Income Tax Treaty Shopping: An Overview of Prevention Techniques

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I. INTRODUCTION

The Internal Revenue Service in recent years has been particularly concerned about third-country residents' use of bilateral income tax treaties to avoid paying tax on United States source income. Although third-country residents have benefited from United States bilateral income tax treaties for more than twenty years, the loss of tax revenue from such unintended use was not considered a major problem. The recent proliferation of tax treaties between the United States and tax havens which resulted in an increased loss of tax revenues, however,

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1 A "third-country resident" is an individual who is not a resident or citizen of the United States or a country party to a tax treaty with the United States. Treasury Regulation § 1.871-2(b) which defines "residence" for an individual provides: "an alien actually present in the United States who is not a mere transient or sojourner is a resident of the United States for purposes of the income tax." Treas. Reg. § 1.871-2(b) (1957). The term "third-country resident" should not be confused with the term "nonresident alien individual," which includes those individuals who are residents or citizens of countries party to a tax treaty with the United States. Treas. Reg. § 1.871-2(a) (1957).


3 The first major case concerning treaty shopping, Aiken Industries, Inc. v. Commissioner, 56 T.C. 925 (1971) acq. 1972-2 C.B. 1, was not decided until more than thirty years after the United States signed its first bilateral income tax treaty. See infra notes 23 & 24 and accompanying text.

4 Although there is no standard definition of a "tax haven," most definitions are similar to one used by the Treasury Department: "any country having a low or zero rate of tax on all or certain categories of income, and offering a certain level of banking or commercial secrecy." IRS, TAX HAVENS AND THEIR USE BY UNITED STATES TAXPAYERS—AN OVERVIEW 14 (1981) [hereinafter cited as TAX HAVENS]. For investors interested in treaty shopping, three important characteristics of a tax haven are a low tax rate, a well-developed banking system and a modern communications system. Other important factors are secrecy laws, lack of currency controls and the time zone in which the haven is located. See TAX HAVENS, supra at 15-20; M. LANGER & R. POVELL, FOREIGN TAX HAVENS, 13 P.L.I. TAX LAW & PRAC. Trans. Ser. 1-22 (1973). One group addressed this issue by stating:

There must be some "tax haven" element arising with respect to the other state. In some instances, this may involve effective exemption from resident income tax in the other state. An example of this would be the partial tax exemption allowed by certain Swiss cantons to "domiciliary" companies not conducting business in Switzerland. Another example would be the indirect foreign tax credit granted by the U.S. itself under I.R.C. § 902. In other instances, the nature of the "tax haven" goes beyond effective exemption from resident income tax to favorable withholding tax relief by the other state on onward transfers and distributions.
has caused the Internal Revenue Service (IRS) to change its evaluation of the treaty shopping problem. The inclusion of a thirty-two page section on treaty shopping in a 1981 IRS report on tax havens is one indication that the IRS now considers third-country residents' abuse of United States tax treaties a serious problem.\(^5\) The proliferation of tax treaties with tax havens, along with the increasing availability of tax advice for investors in the international arena, the large number of investors seeking countries with stable political and economic systems in which to invest their funds, technological advances in communications, and a growing international banking network have made treaty shopping a game virtually any serious investor can play.\(^6\)

The term "treaty shopping" stems from the practice of third-country residents searching for a country that has (1) a favorable income tax treaty with the United States and (2) attractive internal tax laws.\(^7\) Once the third-country resident investor has found such a country, income from the United States may be channelled through a corporation organized under the laws of that country. The withholding tax rate on

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Many of the countries the IRS considers tax havens are present or former British territories. Until recently, when a territory declared independence from the United Kingdom, it had the option of agreeing to honor the terms of the United States-United Kingdom income tax treaty in effect at the time of its declaration, or of terminating its obligations under the treaty. Countries declaring their independence from Belgium were afforded the same opportunities.

Some of the tax havens which are presently developing income tax treaties with the United States are Antigua-Barbuda, British Virgin Islands, Cyprus, and the Netherlands Antilles. The United States recently cancelled 18 treaties which had come into effect by countries declaring their independence from the United Kingdom or Belgium. See infra note 105 and accompanying text.

5 TAX HAVENS, supra note 4, at 156-88. The New York State Bar Association Committee also has recognized "that treaty abuse is becoming an increasingly serious problem that deserves attention." Report on Proposed Treaty, supra note 4, at 284.

6 Undoubtedly, another important influence on the amount of treaty shopping is the growing number of tax treaties. See Report on Proposed Treaty, supra note 4, at 220.

7 The Senate Committee on Foreign Relations, in its Report on the United States-Malta income tax treaty, described treaty shopping as:

the situation where a person who is not a resident of either country a party to a treaty seeks certain benefits under the income tax treaty between the two countries. Under certain circumstances, the nonresident is able to secure these benefits by establishing a corporation (or other entity) in one of the countries which, as a resident of that country, is entitