOPPING THROUGH THE USE OF LIMITATION ON BENEFITS PROVISIONS

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I. INTRODUCTION

In 2007, the United States signed double taxation conventions (DTCs) with Iceland and Bulgaria, as well as a protocol to the 1980 Canada-U.S. DTC.[1] A common feature of these instruments is a comprehensive Limitation on Benefits (LOB) provision, which ensures that treaty benefits flow only to residents of the United States and the other treaty signatory, as opposed to third-country residents.[2] The United States includes LOB provisions in all newly signed DTCs.[3] This policy addresses the United States' concern regarding "treaty shopping"[4]—a form of treaty abuse which occurs when taxpayers create artificial entities or transactions in treaty jurisdictions with the purpose of obtaining treaty benefits.[5]

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[1] *See* Income Tax Convention Between the United States and Bulgaria, U.S.-Bulg., Feb. 23, 2007; Protocol Amending the Income Tax Convention Between the United States and Canada, U.S.-Can., Sept. 21, 2007; Income Tax Convention Between the United States and Iceland, U.S.-Ice., Oct. 23, 2007, *available at* http://ustreas.gov/offices/tax-policy/treaties.html.

[2] *Pending Income Tax Agreements: Hearing Before the S. Comm. on Foreign Relations,* 109th Cong. 1 (2006) (statement of Patricia A. Brown, Deputy International Tax Counsel for Treaty Affairs, Dept. of Treasury).

[3] *See* U.S. DEP'T. OF THE TREASURY, REPORT TO THE CONGRESS ON EARNINGS STRIPPING, TRANSFER PRICING AND U.S. INCOME TAX TREATIES 5, 74–85 (2007) [hereinafter REPORT ON TAX TREATIES], *available at* www.ustreas.gov/offices/tax-policy/library/ajca2007.pdf.

[4] *Id.*

[5] SAMUEL C. THOMPSON, JR., U.S. INTERNATIONAL TAX PLANNING AND POLICY INCLUDING CROSS-BORDER MERGERS AND ACQUISITIONS 169 (2007).

Some commentators and foreign officials have characterized the U.S. approach to LOB provisions as "paranoid"[6] and as an "over-reaction."[7] LOB provisions have been criticized as potentially impeding the ability of the United States to attract foreign capital,[8] as redundant due to the existence of anti-abuse rules in U.S. domestic law,[9] and as possibly incompatible with the law of the European Union.[10] This Comment addresses each of these concerns.

The Comment argues that unilateral anti-abuse measures, such as domestic laws, may not adequately address the problem of treaty shopping. As treaty shopping stems from a lack of coordination between domestic systems of taxation, unilateral anti-abuse measures should be supplemented by a consistent use of the LOB provision in DTCs. The argument proceeds in three parts. Part II examines the treaty shopping phenomenon in the context of the U.S. and global tax policies. Part III assesses domestic unilateral anti-abuse measures, provides a comparative perspective on unilateral anti-abuse measures in Canada, India and the European Union, and analyzes the compatibility of such measures with the DTC obligations of signatories as a matter of international law. Part IV analyzes the evolution and mechanics of the LOB provision of the United States Model Income Tax Convention of November 15, 2006[11] (2006 U.S. Model) and responds to recent criticisms of this provision. The Comment concludes that LOB provisions are a necessary collective measure, which facilitates the concerted effort to harmonize national tax systems.

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[6] Simone M. Haug, *The United States Policy of Stringent Anti-Treaty-Shopping Provisions: A Comparative Analysis*, 29 VAND. J. TRANSNAT'L L. 191, 197 (1996).

[7] Phillip F. Postlewaite et al., *The A.L.I. Tax Treaty Study – A Critique and A Modest Proposal*, 52 TAX LAW. 731, 770 (1999) (stating that the American Law Institute "believes that the United States has, in general, overreacted to the treaty shopping problem").

[8] Raymond Wacker, *Anti-Treaty Shopping Restrictions in the New U.S.-Netherlands Tax Treaty*, 45 TAX EXEC. 383, 389 (1993).

[9] *See, e.g.*, Richard L. Reinhold, *What is Tax Treaty Abuse? (Is Treaty Shopping an Outdated Concept?)*, 53 TAX L. 663 (2000).

[10] *See, e.g.*, Ruth Mason, *U.S. Tax Treaty Policy and the European Court of Justice*, 59 TAX L. REV. 65 (2005).

[11] U.S. Model Income Tax Convention of Nov. 15, 2006, [1 IRS Forms] Tax Treaties (CCH) ¶ 209 (2007) [hereinafter 2006 U.S. Model], *available at* http://www.ustreas.gov/press/releases/reports/hp16801.pdf.

II. TREATY SHOPPING: MECHANICS AND POLICY CONSIDERATIONS

The existing network of over fifty DTCs between the United States and other countries[12] creates significant tax planning opportunities for taxpayers. DTCs ameliorate the effects of juridical double taxation (taxation by more than one jurisdiction on the same item of income).[13] The 2006 U.S. Model, similar to the Model Tax Convention developed by the Organisation for Economic Co-Operation and Development (OECD),[14] reduces taxation at the "source" (the jurisdiction where the income arises,[15] as opposed to the "residence" jurisdiction, the taxpayer's fiscal domicile).[16] Taxpayers use DTCs to reduce costs of doing business and/or increase net investment returns, for example, musician Mick Jagger and the rock band The Rolling Stones reportedly have taken advantage of the extensive treaty network of the Netherlands, where the band established an entity for licensing its music.[17] As Judge Learned Hand pointed out, "there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible."[18]

Seeking to reduce their tax liability, however, some taxpayers engage in "treaty shopping"—a form of treaty abuse.[19] There exists no uniform definition of "treaty shopping,"[20] but the term usually refers to situations where residents of third States otherwise ineligible for treaty benefits create artificial entities referred to as "conduits"[21] or

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[12] I.R.S. Publication No. 519, U.S. Tax Guide for Aliens, § 9, 9.1 (Mar. 12, 2008) (providing a list of tax treaties in effect), *available at* 2007 WL 4986573 (I.R.S.).

[13] Georg W. Koefler & Ruth Mason, *Double Taxation: A European "Switch in Time?"*, 14 COLUM. J. EUR. L. 63, 64 n.9 (2007).

[14] ORGANISATION FOR ECONOMIC CO-OPERATION & DEVELOPMENT, MODEL TAX CONVENTION ON INCOME AND ON CAPITAL (2008) [HEREINAFTER OECD MODEL].

[15] FÉLIX ALBERTO VEGA BORREGO, LIMITATION ON BENEFITS CLAUSES IN DOUBLE TAXATION TREATIES 15, 24 (2006).

[16] Richard L. Reinhold, *Some Things that Multilateral Tax Treaties Might Usefully Do*, 57 TAX LAW. 661, 663 (2003).

[17] Joseph B. Darby III et al., *When Tax Planning Rocks: How the Rolling Stones Went Dutch to Cut Taxes*, PRACTICAL US/INT'L TAX STRATEGIES, June 30, 2007, at 6–11.

[18] ROBERT KINSMAN, THE ROBERT KINSMAN GUIDE TO TAX HAVENS 1 (1978).

[19] *See* UNITED NATIONS, ECONOMIC AND SOCIAL COUNCIL, COMMITTEE OF EXPERTS ON INTERNATIONAL COOPERATION IN TAX MATTERS; TREATY ABUSE AND TREATY SHOPPING, ¶ 21–24, U.N. DOC. E/C.18/2006/2 (2006) [hereinafter UN REPORT ON TREATY SHOPPING].

[20] *Id.*

[21] Treas. Reg. § 1.881-3(a)(2)(ii)(B) (defining "conduit" as "an intermediate entity whose participation in a financing arrangement may be disregarded in whole or in part under the regulations"); BORIS I. BITTKER ET AL., FUNDAMENTALS OF INTERNATIONAL TAXATION: U.S. TAXATION OF FOREIGN INCOME AND FOREIGN TAXPAYERS para. 66.2.10 (2d ed. 1997) (stating that "[g]enerally, an intermediate entity is a

enter into artificial transactions in a treaty jurisdiction to access treaty benefits.[22] In this sense, it is clear that treaty shopping differs from "tax evasion" in employing means, such as creation of "postbox" or "shell" corporations, that are legal in their form.[23] Some commentators distinguish between treaty shopping where taxpayers are merely "searching for a more favorable treaty" from abusive treaty shopping involving an indirect violation of the object or purpose of the treaty.[24] This Comment will focus on the abusive treaty shopping, which can be demonstrated by examples of specific patterns.

A. *The Mechanics of Treaty Shopping*

The 1964 case involving a famous Swedish heavyweight boxer Ingemar Johansson[25] illustrates a classic treaty shopping pattern. Johansson made arrangements to receive his U.S. income as a sole employee of a Swiss corporation,[26] which claimed an exemption from U.S. tax under the U.S.-Swiss tax treaty.[27] The arrangement would have reduced Johansson's U.S. tax liability by almost a million dollars in 1960 and 1961.[28] But the Internal Revenue Service (IRS) and the U.S. courts denied treaty benefits in this arrangement. The United States Court of Appeals for the Fifth Circuit emphasized the lack of a business purpose in the Swiss entity and its nature as a conduit for escaping U.S. taxes.[29] The court reasoned that the purpose of the treaty is to eliminate the impediments of double taxation in international commerce,[30] which were not implicated in this case.

With the development of anti-abuse rules in DTCs and domestic revenue laws, treaty shopping patterns became more sophisticated. In addition to the "direct conduit" scheme, under which an intermediary company is formed in a country which affords treaty benefits,[31]

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conduit if its participation in the financing arrangement reduces tax under § 881 and is "pursuant to a tax avoidance plan").

[22] UN Report on Treaty Shopping, *supra* note 19, ¶ 21–24.

[23] Haug, *supra* note 6, at 191, 199 n.19.

[24] UN Report on Treaty Shopping, *supra* note 19, ¶ 24.

[25] Johansson v. United States, 336 F.2d 809 (5th Cir. 1964).

[26] *Id.* at 811.

[27] The United States imposes tax on U.S.-source income of non-U.S. persons. *See* 26 U.S.C. § 871(a)(1)(A) (2006) (tax on nonresident alien individuals); 26 U.S.C. § 881(a)(1) (2005) (tax on income of foreign corporations not connected with U.S. business).

[28] *Johansson*, 336 F.2d at 811.

[29] *Id.* at 813.

[30] *Id.*

[31] Borrego, *supra* note 15, at 20.

taxpayers also use "stepping stone conduits."[32] Under that scheme, intermediary companies exploit the availability of deductions for expenses incurred by affiliates-residents of third-party States.[33] Taxpayers in third-party jurisdictions have also used agents, representatives, fiduciary arrangements and trusts (in each case, with varying success) to access treaty benefits available in jurisdictions outside of the taxpayers' residence.[34] The underlying theme in these schemes is that they enable taxpayers to access treaty benefits in a manner inconsistent with the purposes of the treaty, namely, to provide tax benefits to the residents of the treaty jurisdictions.[35]

Another common thread in the treaty shopping patterns is that these patterns often are based on taxpayer-favorable national revenue laws. For example, prior to the inclusion of the LOB provision in the U.S.-Netherlands DTC, this treaty was a popular treaty shopping tool,[36] in part, because the Netherlands domestic revenue laws imposed neither debt-to-equity ratio requirements with respect to business entities within the jurisdiction, nor any withholding tax on interest payments flowing from the Netherlands to other jurisdictions.[37] Additionally, when to the U.S.-Netherlands treaty was extended to the Antilles, taxpayers could take advantage of the Antilles bank secrecy laws.[38] These domestic laws create incentives for treaty shopping. As long as such incentives exist, unilateral anti-abuse measures in other isolated jurisdictions will not effectively resolve the problem of treaty shopping.

Several treaty shopping schemes exploit the favorable interplay of two or more domestic systems of taxation, which can be illustrated by the phenomenon of "hybrids"[39]—entities,[40] transactions, or

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[32] The Internal Revenue Service (IRS) and U.S. courts have restricted use of conduit companies. *See infra* Part III.A.

[33] BORREGO, *supra* note 15, at 30–31.

[34] *Id.* at 27–29.

[35] JON E. BISCHEL & ROBERT FEINSCHREBER, FUNDAMENTALS OF INTERNATIONAL TAXATION 273 (2d ed. 1985).

[36] *See* Wacker, *supra* note 8, at 383; Robert Joseph Pineau, Note, *Revenue Ruling 84-152: The Beginning of the End for Treaty Shoppers*, 12 SYRACUSE J. INT'L L. & COM. 170, 171 (1985).

[37] INTERNATIONAL TAX PLANNING AFTER THE TAX REFORM ACT OF 1986 § 9.03[3][b] (Jon E. Bischel et al. eds., 1989).

[38] Pineau, *supra* note 36, at 174.

[39] Daniel Shaviro, *More Revenues, Less Distortion? Responding to Cross-Border Tax Arbitrage*, 1 N.Y.U. J. L. & BUS. 113, 119 (2004).

[40] Philip R. West, *Foreign Law in U.S. International Taxation: The Search for Standards*, 3 FLA. TAX REV. 147, 180–82 (1996).

instruments,[41] which jurisdictions classify differently. For instance, prior to the 1997 Taxpayer Relief Act,[42] under the "Cayman sandwich" hybrid scheme,[43] Canadian residents receiving dividends on U.S. stock could transfer the stock (along with the right to receive dividends) to an entity formed in the Cayman Islands.[44] Canadian revenue law would treat such entity as a corporation, whereas U.S. law would treat it as a partnership.[45] As a result, for U.S. tax purposes, the U.S.-Canada treaty would reduce the withholding tax.[46] For the purposes of Canadian tax, as a "foreign affiliate"[47] this entity would not pay tax. The Cayman Islands would not tax this entity either,[48] which would effectively allow the Canadian taxpayers to escape at least a portion of their U.S. tax.

Similar principles apply to hybrid instruments and transactions.[49] For example, stock repurchase agreements constitute a loan for U.S. tax purposes, but may constitute equity for purposes of taxation in other jurisdictions.[50] Such divergent characterizations result in the treaty exemption of the withholding tax on interest, an interest deduction in the United States, and a non-recognition of income abroad.[51] Thus, as these patterns demonstrate, treaty shopping ultimately stems from a lack of coordination between national taxation systems.

B. *The U.S. Policy with Respect to Treaty Shopping*

As a matter of U.S. tax policy, treaty shopping is problematic in several ways. First, as the previously discussed examples demon-

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[41] Andriy Krahmal, *International Hybrid Instruments: Jurisdiction Dependent Characterization*, 5 HOUS. BUS. & TAX L.J. 98 (2005).

[42] The use of this scheme was limited by the Taxpayer Relief Act of 1997 and Treas. Reg. § 1.894-1(d). Taxpayer Relief Act of 1977, Pub.L. 105-34 § 1054(a) (codified at 26 U.S.C. 894(c)) (denial of treaty benefits for certain payments through hybrid entities).

[43] West, *supra* note 40, at 180–82. The no-longer available "Bermuda sandwich" also took advantage of domestic revenue laws in Bermuda. *See* THOMPSON, *supra* note 5, at 169.

[44] West, *supra* note 40, at 180–82.

[45] *Id.*

[46] *Id.*

[47] *See* Income Tax Act, R.S.C. 1985, ch. 1, § 95(1), (4) (5th Supp.) (1985) (Canada); *see also* Geoffrey S. Turner, *Property Distributions Under Canadian Foreign Affiliate Proposals*, 40 TAX NOTES INT'L 1191, 1191 n.1, 3 (2005) (discussing recent changes and proposals to the "foreign affiliate" regime in Canada).

[48] West, *supra* note 40, at 180–82.

[49] Krahmal, *supra* note 41.

[50] Treas. Reg. §1.861-2(a)(7) (2004).

[51] Krahmal, *supra* note 41, at 13–16.

strate, treaty shoppers escape their tax liability in the United States, which negatively affects the national tax revenue. Second, in treaty shopping patterns, treaty benefits flow to residents of third jurisdictions, while U.S. citizens and residents do not receive a reciprocal benefit in those jurisdictions.[52] Third, the absence of anti-abuse measures in effect rewards treaty shoppers for creating conduits and entering into transactions that lack in economic substance. Each of these concerns is addressed below.

Treaty shopping results in loss of revenue for the United States due to the fact that treaty shoppers do not pay tax that is otherwise owed. In DTC negotiations, the United States agrees to reduce its source taxation in exchange for a reciprocal concession by the treaty partner in favor of U.S. residents.[53] Generally, such concessions are based on data pertaining to the income flow between the countries that are entering into a DTC.[54] Where a country is concerned with losing revenues as a result of such treaty concessions, the country's government may compensate for the shortfall in another fashion, for example, by increasing resident taxation.[55] Treaty shopping upsets this calculation because when third-country residents access treaty benefits, the source jurisdiction loses income, which is not accounted for or otherwise offset. In fact, corporate tax returns filed in the United States in recent years show an increase in the interest payments by foreign-controlled U.S. corporations to their affiliates in countries that have DTCs without LOB provisions, such as Hungary,[56] for the benefit of their mutual parent company in a non-treaty jurisdiction.[57] These payments at least partially escape U.S. taxation and result in a loss of U.S. revenue. For this reason, anti-abuse measures seeking to eliminate treaty shopping, such as LOB provisions in DTCs, protect the United States' tax base.

The possibility of treaty shopping also defeats an incentive for third-party States to negotiate DTCs with the United States. Such third-party States do not need to concede their source taxation of U.S. residents in those countries, because their residents already have an opportunity to take advantage of existing U.S. DTCs with other coun-

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[52] Press Release, Internal Revenue Service, HP-494, Testimony of Treasury International Tax Counsel John Harrington Before the Senate Committee on Foreign Relations on Pending Income Tax Agreements (July 17, 2007), *available at* http://www.ustreas.gov/press/releases/hp494.htm.

[53] *See* BORREGO, *supra* note 15, at 51–52; PAUL R. MCDANIEL ET AL., INTRODUCTION TO UNITED STATES INTERNATIONAL TAXATION 178 (2005).

[54] *See* BORREGO, *supra* note 15, at 51–52; West, *supra* note 40, at 179.

[55] *See* BORREGO, *supra* note 15, at 53.

[56] REPORT ON TAX TREATIES, *supra* note 3.

[57] *Id.* at 5, 74–85.

tries.[58] Before 1992, for example, Canada refused to negotiate an amendment to the DTC with the United States, which would have added an LOB provision, because Canadian investments were channeled through the Netherlands under the U.S.-Netherlands treaty, which at that time contained no LOB provision.[59] After an LOB provision was added to the U.S.-Netherlands treaty, Canada also agreed to include a version of such a provision in its treaty with the United States.[60] This shows that the use of LOB provisions in U.S. DTCs strengthens the position of the United States in future DTC negotiations.[61]

The U.S. anti-treaty shopping policy also advances the principle of horizontal equity and promotes efficient resource allocation. The principle of horizontal equity ensures that similarly situated taxpayers are treated similarly under the tax laws.[62] This principle optimizes the taxpayers' resource allocation by discouraging the creation of artificial entities and transactions which do not contribute to the economy and do not generate economic surplus.[63] In effect, anti-abuse measures remove the incentive to distort taxpayers' economic choices.[64]

Some commentators warn that anti-treaty shopping measures may impede the United States' ability to attract foreign capital[65] and, consequently, increase the cost of credit available to U.S. businesses.[66] For example, in the 1960s, U.S. companies could access relatively cheap credit in the Eurobond market. These companies issued debt instruments through their subsidiaries in the Netherlands Antilles. The interest payments on those instruments were exempted under the U.S.-Netherlands Antilles treaty and were not taxed by the Netherlands Antilles.[67] These tax benefits resulted in a low cost of credit,

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[58] *See* UN REPORT ON TREATY SHOPPING, *supra* note 19, ¶ 22.

[59] BORREGO, *supra* note 15, at 54 n.39.

[60] *Id.*

[61] *See id.* at 14.

[62] Dionisios D. Stathis, *Compatibility of Anti-Treaty Shopping Policies with Basic International Trade Imperatives: Relevance of Fiscal Equity and Neutrality in the International Trade Regime and Lessons for International Tax Lawyers*, 1 MANCHESTER J. INT'L ECON. L. 20, 23 (2004).

[63] *See* BORREGO, *supra* note 15, at 55.

[64] *See* Stathis, *supra* note 62, at 20, 23.

[65] *See* Daniel Shaviro, *Money on the Table?: Responding to Cross-Border Tax Arbitrage*, 3 CHI. J. INT'L L. 317, 318 (2002); *see also* UN REPORT ON TREATY SHOPPING, *supra* note 19, ¶ 92.

[66] *See* Wacker, *supra* note 8, at 383, 389; Pineau, *supra* note 36, at 175–76.

[67] Frith Crandall, *The Termination of the United States-Netherlands Antilles Tax Treaty: What Were the Cost of Ending Treaty Shopping?*, 9 NW. J. INT'L & BUS. 355, 360–61 (1988).

which was no longer available after the United States terminated the U.S.-Netherlands Antilles treaty in 1987.[68]

Despite this apparent interrelation between tax benefits and the cost of borrowing, mere toleration of treaty shopping inefficiently decreases the cost of credit. Treaty shopping results in the low cost of foreign credit at the price of losing U.S. revenue; this shows that the low cost of credit merely reflects an indirect subsidy to treaty shoppers from the U.S. government. If the United States makes a decision to allocate government funds for the purpose of lowering the cost of credit, cutting credit rates or providing direct subsidies may be more manageable and efficient. Unlike passive toleration of treaty shopping, with the expectation of attracting foreign capital, affirmative domestic measures, such as tax incentives for specific businesses or groups of taxpayers, would reach the intended beneficiaries. As such, the negative effect of anti-abuse policies on the United States' effort to maintain an affordable cost of credit is overstated.

C. Global Perspective on Treaty Shopping

The United States' national interests overlap with policies of "the world welfare,"[69] which concern the global efficiency[70] and coordination of national tax systems. From the global perspective, treaty shopping often results in double non-taxation—a situation where an item of income escapes taxation in two or more jurisdictions.[71] For example, in the Eurobond market, creditors exempted U.S. withholding tax on interest under the U.S.-Netherlands Antilles treaty and did not pay tax in the Netherlands Antilles. In such situations, neither jurisdiction, both having contributed to the creation of the infrastructure for the economic activity, collects a portion of the economic surplus created by the activity. Treaty shoppers escape their share of public spending expenses, which pertain to the administration of justice, industry regulation, and public utilities, both in the source and the residence jurisdictions.[72] For this reason, in its study of harmful international tax competition, the Organisation for Economic Co-Operation and Development (OECD) labeled this phenomenon as "free-riding."[73] Moreover, instead of paying taxes, treaty shoppers allocate their resources to form artificial tax-motivated structures that have

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[68] *See id.*
[69] *See* Shaviro, *supra* note 65, at 317, 318.
[70] Shaviro, *supra* note 39, at 115.
[71] UN REPORT ON TREATY SHOPPING, *supra* note 19, ¶ 22.
[72] Org. for Econ. Co-Operation & Dev. [OECD], *Harmful Tax Competition: An Emerging Global Issue*, at 24–25 (1998) [hereinafter OECD Harmful Competition Report].
[73] *Id.*

little benefit to world welfare, other than that a portion of the economic surplus is diverted to the services sector, including the legal services field. From the global economic perspective, treaty shopping is an inefficient phenomenon.

III. THE LIMITATIONS OF STATES' UNILATERAL ANTI-ABUSE MEASURES

To advance their anti-abuse policy, States may implement unilateral and/or multilateral anti-abuse measures. Unilateral measures encompass promulgation of domestic revenue laws and regulations, while multilateral measures include the incorporation of the LOB provisions in DTCs. In the past thirty years, the United States has unilaterally limited treaty benefits through its court decisions, revenue statutes, and administrative law,[74] raising several questions.

A. *The United States' Unilateral Anti-abuse Measures*

The domestic revenue law in the United States includes unilateral anti-abuse measures embodied in judicial doctrines, legislature and administrative law. Under the economic substance doctrine, "a court may deny tax benefits arising from transactions that do not result in a meaningful change to the taxpayer's economic position other than purported reduction in federal income tax."[75] When applied to interpretation of DTCs, the economic substance doctrine represents a "general" anti-abuse rule as opposed to a "specific" rule that identifies and targets specific schemes and/or transactions.[76] The U.S. Congress and Treasury have implemented numerous "specific" anti-abuse rules in the past decades, but these measures reveal significant limitations.

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[74] *See* Anthony C. Infanti, *Curtailing Tax Treaty Overrides: A Call to Action*, 62 U. PITT. L. REV. 677 (2001); David Sachs, *Is the 19th Century Doctrine of Treaty Override Good Law for Modern Day Tax Treaties?*, 47 TAX LAW. 867 (1994); H. David Rosenbloom, *Toward a New Tax Treaty Policy for a New Decade*, 9 AM. J. TAX POL'Y 77, 78 (1991).

[75] Yoram Keinan, *It is Time for the Supreme Court to Voice its Opinion on Economic Substance*, 7 HOUS. BUS. & TAX L. J. 93, 94 (2006).

[76] *See generally* Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee, *The Application of Anti-Abuse Measures in the Area of Direct Taxation within the E.U. and in Relation to Third Countries*, at 2, COM (2007), 785 final (Dec. 10, 2007), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2007:0785:FIN:EN:PDF (discussing "general " and "specific" anti-abuse rules) [hereinafter 2007 E.C. Commc'n].

1. *The Inconsistent Application of the Judicial Anti-abuse Doctrines*

A discussion about U.S. judicial anti-abuse doctrines usually begins with the 1971 decision in *Aiken Industries Inc. v. Commissioner.*[77] In that case, a U.S. subsidiary borrowed funds from its parent company in Ecuador, and in order to be able to exempt the interest payments under the U.S.-Honduras treaty, paid the interest to a subsidiary in Honduras.[78] The U.S. Tax Court disallowed treaty benefits in this back-to-back loan because, in the absence of a business purpose, the Honduran affiliate acted as a "conduit" for passing the interest payments to the parent in Ecuador.[79]

A similar scenario resulted in a different outcome in the 1995 case *Northern Indiana Public Service Co. v. Commissioner.*[80] In that case, a U.S. parent borrowed funds in the Eurobond market through its Netherlands Antilles subsidiary and exempted interest payments to the subsidiary under the U.S.-Netherlands treaty.[81] On appeal, the United States Court of Appeals for the Seventh Circuit distinguished this case from *Aiken Industries Inc.* in that in *Northern Indiana Public Service Co.*, the subsidiary conducted a "concededly minimal activity, but business activity nonetheless."[82] According to *Northern Indiana Public Service Co.*, the subsidiary's profit of one-percent spread between the interest the subsidiary received from the parent and the interest the subsidiary paid to its creditors on Eurobonds, was sufficient to establish the existence of a "business activity."[83]

The 2001 case, *Del Commercial Properties, Inc. v. Commissioner*,[84] however, shows that courts may subject the "business purpose" to greater scrutiny than accorded in *Northern Indiana Public Service Co.* In *Del Commercial Properties, Inc.*, through a chain of transactions involving its Netherlands subsidiary, a U.S. company accessed financing ultimately provided by the Royal Bank of Canada.[85] The U.S. company argued that its subsidiary's "business purpose" was to secure savings in Canadian tax.[86] The Tax Court and the United States Court of Appeals for the District of Columbia rejected this contention and denied benefits under the U.S.-Netherlands treaty be-

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77 Aiken Indus. Inc. v. Comm'r, 56 T.C. 925 (1971).
78 *Id.*
79 *Id.*
80 N. Ind. Pub. Serv. Co. v. Comm'r, 105 T.C. 341, *aff'd*, 115 F.3d 506 (7th Cir. 1997).
81 *Id.*
82 N. Ind. Pub. Serv. Co. v. Comm'r, 115 F.3d 506, 513 (7th Cir. 1997).
83 *Id.*
84 Del Commercial Properties, Inc. v. Comm'r, 251 F.3d 210 (D.C. Cir. 2001).
85 *Id.* at 211–13.
86 *Id.*

cause the taxpayer failed to provide evidentiary support for its purported business purpose and did not cite any relevant provisions of the Canadian tax code.[87]

This trilogy of cases demonstrates that through court decisions, the economic substance doctrine developed elasticity that anticipates financial innovation and other creations of taxpayer's ingenuity. The application of this doctrine, however, lacks uniformity.[88] The doctrine has developed through individual cases involving complex transactions, which taxpayers can arguably distinguish, and when applied prospectively, the doctrine fails to provide sufficient predictability for taxpayers' planning. To complicate the matter, terms such as "substance-over-form," "step-transaction," "business purpose," "sham transaction," and "economic substance" are often used interchangeably.[89] In that background, Congress was also taking steps to combat treaty shopping.

2. *U.S. Legislative Anti-abuse Measures*

The Congressional response to treaty shopping was less nuanced than that of the U.S. courts. As early as in 1986,[90] in passing the Tax Reform Act,[91] Congress expressed its intention to go as far as to override "on a wholesale basis"[92] tax treaties permitting treaty shopping.[93] Subsequently, Congress enacted several other statutes which sought to curtail treaty shopping.[94] In response, some commen-

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[87] *Id.* at 215.

[88] Karen B. Brown, *U.S. Tax Avoidance, Treaty Shopping and the Economic Substance Doctrine in the United States*, 2 BRITISH TAX R. 160, 160 (2008).

[89] *See* Yoram Keinan, *Rethinking the Role of the Judicial Step Transaction Principle and a Proposal for Codification*, 22 AKRON TAX. J. 45, 45–47 (2007); Keinan, *supra* note 75.

[90] Congress expressed its intent to override tax treaties as early as in 1962. Revenue Act of 1962, Pub. L. No. 87-834, § 31, 76 Stat. 961, 1069 (1962) (indicating that the statute overrides tax treaties); *see also* Infanti, *supra* note 74, at 681 n.16 (explaining that Congress expressed its intent to override tax treaties, but the U.S. Treasury commented that the proposed statute did not conflict with any treaties, except for Greek Estate Tax Treaty which U.S. Treasury would seek to renegotiate).

[91] The Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986).

[92] Richard L. Doernberg, *Legislative Override of Income Tax Treaties: the Branch Profits Tax and Congressional Arrogation of Authority*, 42 TAX LAW. 173, 174 (1989).

[93] H.R. CONF. REP. 99-841, *reprinted in* 1986 U.S.C.C.A.N. 4075, 4734–38 [hereinafter H.R. CONF. REP. 99-841].

[94] *See* Infanti, *supra* note 74, at 682–83 (providing a list of statutes which overrode tax treaties).

tators[95] and United States' treaty partners[96] have criticized "treaty override" as a violation of international law. This, however, does not change the fact that, as a matter of the U.S. domestic law, Congress has the power to enact anti-abuse statutes that override DTCs.

Two features of the United States' constitutional design make tax treaty override possible.[97] The first is that two different branches of the U.S. government are responsible for treaties and revenue statutes.[98] The Treasury Department negotiates tax treaties,[99] and the President signs them "upon advice and consent" of the Senate,[100] while and the House of Representatives initiates tax legislation.[101] The House of Representatives has "little political capital"[102] in the tax treaty process and, thus, has passed bills overriding DTCs that favor non-residents (who are also usually non-voters). The second feature is that the U.S. Constitution places statutes and treaties on equal footing[103] and does not expressly identify a mechanism for resolving any potential conflicts between these two sources of law.[104] In response, the U.S. courts developed rules which aim to resolve conflicts between treaties and domestic law.

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95 *See, e.g.*, COMM'N ON U.S. ACTIVITIES OF FOREIGN TAXPAYERS AND FOREIGN ACTIVITIES OF U.S. TAXPAYERS, N.Y. S. BAR ASS'N, LEGISLATIVE OVERRIDES OF TAX TREATIES (1987), *reprinted in New York State Bar Association Tax Section Opposes Treaty Override Provisions in the Technical Corrections Bill*, 37 TAX NOTES 931 (1987); Infanti, *supra* note 74, at 682–83; Rosenbloom, *supra* note 74, at 77–78; Sachs, *supra* note 74, at 876.

96 *See, e.g.*, Letter from Emmanuel de Margerie, France's Ambassador to the United States, to James Baker III, United States Treasury Secretary, July 16, 1987, *reprinted in EEC Group of Six Addresses 1986 Act's Treaty Override Provisions*, 36 TAX NOTES 437 (1987) [hereinafter Letter from France's Ambassador to the United States].

97 BITTKER ET AL., *supra* note 21, ¶ 65.1.6; Irwin Halpern, *United States Treaty Obligations, Revenue Laws, and New Section 7852(d) of the Internal Revenue Code*, 5 FLA. INT'L L. J. 1, 25 (1989).

98 *See* Halpern, *supra* note 97, at 3.

99 *See* U.S. CONGRESS, JOINT COMMITTEE ON TAXATION AND SENATE COMMITTEE ON FOREIGN RELATIONS, TAX TREATIES AND STATUS OF PROPOSED TAX TREATIES (Joint Comm. Print 1979).

100 U.S. CONST. art. II, § 2, cl.2.

101 *Id.* art. I, § 7, cl.1.

102 William P. Streng, *U.S. Tax Treaties: Trends, Issues, & Policies in 2006 and Beyond*, 59 S.M.U. L. REV. 853, 864 (2006).

103 See U.S. CONST. art. VI, cl.2 ("the laws of the United States. . . and treaties . . . shall be the supreme law of the land").

104 Halpern, *supra* note 97, at 5.

These rules emerged in the nineteenth century, well before the United States entered into its first tax treaty in 1932.[105] The *Charming Betsy*[106] canon requires that statutes should be interpreted to avoid conflicts with treaties.[107] Where the conflict is unavoidable, under the "last-in-time rule," the later source, whether the statute or the treaty, prevails.[108] For instance, in the 1870 case where the U.S. Supreme Court first adopted the last-in-time rule, a later enacted statute imposing taxes on liquor and tobacco overrode a treaty with the Cherokee nation.[109] Congress codified the "last-in-time" rule as applied to "any law of the United States affecting revenue" in 1988.[110] Today, domestic revenue law should be "applied with due regard" to United States' treaty obligations, where such obligations came into effect after August 16, 1954.[111] But neither treaties nor statutory law have "preferential status by reason of its being a treaty or law."[112] These legal mechanisms allowed Congress to enact statutes targeting treaty shopping patterns and in effect override inconsistent provisions of DTCs.[113]

One of the early treaty overrides justified by anti-treaty shopping considerations was contained in the 1986 Tax Reform Act.[114] In that statute, Congress imposed a new tax on foreign corporations with

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[105] Convention and Protocol Between the United States of America and France Concerning Double Taxation, U.S.-Fr., Apr. 27, 1932, 49 Stat. 3145; *see also* Julian G. Ku, *Treaties as Laws: A Defense of the Last-in-Time Rule for Treaties and Federal Statutes*, 80 IND. L. J. 319 (2005).

[106] Murray v. Schooner Charming Betsy, 6 U.S. 2 Cranch 64, 64 (1804).

[107] Whitney v. Robertson, 124 U.S. 190 (1888); Pekar v. Comm'r. 113 T.C. 158, 161 (1999) (finding that in the absence of a conflict between a provision of the Internal Revenue Code and a treaty "the Code and the treaty should be read harmoniously, to give effect to each").

[108] *See* Kappus v. Comm'r., 337 F.3d 1053 (D.C. Cir. 2003) (holding that even if 26 U.S.C. § 59(a)(2), which limits the allowable foreign tax credit, conflicts with the U.S.-Canada DTC, the statute prevails under the "last-in-time" rule); RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 114 (1987); MCDANIEL ET AL., *supra* note 53, at 178.

[109] The Cherokee Tobacco, 78 U.S. 616 (1870).

[110] 26 U.S.C. § 7852(d) (providing that where a treaty and a tax law conflict, "neither the treaty nor the law shall have preferential status by reason of its being a treaty or law").

[111] 26 U.S.C. § 894.

[112] 26 U.S.C. § 7852(d).

[113] *See* Infanti, *supra* note 74, at 682–83 (providing a list of statutes which overrode tax treaties, including anti-abuse statutes); Sachs, *supra* note 74, at 876, 871–74 (listing statutes which overrode tax treaties, including anti-abuse statutes).

[114] Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986).

U.S. branches.[115] The statute acknowledged that DTCs would exempt such tax and it disallowed such exemption in "cases of treaty shopping."[116] Legislative history explains that it was "necessary to prevent nonresidents of a treaty country from gaining benefits the treaty accords."[117] To distinguish such nonresidents, the statute provides tests for "qualified residents."[118]

The "qualified resident" test uses corporate ownership as a proxy for nexus with the treaty jurisdiction, with the intent of ensuring the entity claiming treaty benefits is not a conduit. Under this test, a foreign corporation does not "qualify" for treaty benefits if fifty percent or more is owned by non-residents of the treaty jurisdiction or the United States, or if fifty percent or more of the corporation's income is used (directly or indirectly) to meet liabilities to non-residents of such treaty jurisdiction or the United States.[119] Corporations publicly traded in the treaty jurisdiction or wholly-owned by a U.S. corporation or a corporation publicly traded in the treaty jurisdiction also fall under the definition of a "qualified resident."[120] As a result, the "qualified resident" regime limited the treaty shopping analysis to a set of bright-line objective criteria.

Similar to the economic substance doctrine, the objective "equity ownership look-through" test[121] used under the "qualified resident regime" results in disallowance of treaty benefits in typical "conduit" scenarios. This test, however, has oversimplified the economic substance approach in that this test effectively defines treaty shopping through a set of rather arbitrary objective factors, as opposed to the examination of all the relevant circumstances. Under the test, an entity with fifty percent of resident ownership is regarded as a treaty shopping pattern, while forty-nine is not. For this reason, the "qualified resident" regime presents a revenue grab conflicting with DTCs, despite the purported justification as anti-treaty shopping measure.

After 1986, Congress continued enacting specific anti-abuse provisions with bright-line, objective criteria for treaty-benefits disqualification. For example, earnings-stripping rules generally disqualify excessive deductions for interest paid to certain exempt or partially exempt persons[122] according to certain numeric criteria, such as debt-

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115 26 U.S.C. § 884.

116 H.R. CONF. REP. 99-841, *supra* note 93.

117 *Id.*

118 26 U.S.C. § 884.

119 *Id.* § 884 (e)(4).

120 *Id.* § 884 (e)(4)(B)–(C).

121 Halpern, *supra* note 97, at 17.

122 Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7210(a)–(b), 103 Stat. 2339, 2342 (codified at 26 U.S.C. § 163(j)); *see also* Omni-

to-equity ratio exceeding 1.5 to 1. The anti-inversion provision,[123] which serves as a disincentive for tax-motivated expatriations of U.S. companies, also utilizes numeric criteria.[124] This provision discourages restructurings that change the place of incorporation of the parent in a corporate group from the United States to a foreign country, such as Cayman Islands or Bermuda.[125] The imposed tax disincentive depends on the percentage of continuing U.S. ownership,[126] so at least sixty percent results in disallowance of any offsets created in the inversion transaction and at least eighty percent results in treatment of the newly created foreign corporation as a U.S. corporation.[127]

The statutory specific anti-abuse rules,[128] as opposed to general judicial anti-abuse doctrines, sacrifice flexibility, characteristic of judicial doctrines, for clarity and convenience. The numeric tests, such as the fifty percent resident ownership requirement, are formalistic in that treaty-shoppers may simply find ways to comply with the literal language of such rules.[129] Formalism, of course, is a rather trivial criticism of legal rules in general.[130] But the irony of this case is that the anti-abuse rules are supposed to combat treaty shopping, a byproduct

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bus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13238, 107 Stat. 508 (codified as 26 U.S.C. § 7701).

[123] American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 801(a), 118 Stat. 1565 (codified at 26 U.S.C. § 7874).

[124] *See* Marco Blanco et al., *The Noose Tightens: The New Expatriation Provisions*, 106 TAX NOTES 91 (2005).

[125] Michael Kirsch, *The Congressional Response to Corporate Expatriations: The Tension between Symbols and Substance in the Taxation of Multinational Corporations*, 24 VA. TAX REV. 475, 478 (2005).

[126] *See* 26 U.S.C. § 7874.

[127] *See id.*

[128] Senate Finance Committee is currently reviewing the Stop Tax Haven Abuse Act, a sponsor of which was then-Senator Barack Obama. The bill proposes, among other things, to codify the economic substance doctrine, which would be a general anti-abuse rule. Stop Tax Haven Abuse Act, H.R. 2136, 110th Cong. § 401 (2007).

[129] Doernberg, *supra* note 92, at 186 (noting with respect to Section 884 that "it is disturbing that the new Code provisions place such a premium on form").

[130] ANTONIN SCALIA, A MATTER OF INTERPRETATION 25 (Amy Gutmann ed., 1997) ("Of all the criticisms leveled against textualism, the most mindless is that it is formalist. The answer to that is, of course it's formalistic! The rule of law is about form . . . A murderer has been caught with blood on his hands, bending over the body of his victim; a neighbor with a video camera has filmed the crime and the murderer has confessed in writing and on videotape. We nonetheless insist that before the state can punish this miscreant, it must conduct a full-dress criminal trial that results in a verdict of guilty. Is that not formalism? Long live formalism! It is what makes us a government of laws and not of men.").

of other formalistic rules, such as the place of incorporation,[131] under which, for example, as in *Johansson*, a corporation formed by a Swedish resident in Switzerland is deemed a Swiss corporation. Because of this formalism, specific anti-abuse rules are less likely than judicial anti-abuse doctrines to address new forms of treaty shopping. At the same time, objective criteria set forth in specific anti-abuse rules provide bright-line guidelines for the taxpayers and tax authorities, and thus, increase predictability and ease the tax administration.

3. *Administrative Anti-abuse Measures in the United States*

Along with U.S. courts and Congress, the U.S. Treasury and the IRS have also been concerned with the problem of treaty shopping since the early 1980s. The U.S. Treasury attempted to renegotiate the DTCs that provided treaty shopping opportunities, but "tax havens" had little incentive for re-visiting these agreements.[132] In this context, the IRS took steps to curb treaty-abuse through its revenue rulings, and the U.S. Treasury promulgated regulations responding to the Congress' request for anti-abuse measures.[133] These measures, however, raised the issue of whether, under the Constitution, administrative guidance may limit the scope of United States' treaties, resulting in treaty override.

It is clear that revenue rulings and regulations may interpret U.S. domestic statutes or treaty provisions that already limit benefits.[134] Where a treaty is silent on the limitation on benefits, the application of the economic substance doctrine to treaties may also be arguably consistent with treaty obligations as an interpretation of the treaty.[135] For example, in Revenue Ruling 84-152[136] the IRS examined a back-to-back loan. Under the terms of that arrangement, a U.S. subsidiary of a Swiss company borrowed funds from a Netherlands Antilles subsidiary at the interest rate of eleven percent annually. The Netherlands Antilles subsidiary, in turn, borrowed from the Swiss parent at the rate of ten percent annually. Similarly to *Aiken Industries Inc.*, the IRS concluded that the U.S-Netherlands treaty did not exempt the interest the U.S. subsidiary paid to the Netherlands

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[131] 26 U.S.C. § 7701(a)(4) (defining "domestic corporation" as "created or organized" in the U.S. or under the laws of the U.S. or any U.S. State).

[132] Pineau, *supra* note 36, at 170–71.

[133] *See, e.g.,* Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13238, 107 Stat. 508 (codified at 26 U.S.C. 7701).

[134] Richard L. Doernberg, *Treaty Override by Administrative Regulation: The Multiparty Financing Regulations*, 2 FLA. TAX REV. 521, 523 (1995).

[135] *Id.* at 528.

[136] Rev. Rul. 84-152, 1984-2 C.B.; *see also* Rev. Rul. 84-153, 1984-2 C.B. (the U.S.-Netherlands DTC does not exempt interest payments a U.S. made to a U.S. parent through a Netherlands Antilles subsidiary).

Antilles intermediary because the intermediary lacked a "sufficient business purpose."[137] Despite the fact that this decision was more expansive than *Aiken Industries Inc.*, as it required a "sufficient business purpose" rather than "some" business purpose as in *Aiken Industries Inc.*,[138] the disallowance arguably did not override the treaty but rather interpreted it.

It remains more controversial as to under what circumstances administrative law may disallow benefits that are "clearly permitted by the treaty."[139] Under the Constitution, to have legal force, the guidance of the U.S. Treasury requires an authorization of Congress.[140] As such, commentators question whether Congress may, as a matter of U.S. constitutional law, delegate its power to override treaties to the U.S. Treasury,[141] and if so, whether any such authorization has to be explicit.[142] For instance, in 1993 Congress authorized the U.S. Treasury to promulgate regulations re-characterizing multiple-party financing transactions,[143] but did not expressly state any intent to override DTCs.[144] The promulgated regulations effectively deny treaty benefits in certain financing transactions,[145] but the validity of these regulations is yet to be determined by the courts and the process of invalidation of regulations may take decades.[146] Given this uncertainty, in the United States, unilateral administrative anti-abuse measures present a problematic avenue for combating treaty shopping.

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[137] *Id.*; ERNEST R. LARKINS, INTERNATIONAL APPLICATIONS OF U.S. INCOME TAX LAW: INBOUND AND OUTBOUND TRANSACTIONS 43–44 (2004); Pineau, *supra* note 36, at 170.

[138] Pineau, *supra* note 36, at 178.

[139] *See* Doernberg, *supra* note 134, at 523, 530.

[140] *See* Chrysler Corp. v. Brown, 441 U.S. 281 (1978).

[141] *See, e.g.* Doernberg, *supra* note 134, at 533–44.

[142] *See, e.g.* Anthony C. Infanti, *The Proposed Domestic Reverse Hybrid Entity Regulations: Can the Treasury Department Override Treaties*, 30 TAX MGM'T INT'L J. 307, 310–14 (2001).

[143] Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13238, 107 Stat. 508 (codified at 26 U.S.C. 7701).

[144] *See* H.R. REP. No. 103-111, at 727–29 (1993), *reprinted in* 1993 U.S.C.C.A.N. 958-60; H.R. REP. No. 103-213, at 654–55 (1993) (Conf. Rep.), *reprinted in* 1993 U.S.C.C.A.N. 1343–44.

[145] *See* Treas. Reg. § 1.881-3 (1993) (disregarding conduit entities in financing transactions); *see also* Treas. Reg. § 1.1441-3(g) (1993) (requiring the financed entity or person to withhold tax with respect to re-characterized portions of interest payments as determined by § 1.881-3(d)).

[146] For example, in 2008, the United States Court of Appeals for the Federal Circuit found that Treasury Regulation § 1.882-5 violated the 1975 U.S.-U.K. DTC. The case concerned the tax liability of National Westminster Bank, PLC for the tax years 1981–1987. Nat'l Westminster Bank, PLC v. United States, 512 F.3d 1347 (Fed. Cir. 2008), *rehearing en banc denied* (Apr. 21, 2008).

B. Comparative Perspective on Domestic Anti-abuse Laws

Other States also face challenges in implementing unilateral anti-abuse measures. A brief survey of recent developments in the area of unilateral anti-abuse measures in Canada, India, and the European Union provides an insight into the variety of issues that arise in individual States' legal systems in the course of those States' attempts to curb treaty shopping. To be clear, under the "revenue rule" U.S. courts would not apply or enforce, even indirectly, revenue laws of other sovereigns.[147] But such laws are relevant to the U.S. anti-treaty shopping policy because, as discussed earlier, treaty shopping schemes arise from the interplay of treaties and national tax laws.

1. Canada Is Developing a Methodology for Applying Anti-abuse Rules to DTCs

North of the United States border, the Canada Revenue Agency (CRA) has challenged artificial, treaty-abusing structures, but so far without avail. In 2005, the Canadian legislature extended the General Anti-Avoidance Rule (GAAR) of the Income Tax Act to treaties.[148] In June of 2007, the Federal Court of Appeal (the court that hears appeals from the Tax Court of Canada)[149] decided the first case on this issue, *The Queen v. MIL (Investments) S.A.*[150]

The case involved Mr. Boulle, resident, at relevant times, of Belize and Monaco, who ultimately held shares of a Canadian company through MIL (Investments) S.A., a Cayman Islands corporation operating out of Luxembourg. The proceeds from the sale of shares were exempted from tax in Canada under the Canada-Luxembourg treaty and not subject to tax in Luxembourg. Given this incidence of double non-taxation, CRA argued that the transaction in question was an "avoidance transaction" under GAAR.[151] The court recognized the taxpayer's admission that its continuance as a Luxembourg corporation

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[147] Att'y Gen. of Canada v. R.J. Reynolds Tobacco Holdings, Inc., 268 F.3d 103 (2d Cir. 2001) (holding that the "revenue rule" barred Canada's claim where Canada sought to recover under the Racketeer Influenced and Corrupt Organizations Act (RICO), 18 U.S.C. §§ 1961–68, the lost revenue and law enforcement costs from defendants who had allegedly smuggled cigarettes across U.S.-Canadian border for sale on the Canadian black market and avoided Canadian cigarette taxes).
[148] Income Tax Act, R.S.C., ch. 1 § 245 (1985).
[149] *See* Federal Courts Act, R.S.C., ch. F-7 § 3, ch. 34 § 68(F), ch.8 § 16 (1985), *as amended, available at* http://laws.justice.gc.ca/en/ShowFullDoc/cs/F-7///en; *see also* http://www.fca-caf.gc.ca/index_e.shtml.
[150] The Queen v. MIL (Investments) S.A., [2007] F.C.A. 236 (Can.), *available at* http://decisions.fca-caf.gc.ca/en/2007/2007fca236/2007fca236.html; *see also* MIL (Investments) S.A. v. The Queen, [2006] T.C.C. 460 (Can.), *available at* http://decision.tcc-cci.gc.ca/en/2006/2006tcc460/2006tcc460.html.
[151] Income Tax Act, R.S.C., ch. 1 § 245 (1985).

was tax-motivated, but found that neither the treaty, nor GAAR supported the proposition that the tax benefits received in the course of this transaction resulted in abuse or misuse of the treaty.[152] This case has shown that "the Crown is ready and willing"[153] to enforce anti-abuse measures in the context of DTCs, but it is yet to be seen how this will be accomplished.

In a subsequent case, *Prévost Car Inc. v. The Queen*,[154] the CRA advanced a different theory and argued that where a Netherlands holding company received dividends on stock of a Canadian corporation and distributed them to its shareholders in Sweden and the United Kingdom, such shareholders were the "beneficial owners" of the dividends.[155] In its decision in April of 2008, the Tax Court of Canada refused to pierce the Netherlands holding company's corporate veil.[156] The court pointed out that the holding company had discretion in use of its assets, had its own liabilities, and was not merely instructed to receive funds.[157] The holding company's function was different from, for example, that of a "stockbroker who is the registered owner of the shares it holds for clients."[158] Both *MIL (Investments) S.A.* and *Prévost Car Inc.* were decided in favor of the taxpayers, but these cases indicate that the CRA may continue to challenge entities and/or transactions that lack economic substance.

2. *India is Interpreting the Terms "Liable to Tax" and "Subject to Tax"*

Several recent decisions in India have defined the scope of treaty benefits through interpretation of the concept of eligibility under the DTCs. In a 2003 case, *India v. Azadi Bachao Andolan*,[159] the Supreme Court of India[160] considered the eligibility for benefits under the 1983 Mauritius-India DTC.[161] This DTC expressly limits its benefits to persons "liable to taxation" in the treaty jurisdiction.[162]

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[152] MIL (Investments) S.A., [2007] F.C.A. 236.

[153] Kimberly Brown, *Tax Treaty Shopping and the GAAR: MIL (Investments) S.A. v. The Queen*, 66 U. TORONTO FAC. L.REV. 33, 36 (2008).

[154] Prévost Car Inc. v. The Queen, [2008] T.C.C. 231, *available at* http://decision.tcc-cci.gc.ca/en/2008/2008tcc231/2008tcc231.html.

[155] *Id.* ¶ 1.

[156] *Id.* ¶ 100.

[157] *Id.* ¶ 102.

[158] *Id.* ¶ 100.

[159] Union of India v. Azadi Bachao Andolan, [2003] 263 I.T.R. 706 (India), *available at* http://www.gov.mu/portal/sites/ncb/fsc/download/supreme.pdf.

[160] *See* Supreme Court of India, http://www.supremecourtofindia.nic.in (last visited Feb. 21, 2009).

[161] Azadi Bachao Andolan, [2003] 263 I.T.R. 706 (S.C.).

[162] *Id.*

The case involved Foreign Institutional Investors (FIIs), entities which were incorporated in Mauritius, that possessed Tax Residency Certificates issued by the Mauritius Tax Authorities, but were managed and controlled by third-country residents.[163] As Mauritius does not generally impose capital gains tax, the court had to decide whether the FIIs are in fact "liable to taxation" in Mauritius within the meaning of the Mauritius-India DTC.[164] The court found that actual imposition of tax was irrelevant, and the FIIs were entitled to treaty benefits because Mauritius tax laws apply to the FIIs.[165] Interestingly, the Supreme Court of India mentioned the *Johansson* case where the U.S. Court of Appeals for the Fifth Circuit applied the economic substance doctrine.[166] The Supreme Court of India distinguished *Johansson* in that in *Azadi Bachao Andolan* the term "resident" was expressly defined in the Mauritius-India DTC and the FIIs met this definition.[167] In the court's view, literal compliance with the treaty terms entitled the FIIs to treaty benefits.[168]

Following the taxpayer-favorable *Azadi Bachao Andolan*, the Authority for Advance Ruling of India (AAR) (an administrative body providing binding advance rulings)[169] issued several decisions which limited entitlements to treaty benefits. In *Abdul Razak A. Meman,*[170] the AAR interpreted the term "liable to tax" under the India-United Arab Emirates (UAE) treaty.[171] The AAR considered a case of an individual-resident of the United Arab Emirates who received investment income on certain Indian assets.[172] The fact that individuals in UAE are not subject to income tax allowed AAR to conclude that the individual was not "liable to tax within the meaning of the treaty."[173] The AAR distinguished this case from *Azadi Bachao Andolan*, which emphasized the irrelevance of actual imposition of tax, in that the Mauritius Tax Authorities in *Azadi Bachao Andolan* by virtue of issuing the Tax Residency Certificates asserted taxing jurisdiction over the FIIs.[174]

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[163] *Id.*

[164] *Id.*

[165] *Id.*

[166] *Id.*

[167] Azadi Bachao Andolan, [2003] 263 I.T.R. 706 (S.C.).

[168] *See id.*

[169] *See* Authority for Advanced Rulings, http://aar.gov.in/ (last visited Feb. 21, 2009).

[170] Abdul Razak A. Meman, A.A.R. No. 637, 638 & 640 OF 2004, 276 I.T.R. 306 (2004), *available at* http://rulings.co.in/ruling/show_ruling/142.html.

[171] *Id.*

[172] *Id.*

[173] *Id.*

[174] *Id.*

This distinction, however, is yet to be clarified, especially after the 2005 AAR ruling in *General Electric Pension Trust.*[175] The ruling interpreted eligibility requirements under the U.S-India DTC, which provides that a trust is a "resident" of a treaty jurisdiction only to the extent its income is "subject to tax" in that jurisdiction.[176] In this ruling, the taxpayer was a U.S. tax-exempt pension trust,[177] which made investments in India.[178] Based on the fact that the taxpayer was exempt from tax in the United States, the AAR concluded that General Electric Pension Trust was not a "resident" of the United States, and thus not entitled to treaty benefits.[179] While these three decisions interpreted the language of different tax treaties and could be distinguished on that basis, it is uncertain whether the courts of India will, in the future, agree with the AAR's interpretation of the terms "liable to tax" and "subject to tax."

To clarify any confusion, India and the UAE recently signed a protocol addressing the "contentious issue"[180] of individuals' eligibility under the India-UAE treaty. Under this protocol, a taxpayer is a "resident" of the UAE within the meaning of the India-UAE treaty if such taxpayer meets certain physical presence requirements.[181] It remains to be seen, however, how Indian tax authorities and courts, as well as their treaty partners, will address the issue of treaty eligibility with respect to other India's DTCs.

3. *The European Union Is Limiting Anti-abuse Measures To "Wholly Artificial Arrangements"*

Anti-abuse laws in the countries of the European Union are also in a state of flux. The European Commission (the executive body of the European Union)[182] is currently reviewing domestic anti-abuse rules of the E.U. Member States to ensure their compliance with the E.U. law. In the European Union, Member States may not unjustifi-

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175 Gen. Elec. Pension Trust, A.A.R. No. 659 of 2005, 280 I.T.R. 425 (2005), *available at* http://rulings.co.in/ruling/show_ruling/156.html.

176 *Id.*

177 26 U.S.C. § 401(a).

178 Gen. Elec. Pension Trust, A.A.R. No. 659 of 2005.

179 *Id.*

180 K.R. Sekar et al., *Indian Update*, 19 J. INT'L TAX'N 54, 56 (2008).

181 *Id.*

182 *See* Commission of the European Communities, *Governance Statement of the European Comission*, at 2, (May 30, 2007), *available at* http://ec.europa.eu/atwork/synthesis/doc/governance_statement_en.pdf; *see also* Michael J. Graez et al., *Income Tax Discrimination and the Political and Economic Integration of Europe*, 115 YALE L.J. 1186, 1190 (2006) (discussing the lawmaking and enforcement process in the European Union).

ably infringe on the "freedom of establishment."[183] This principle requires E.U. Member States to treat persons of other E.U. Member States equally, compared to its own persons.[184] As a result of this ongoing review, the European Commission, for example, has requested Spain to furnish an explanation for its discriminatory anti-abuse rules in the area of taxation, such as the discriminatory exemption of dividends tax afforded only to Spanish companies.[185] Recent E.U. case law illustrates the view of the European Commission on anti-abuse laws.

The European Court of Justice (ECJ) has recently limited to "wholly artificial arrangements" the permissible scope of anti-abuse rules in E.U. Member States, as applied to other E.U. Member States. In the 2006 case *Cadbury Schweppes Plc v. Commissioners*,[186] the ECJ examined a U.K. anti-abuse rule which imposed tax on the profits of subsidiaries of U.K. companies outside of the United Kingdom if such profits were taxed at a rate lower than the U.K. tax rate.[187] In that case, a U.K. parent company established two wholly-owned subsidiaries in Ireland to raise capital for entities within its corporate group.[188] As Ireland imposed only a ten percent tax on the two subsidiaries, a rate lower than the U.K. tax rate, the United Kingdom sought to enforce its anti-abuse rule.[189] The ECJ found that this rule disadvantaged conduct of business in E.U. Member States and, therefore, restricted the freedom of establishment.[190] Under this decision, such restriction could be justified only if it were limited to "wholly artificial arrangements intended to escape the national tax normally payable."[191] This means that anti-abuse rules should be limited to such arrangements.

In its October 2007 Communication, the European Commission likened this standard to the substance-over-form analysis.[192] The E.U. approach, however, differs from the U.S. substance-over-form doctrine. In the European Union, national anti-abuse rules must "serve the spe-

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[183] Treaty Establishing the European Community (consolidated text), art. 43, 48, 2002 O.J. (C325) 52–57 [hereinafter EC Treaty].

[184] Case C-196/04, Cadbury Schweppes Plc v. Comm'rs of Inland Revenue, 2006 E.C.R. I-7995, ¶ 41, 42.

[185] *European Commission Challenges Spain on Anti-Abuse Rules*, INT'L TAX R., Apr. 1, 2008, at 4.

[186] *Cadbury Schweppes Plc*, Case C-196/04.

[187] *See id.* ¶ 3–5, 75.

[188] *Id.* ¶ 15, 18.

[189] *Id.*

[190] *Id.*

[191] *Id.* ¶ 75.

[192] 2007 E.C. Commc'n, *supra* note 76, at 4.

cific purpose of preventing wholly artificial arrangements."[193] Contrastingly, in the United States the IRS requires a "sufficient," not merely "some" business purpose for an entity to avoid conduit characterization.[194] Taxpayers in the United States have the burden of proof in establishing the "business purpose," which is illustrated by the *Del Commercial Properties, Inc.* decision.[195] In comparison, in the European Union, the individual governments of the E.U. Member States carry the burden of justifying any discriminatory treatment of residents of other E.U. Member States, as shown by *Cadbury Schweppes Plc.*[196] As such, the scope of the E.U. "wholly artificial arrangements" test is narrower than that of the U.S. substance-over-form doctrine.

It should be kept in mind, however, that the E.U. law limits E.U. Member States' right to assess direct tax on residents of other E.U. Member States,[197] but not on residents of other countries. So it remains to be seen whether this internal E.U. reform will also change national anti-abuse measures of E.U. Member States with respect to residents of non-E.U. countries. In any case, the harmonization of E.U. national anti-abuse laws to ensure compliance with the principle of freedom of establishment may in the future significantly distinguish these laws from those adopted in the United States, Canada, and India.

4. *Conclusions from a Comparative Survey of States' Unilateral Anti-abuse Measures*

The above analysis leads to two conclusions. First, as States' anti-abuse measures vary, unilateral measures in one country alone may not effectively discourage treaty shopping as a global problem. The United States' anti-abuse measures may discourage treaty shopping by U.S. persons or in connection with U.S. income, but it will not eliminate treaty shopping as a phenomenon. A long-term solution of the treaty shopping problem should take into consideration other jurisdictions' practices.[198] Second, a comparative survey of anti-abuse measures shows that States' understanding of what constitutes "treaty abuse" differs. Where treaty shopping is not defined in a DTC, but instead left up to the interpretation of individual States' courts and

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[193] *Id.* at 3.

[194] Pineau, *supra* note 36, at 178.

[195] *Del Commercial Properties, Inc.*, 251 F.3d 210, 215–16 (D.C. Cir. 2001).

[196] *Cadbury Schweppes Plc*, Case C-196/04.

[197] *See, e.g., id.* ¶ 40.

[198] *See* West, *supra* note 40, at 148; *see generally* Charles I. Kingson, *The Coherence of International Taxation*, 81 COLUM. L. REV. 1151 (1981) (discussing anti-abuse measures instituted in select foreign countries).

administrative agencies, treaty partners may disagree on such interpretation and perceive it as a violation of the DTC.

C. *Status of Unilateral Anti-abuse Measures under International Law*

States' unilateral anti-abuse measures may be inconsistent with their international obligations. Under the Vienna Convention on the Law of Treaties (VCLT), States must fulfill their treaty obligations in accordance with the principle of *pacta sunt servanda*—good faith.[199] By signing DTCs, States promise to provide tax benefits to the residents of the treaty partner.[200] For this reason, unilateral disallowance of such benefits resulting in a treaty override may constitute a treaty breach.[201]

In the past three decades, the United States implemented several anti-abuse measures which effectively overrode DTCs, which was made possible as a result of the last-in-time rule in the U.S. domestic law. The interaction of the U.S. last-in-time rule and international law has yielded peculiar results. A U.S. court may be restrained by the last-in-time rule and precedent, and thus, uphold the treaty override, while the international law analysis may demand a different outcome. Under international law, however, States may not rely on their domestic law in justifying their breach of treaty obligations.[202] Instead, States may rely on norms derived from such sources of international law as treaties,[203] customary international law,[204] and the general principles of law.[205] These sources provide arguments for the

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[199] Vienna Convention on the Law of Treaties, art. 26, May 23, 1969, 8 I.L.M. 679 [hereinafter Vienna Convention]. The United States has not ratified this convention, but considers it binding customary international law. *See* RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 102 cmt. f (1987).

[200] *See, e.g.*, 2006 U.S. Model, *supra* note 11, pmbl.

[201] *See, e.g.*, Detlev F. Vagts, *The United States and Its Treaties; Observance and Breach*, 95 AM. J. INTL L. 313 (2001).

[202] Vienna Convention, *supra* note 199, art. 26, 27.

[203] Treaties constitute express agreements between States. Treaties bind the States that have ratified such treaties. Vienna Convention, *supra* note 199, art. 2 (1)(a), (b), 11–19.

[204] Customary international law encompasses the rules adopted by the States in their practice or a "tacit agreement" of certain States to such rule, from which, nevertheless, other States may derogate. ANTONIO CASSESE, INTERNATIONAL LAW 153–154 (2d ed. 2005).

[205] The general principles of law are commonly understood as "the principles endorsed by the developed domestic legal systems of different states," for example, the principle of good faith. DAVID BEDERMAN ET AL., INTERNATIONAL LAW: A HANDBOOK FOR JUDGES 32 (2003); BING CHENG, GENERAL PRINCIPLES OF LAW AS APPLIED

disallowance of treaty benefits, as well as proposing some solutions for the problem of treaty override.

1. Anti-abuse Measures and the Scope of States' Obligations under DTCs

Several canons of treaty interpretation may support the contention that certain unilateral anti-abuse measures may be consistent with States' obligations under DTCs. Such canons look to the text of the treaty, the treaty's object and purpose, the signatories' subsequent practice, and the general principles of international law—principles which are endorsed by developed national legal systems.[206] Generally, these canons allow for liberal interpretation of treaties,[207] which, however, does not mean that the treaty language may be "stretched" indefinitely or interpreted against its plain meaning.

In the absence of an LOB provision in a DTC, an express "savings clause" and a "gap-filling clause" may justify the adoption of certain domestic anti-abuse rules. A typical savings clause provides that nothing in the DTC will prevent a State from imposing taxes on their residents and citizens, as if the DTC was not in effect.[208] A gap-filling clause would usually instruct that terms that are not specifically defined in the treaty will be interpreted by reference to domestic laws, as enacted from time to time.[209] These clauses may support promulgation of some unilateral anti-abuse measures, but commentators caution that the language of such savings clauses cannot be expanded indefinitely to provide a blanket authorization for any domestic anti-abuse laws.[210]

"Purposive" interpretation of DTCs–interpretation in light of their object and purpose[211]–may also allow for application of certain anti-abuse measures. The VCLT provides that treaties should be interpreted by giving effect to the ordinary meaning of their text and "in the context and in the light of"[212] their object and purpose. DTCs' purpose is both to *avoid* double taxation and *prevent* fiscal evasion.[213] For this reason, the IRS has argued that tax treaties do not create an abso-

BY INTERNATIONAL COURTS AND TRIBUNALS 105–158 (1987); G.M. DANILENKO, LAW-MAKING IN THE INTERNATIONAL COMMUNITY 175 (1993).

[206] *Id.*

[207] Nathalie Goyette, *Tax Treaty Abuse: A Second Look*, 51 CANADIAN TAX J. 764, 778 (2003).

[208] 2006 U.S. Model, *supra* note 11, art. 1 (3).

[209] *See* UN REPORT ON TREATY SHOPPING, *supra* note 19, ¶ 92.

[210] *Id.* ¶ 93.

[211] *See* Maurice Cashmere, *GAAR for the United Kingdom? The Australian Experience*, 2 BRITISH TAX R. 125 (2008).

[212] Vienna Convention, *supra* note 199, art. 26, 27.

[213] *See, e.g.*, 2006 U.S. Model, *supra* note 11.

lute entitlement to be free from double taxation because *avoiding* double taxation is aspirational, in contrast to terms like "prohibiting," "eliminating," or "preventing" double taxation.[214] Unilateral anti-abuse measures, at least arguably, are consistent with the States' pledge to *prevent* fiscal evasion.

States' subsequent practice in applying the treaty "establishes the agreement of the parties regarding its interpretation,"[215] and thus, may also legitimize certain anti-abuse measures.[216] Where revenue authorities of both India and the United States, for example, deny treaty benefits under a certain set of circumstances, such subsequent mutual practice would put in question the right of either party to invoke a breach of international obligations.

As numerous States have implemented unilateral anti-abuse rules, such rules have arguably become general principles of international law.[217] Similar to other recognized general law principles, such as the attorney-client privilege[218] and the principle of good faith,[219] anti-abuse measures may play a role of a "gap-filler" in international law. As such, anti-abuse principles aiding in treaty interpretation may be imposed by operation of law. Admittedly, as was discussed earlier, States differ in their understanding of the appropriate scope or methodology for anti-treaty shopping measures. But where States accept a particular rule in principle, courts can select the lowest common denominator on which the relevant States agree.[220] This interpretative approach would more likely succeed in justifying disallowance of conduits devoid of any non-tax business purpose (for example, wholly

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214 Jamieson v. Comm'r. 95 T.C.M. (CCH) 1430 (2008) (The IRS argued that while the intent of DTCs is to avoid double taxation, that does not mean that DTCs prohibit any instances of double taxation).

215 Vienna Convention, *supra* note 199, art. 31(3)(b).

216 *See* Robert Critchfield et al., *Pass-Through Entities, Double Tax Conventions, and Treaty Overrides*, 82 TAX NOTES 873, 889 (1999).

217 Goyette, *supra* note 207, at 769; Haug, *supra* note 6, at 191, 234; *see also* Reuven S. Avi-Yonah, *International Tax as International Law*, 57 TAX L. REV. 483, 495 (2004).

218 *See* Case 155/79, AM&S Europe Ltd. v. Comm'n, 1982 E.C.R. 1575 (finding that where the European Community Treaty and subordinate legislation do not address the issue of attorney-client privilege and where comparative analysis of national legal systems shows unanimous recognition of such privilege, the European Community law incorporates the principle of attorney-client privilege as a general principle of international law).

219 See *supra* text accompanying note 205.

220 Goyette, *supra* note 207, at 771; *see also* AM&S Europe Ltd. v. Comm'n, 1982 E.C.R.1575 (finding that the attorney-client privilege is a general principle of international law).

artificial arrangements), rather than of entities with some, but limited purpose.

2. *Certain Anti-abuse Measures May Not "Materially Breach" DTCs*

Even where anti-abuse measures do not merely complement or interpret a treaty, to constitute a violation of international law, such measures must "materially" breach the treaty.[221] The VCLT distinguishes the "material breach" from other acts of noncompliance in that a "material breach" is a "repudiation of the treaty," or a violation of "a provision essential to the accomplishment of the object or purpose of the treaty."[222] As DTCs have the dual purpose of avoiding double taxation and preventing fiscal evasion,[223] disallowance of treaty benefits in treaty shopping schemes may arguably conflict with the purpose of providing relief from double taxation. At the same time, if a State tolerates treaty shopping, such an approach may violate the purpose of preventing fiscal evasion. This tension shows that the determination as to the existence of a material breach depends on the scope of a particular anti-abuse measure.

Denial of treaty benefits to conduits may be also be consistent with treaty obligations in light of the status of conduits under international law. Generally, States may assert claims only on behalf of their constituents, or "nationals."[224] "Nationality" under international law is based not only on the act of a formal grant of citizenship by one State, but also on the basis of all relevant circumstances. In the 1955 *Liechtenstein v. Guatemala* decision, the International Court of Justice (ICJ) examined the case of Mr. Nottebohm,[225] a German national by birth, who obtained formal citizenship of Liechtenstein in the beginning of the Second World War. The ICJ found that Guatemala was not compelled to recognize such formal grants of citizenship by Liechtenstein because Mr. Nottebohm had permanently lived in Guatemala for over thirty years and had tenuous connections with Liechtenstein.[226] As a result, Liechtenstein could not assert a claim against Guatemala on behalf Mr. Nottebohm.[227] The court reasoned that "nationality is a

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[221] *See* Vienna Convention, *supra* note 199, art. 60(3).
[222] *Id.*
[223] *See, e.g.*, 2006 U.S. Model, *supra* note 11.
[224] *See* Barcelona Traction Case (Belg. v. Spain), 1970 I.C.J. 3 (Feb. 5), ¶ 33–36 (finding that Belgium may not assert a claim against Spain for an injury to a Canadian corporation owned by Belgian nationals and operating in Spain because the injured corporation, was not a Belgian constituent; the case did not implicate an *erga omnes* obligation—obligation owed to the international community as a whole, such as to refrain from aggression or genocide).
[225] Nottebohm Case (Liech. v. Guat.), 1955 I.C.J. 4 (Apr. 6).
[226] *Id.* at 26.
[227] *Id.*

legal bond having as its basis a social fact of attachment, a genuine connection of existence, interests and sentiments, together with the existence of reciprocal rights and duties."[228] As to conduits, their existence in the treaty jurisdiction may be limited to the lawyer's desk.[229] This means that because conduits' ties with the treaty jurisdiction are tenuous, under international law, such treaty jurisdiction may not assert claims on behalf of such conduits. Given that, where one State denies treaty benefits to a conduit in a treaty jurisdiction, such State does not breach any duty owed to the treaty partner under the DTC.

3. Remedies and Solutions for the Problem of Treaty Override

Where anti-abuse measures do not fall under any of the above-discussed categories justified under international law, the next issue that should be addressed is the remedies that are available to the aggrieved party. Commentators have widely acknowledged the lack of mechanisms for enforcement of international law, and thus realistically available remedies.[230] Historically, major powers "released themselves from treaty obligations when they deemed it fit."[231] As General de Gaulle once reportedly put it, treaties "are like roses and young girls; they last while they last."[232] Today, however, some DTCs offer a creative solution to this problem—a "baseball-style arbitration," which will be discussed below.

The issue of legitimacy of the United States' treaty override does not seem to have a forum for judicial adjudication.[233] In deciding tax treaty override controversies, U.S. courts do not reach the international law issues because they are constrained by the last-in-time rule and by precedent.[234] A lawsuit against the United States in foreign domestic courts is likely to be precluded by the doctrine of sovereign immunity, under which foreign States are generally immune from suits in domestic courts,[235] and the Act of State Doctrine, "which prevents courts from passing judgment on the international validity of foreign sovereign acts."[236] The ICJ has not decided a single case in-

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228 *Id.* at 23.

229 Lee A. Sheppard, *News Headlines: Preventing Corporate Inversions*, 26 TAX NOTES INT'L 8, 11 (2002).

230 *See, e.g.*, BENEDETTO CONFORTI, INTERNATIONAL LAW AND THE ROLE OF DOMESTIC LEGAL SYSTEMS 7 (1993).

231 CASSESE, *supra* note 204, at 180.

232 *Id.* at 180 n.9 (citing ECONOMIST 6, Mar. 18, 1972).

233 *See* John Turro, *U.S. Treaty Overrides Criticized by IFA Members*, 45 TAX NOTES 22, 23 (1989).

234 *See infra* Part III.A(b).

235 LUNG-CHU CHEN, AN INTRODUCTION TO CONTEMPORARY INTERNATIONAL LAW: A POLICY ORIENTED PERSPECTIVE 234–36 (2d ed. 2002).

236 *Id.* at 236–40; CONFORTI, *supra* note 228, at 20.

volving a tax treaty and is unlikely to address such an issue in the near future.[237] Furthermore, any adjudication of such a case would require the United States' consent due to the fact the United States withdrew its consent to the ICJ's jurisdiction in 1985.[238] In this context, tax treaty disputes require new, creative solutions.

One such solution is the mandatory arbitration clause, or the so-called "baseball-style arbitration." A recently signed protocol to the U.S.-Germany DTC contains such a clause, which provides for binding arbitration of cases which the competent authorities of the two States could not resolve.[239] In "baseball-style arbitration," each side submits its proposed settlement offer and the arbitrator selects one of the offers.[240] The arbitrator may not modify the offers and must choose either one or the other, and so each State has an incentive to propose a balanced, compromise solution. The resolution of a specific dispute, however, does not address the root of the problem—the lack of agreement on the scope and application of anti-abuse rules in the different national systems.

Even where unilateral anti-abuse measures are consistent with States' obligations under DTCs and where remedies for breach are available, unilateral measures, as opposed to collective action, are limited in a number of ways. First, the arguments justifying unilateral anti-treaty shopping measures have not been fully tested in litigation, which means that parties to DTCs may vastly disagree on their positions. Second, imposition by implication of anti-abuse measures into internationally binding agreements that affect States' budgets and constituents is an undesirable policy due to the uncertainty of such an approach. Third, when a treaty partner perceives certain unilateral measures of the other party as breaching the treaty, the relationship between the parties and the trust that they have built in the course of their treaty negotiations are at stake.[241] For these reasons, unilateral anti-abuse measures should be considered a temporary solution to the treaty shopping problem and limited to the most flagrant cases of treaty abuse. Where possible, States should seek to incorporate anti-abuse measures in the text of DTCs.

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[237] *See, e.g.*, John Turro, *U.S. Treaty Overrides Criticized by IFA Members*, 45 TAX NOTES 22, 23 (1989) (observing that litigation in the ICJ has been a "theoretical solution").

[238] Doernberg, *supra* note 92, at 205 n.213.

[239] JOINT COMM. ON TAX'N, EXPLANATION OF THE PROPOSED PROTOCOL TO THE INCOME TAX TREATY BETWEEN THE UNITED STATES AND GERMANY (JCX-47-07) 69, July 13, 2007.

[240] Tax Executives Institute, *Pending Canadian Income Tax Issues*, 59 TAX EXEC. 77, 77 (2007).

[241] *See, e.g.*, Letter from France's Ambassador to the United States, *supra* note 96.

IV. LOB PROVISIONS AS A SOLUTION TO THE TREATY SHOPPING PROBLEM

Several clauses in DTCs may serve as anti-abuse measures. For example, the 2006 U.S. Model limits treaty benefits to "residents,"[242] defined as persons "liable to tax"[243] in a country-treaty signatory. Another provision, the so called "tie-breaker" clause, addresses the issue of "dual" residents, including, for instance, corporations formed in one State-party to the DTC and operating in the other.[244] A "Limitation on Benefits" (LOB) provision specifically deals with treaty shopping patterns and sets forth the rules by which treaty signatories elect "to confine source-country treaty benefits to entities that are true residents of the treaty partner and are fully taxable in that country."[245]

A. The Evolution and Mechanics of Limitation on Benefits Provisions in U.S. DTCs

The United States pioneered the use of LOB provisions in DTCs.[246] Since the 1980s the U.S. Treasury Department has pursued an anti-treaty shopping policy.[247] Beginning with the 1981 U.S. Model Treaty, the United States has included some version of an LOB provision in all of its treaties.[248] LOB provisions emerged as clauses seeking to capture the subjective treaty shopping intent of the taxpayer, but gradually developed into the LOB provision contained in the 2006 U.S. Model,[249] which adopts several objective tests addressing modern treaty shopping tactics.

1. The Emergence of the Objective Tests of LOB provisions

Early LOB provisions disallowed treaty benefits for entities that were formed with the "principal purpose" of taking advantage of the treaty benefits.[250] Given the difficulty of administering rules associated with taxpayers' subjective intent,[251] newly negotiated LOB provisions began utilizing objective criteria. The primary aspect of these objective criteria was limiting the percentage of ownership in the cor-

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242 2006 U.S. Model, *supra* note 11, art. 1.
243 *Id.* art. 4(1).
244 *Id.* art. 4(4).
245 Postlewaite et al., *supra* note 7, at 768.
246 BORREGO, *supra* note 15, at 13.
247 MCDANIEL ET AL., *supra* note 53, at 182.
248 *Id.* at 183.
249 2006 U.S. Model, *supra* note 11.
250 MCDANIEL ET AL., *supra* note 53, at 182–183.
251 *See* Lee A. Sheppard, *News Analysis: Where is the Italian Treaty?*, 108 TAX NOTES 986, 987–989 (2005).

porate taxpayer by residents of third countries. As a result, the 1977 U.S. Model Tax Treaty required at least 25 percent ownership by treaty jurisdiction residents, while the proposed 1981 U.S. Model Tax Treaty imposed a 75 percent-ownership requirement.[252] After Congress introduced what the above-discussed "qualified resident" regime, LOB provisions in newly negotiated treaties were adjusted to reflect the tests contained in that section. The "qualified resident" regime thus became a prototype of the modern LOB provision.[253]

2. The Mechanics of the LOB Provision in the 2006 U.S. Model

The effect of the LOB provision in the 2006 U.S. Model is that it disallows benefits in classic treaty shopping schemes. As a threshold, under 2006 U.S. Model, only a "resident," or a person "liable to tax" in the place of residence,[254] may receive treaty benefits. The LOB provision further narrows the pool of recipients of benefits under the DTC. This provision is flexible because it allows treaty benefits for qualifying persons and, where taxpayers do not meet the criteria, in the alternative, for qualifying items of income.[255]

As for the first alternative, the eligibility of persons, under the LOB provision, residents would qualify if they fall into one of the following six categories: (1) individuals, (2) governments of the signatories to the DTC, (3) certain charitable organizations and pension funds with more than 50 percent of participants residing in either of the treaty signatories,[256] (4) certain corporations that are either publicly-traded or managed or controlled by resident(s) in one of the treaty signatories,[257] (5) subsidiaries of corporations that are at least 50 percent-owned by the residents of the DTC signatories,[258] and (6) entities that meet the two-part "ownership and base erosion" test.[259] This test ensures that 50 percent or more of each class of shares or other beneficial interests in the entity is owned for at least half of the entity's taxable year by residents entitled to the treaty benefits.[260] Hence, this

[252] Wacker, *supra* note 8, at 384.
[253] *Id.* at 389.
[254] 2006 U.S. Model, *supra* note 11, art. 4(1) (defining "resident" as "person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature, and also any "qualified governmental entity").
[255] *Id.* art. 22.
[256] *Id.* art. 4(1)(b), 22(d)–(e).
[257] *Id.* art. 22(2)(c)(i).
[258] *Id.* art. 22(2)(c)(ii).
[259] *Id.* art. 22(2)(e); DEPT. OF THE TREASURY, U.S. MODEL TECHNICAL EXPLANATION ACCOMPANYING THE U.S. MODEL INCOME TAX CONVENTION 68–69 (2006).
[260] 2006 U.S. Model, *supra* note 11, art. 22(2)(e).

first alternative provides relatively easy access to treaty benefits for individuals, governments, and charities, but scrutinizes other entities.

Certain items of income may qualify for treaty benefits independently of the above test. This applies in a situation where a resident of one State-signatory actively conducts a trade or business in that State and, "in connection with" or "incidental to" that trade or business, derives income in the other State-party to the DTC.[261] The resident may establish a connection between the resident's trade or business in one State and its activity in the other State by showing that such activity is a line of business that "forms part of" the trade or business (such as distribution in one State of products manufactured in the other State) or is "complementary to" the resident's trade or business (for example, hotel business may be complementary to an airline business).[262] As such, the LOB provision represents a comprehensive and flexible way of testing the economic connection[263] of the taxpayer with the claimed country of residence, the core issue in the treaty shopping problem.

B. *Addressing the Criticism of LOB Provisions in U.S. DTCs*

Commentators raise several objections to the use of LOB provisions. The negotiation of LOB provisions is a costly and time-consuming process.[264] The use of LOB provisions may also seem merely to duplicate the existing domestic anti-abuse rules. These provisions may also seem excessive[265] given that comparable model DTCs, such as the OECD Model[266] and the United Nations (UN)[267] Model do not have such provisions.[268] In addition, some commentators argue that LOB provisions in United States' treaties with European Union countries may conflict with the principle of freedom of establishment under E.U. law.[269] These criticisms, however, do not warrant abandonment of the LOB provisions.

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261 *See id.* art. 22(3); DEPT. OF THE TREASURY, *supra* note 257, at 69–72.

262 Notably, a business of making or managing investments for its own account (unless it is a bank, insurance company or registered securities dealer) does not fall under this definition. DEPT. OF THE TREASURY, *supra* note 257, at 69.

263 *See* MCDANIEL ET AL., *supra* note 53, at 184.

264 *See* OECD Harmful Competition Report, *supra* note 72, at 38; *see also* S. REP. NO. 100 445, at 323 (1988), *reprinted in* 1988 U.S.C.C.A.N. 4515, 4834.

265 *See generally* Reinhold, *supra* note 9, at 663.

266 OECD Model, *supra* note 14.

267 UNITED NATIONS DEPARTMENT OF ECONOMIC AND SOCIAL AFFAIRS, UNITED NATIONS MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES (2003) [hereinafter UN Model].

268 *See* OECD Model, *supra* note 14; UN Model, *supra* note 267; Avi-Yonah, *supra* note 217, at 495.

269 *See generally* Mason, *supra* note 10, at 65.

1. *Cost-benefit Analysis of the Use of LOB Provisions*

Negotiation and implementation of treaty clauses, including LOB provisions, is admittedly a more time and resource consuming endeavor than implementation of unilateral measures.[270] Renegotiation[271] of treaty provisions to reflect changing provisions of U.S. domestic anti-abuse law may also be difficult.[272] Unilateral measures, however, are inferior to LOB provisions, as unilateral measures have limited jurisdictional reach and may conflict with international law. Each of these considerations should be factored into the cost-benefit analysis of LOB provisions.

Unilateral measures fail to address the root of the treaty shopping problem: the lack of coordination between national tax systems. In the absence of an LOB provision, where India or Canada, for example, do not discourage treaty shopping under the U.S.-India or U.S.-Canada treaty, United States anti-abuse measures are limited to the U.S. tax. This means that unilateral anti-abuse measures "could only curtail flagrant cases of treaty shopping"[273] and would not eliminate treaty shopping patterns. By contrast, treaty provisions combat treaty shopping in the combined jurisdictions of the countries-signatories. Treaty provisions are not intended to replace domestic revenue laws since it is through domestic laws that taxes are ultimately imposed.[274] LOB provisions, however, do help to coordinate the tax systems, and thus contribute to their collective efficiency. As such, the U.S. Treasury considers LOB provisions a "critical area" that provides "significant deterrence against" treaty abuse.[275]

In the absence of LOB provisions, stringent domestic anti-abuse measures by one State may complicate its relations with the treaty partner. Unilateral anti-abuse measures may be viewed as "aggressively grabbing"[276] the joint economic surplus available for taxation to both States. In fact, United States treaty partners have in the past objected to the United States' treaty overrides, which raised the risk that treaty partners would terminate the DTCs.[277] In the event

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[270] OECD Harmful Competition Report, *supra* note 72, at 38; *see also* S. REP. NO. 100-445, at 323; Rosenbloom, *supra* note 74, at 81.

[271] M.L. Dionne, *Branch Profits Tax and Treaty Override Problems May Be Resolved; White Paper on Treaty Policy Underway*, 39 TAX NOTES 799 (1988); Doernberg, *supra* note 92, at 198.

[272] S. REP. NO. 100-445, at 323.

[273] Wacker, *supra* note 8, at 385.

[274] *UN Report on Treaty Shopping*, *supra* note 19, ¶ 92.

[275] REPORT ON TAX TREATIES, *supra* note 3, at 5; *see also* Andrew H. Kingissepp, *Long-Awaited Protocol to Canada-U.S. Tax Treaty Provides Significant Benefits*, 18 J. INT'L TAX'N 22 (2007).

[276] Shaviro, *supra* note 39, at 133.

[277] *See, e.g.*, Letter from France's Ambassador to the United States, *supra* note 96.

that a DTC is terminated, the U.S. foreign credit regime[278] would become the primary source of double taxation relief in the United States. This regime, however, imposes significant costs because under it, the United States foregoes the collection of revenue on the amount of foreign taxes that U.S. taxpayers pay abroad and does not necessarily secure a reciprocal benefit.[279] Should the United States, in response, move away from the foreign credit regime, the lack of any mechanisms for ameliorating the effects of double taxation would impede trade and capital flows. Even where unilateral measures are consistent with international law, a perceived breach may undermine both the trust between the treaty partners and the stability of the international tax system. For these reasons, States should seek to ascertain and mutually agree to treaty shopping patterns which will not generate treaty benefits that can be exploited by the parties.

As for the difficulty in renegotiating LOB provisions, they are relatively easier to negotiate than, for instance, treaty clauses pertaining to the exchange of information, especially in cases where a treaty partner is restricted by its domestic secrecy laws.[280] Given that, the benefits that LOB provisions afford outweigh the costs, as such clauses are imperative in improving the overall efficacy of anti-abuse measures, the stability of the international taxation system and the trustworthiness of the United States as a treaty partner.

2. *The UN and OECD Models are distinguishable from the 2006 U.S. Model*

Another basis for criticism of LOB provisions is that they seem excessive, in light of the fact that the models developed by the OECD[281] and the UN[282] do not contain such provisions.[283] However, unlike the 2006 U.S. Model, which is an expression of the United States' initial position in DTC negotiations, the OECD and UN Models are not country-specific and serve as model DTCs for use by a multitude of States.[284] The UN and OECD Models could not reflect the specifics of the tax policies of all the countries of the world because "taxes are the last topic on which one would expect sovereign nations to reach

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[278] 26 U.S.C. §§ 901, 903 (2006).

[279] Charles I. Kingson, *The Foreign Tax Credit and Its Critics*, 9 AM. J. TAX POL'Y 1 (1991).

[280] John Turro, *Override Articles May Appear in Future U.S. Treaties, Morrison Warns; Foreign Officials Discuss ADR*, 49 TAX NOTES 609, 610 (1990).

[281] OECD Model, *supra* note 14.

[282] UN Model, *supra* note 255.

[283] *See* OECD Model, *supra* note 14; UN Model, *supra* note 255; Avi-Yonah, *supra* note 217, at 495.

[284] *See* Streng, *supra* note 102, at 860–864.

a consensus."[285] The availability of treaty shopping, however, is determined by the domestic tax laws specific to the parties to a DTC and their respective network of the DTCs with other countries.[286] Thus, the 2006 U.S. Model serves different purposes than the UN and OECD Models, and, for this reason, differs in content.

Even in the absence of an express LOB provision, the OECD and UN Models arguably contemplate the use of anti-abuse clauses in DTCs. The commentaries to the OECD Model, which some courts accept as a binding interpretation of that Model,[287] provide that parties may use anti-abuse provisions.[288] Moreover, some commentators argue that DTCs, including the OECD and UN Models, are based on the assumption that they provide benefits to residents of the treaty signatories, which means that DTCs include implied anti-treaty shopping measures.[289] For these reasons, the 2006 U.S. Model's is consistent with the OECD and UN Models with regard to LOB provisions.

3. *Compatibility of LOB Provisions with E.U. Law*

Since the late 1980s there has been a debate regarding the compatibility of LOB provisions and E.U. law,[290] specifically, the principle of non-discrimination and its manifestations in the principles of freedom of establishment, freedom to provide services, and freedom of capital and payments.[291] As discussed above, these principles seek to lift restrictions on E.U. nationals' ability to conduct trade or do business across the borders of E.U. Member States.[292] In treaties between E.U. Member States and other countries, an LOB provision may result in discrimination against other E.U. Member States' entities that lack sufficient economic nexus with the treaty jurisdiction. However, it is yet to be decided whether such a denial of treaty benefits constitutes discrimination under E.U. law and, if so, whether the discrimination is justified, for example, on the grounds of "public policy, public security or public health."[293]

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[285] Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301, 1303 (1996).

[286] *See* BORREGO, *supra* note 15, at 56–57.

[287] Hugh J. Ault, *The Importance of International Cooperation in Forging Tax Policy*, 26 BROOK. J. INT'L L. 1693, 1694 (2001); David T. W. Lai, *Interpretation of Double Taxation Agreements in Hong Kong*, 37 HONG KONG L. J. 137, 143–51 (2007).

[288] Commentaries to the 2003 OECD Model, Art. 1, 9.

[289] *See* Avi-Yonah, *supra* note 217, at 495.

[290] BORREGO, *supra* note 15, at 237.

[291] EC Treaty, *supra* note 183, art. 43–60.

[292] Kofler et al., *supra* note 13, at 64.

[293] EC Treaty, *supra* note 183, art. 46.

The European Court of Justice (ECJ) has not addressed the legality of LOB provisions.[294] Substantively, most closely analogous to such a potential challenge are the *Open Skies* cases, where the ECJ invalidated several bilateral transportation treaties that contained a nationality clause somewhat similar to the LOB provisions.[295] The area of taxation, however, differs from the regulation of transportation, in that under international law, the power of States to tax (for as long as they have the requisite jurisdictional nexus with the taxpayer) is practically unlimited.[296] Also, in its recent Communication regarding national anti-abuse rules, the E.U. Commission clarified that E.U. law does not restrict discrimination by the E.U. Member States of establishments outside of the European Union or establishments of third-country nationals in the European Union.[297] As E.U. caselaw on the compatibility of domestic anti-abuse measures with E.U. law demonstrate, such measures may be justified where limited to "wholly artificial arrangements."[298] This means that LOB provisions that meet such a limitation should be consistent with E.U. law. Nevertheless, the issue of compatibility between LOB provisions and E.U. law remains untested.

V. CONCLUSION

The current practice of including LOB provisions in the U.S. DTCs is an important step towards harmonization of the national tax systems. This practice targets the problem of treaty shopping, which leads to a revenue loss in the United States, weakens the U.S. position in future negotiations and creates economic inefficiencies, both in the United States and globally. Several States have adopted unilateral measures seeking to combat treaty shopping, but such uncoordinated measures alone do not completely remove the incentives for treaty shopping. Moreover, a comparative perspective on anti-abuse laws in different jurisdictions, such as Canada, India and the European Union demonstrates that States differ in their views on the appropriate scope of unilateral anti-abuse principles. This shows the need to raise the issue of anti-abuse measures in the course of treaty negotiations and

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294 BORREGO, *supra* note 15, at 239; Mason, *supra* note 10, at 90.

295 Case C-446/98, Comm'n v. U.K., 2002 E.C.R. I-9427; Case C-467/98, Comm'n v. Denmark, 2002 E.C.R. I-9519; Case C-468/98, Comm'n v. Sweden, 2002 E.C.R. I-9575; Case C-469/98, Comm'n v. Finland, 2002 E.C.R. I-9627; Case C-471/98, Comm'n v. Belgium, 2002 E.C.R. I-9681; Case C-472/98, Comm'n Luxembourg, 2002 E.C.R. I-9741; Case C-475/98; Comm'n v. Austria, 2002 E.C.R. I-9797; Case C-476/98, Comm'n v. Germany, 2002 E.C.R. I-9855.

296 *See* Sjoerd Douma, *The Three Ds of Direct Tax Jurisdictions: Disparity, Discrimination and Double Taxation*, 46 EUR. TAX'N 522 (2006).

297 2007 E.C. Commc'n, *supra* note 76.

298 *See Cadbury Schweppes Plc*, 2006 E.C.R. I-7995.

develop mutually acceptable anti-abuse clauses in DTCs, such as LOB provisions. A collaborative approach, rather than unilateral one, would be more likely to succeed in solving the problem of treaty shopping.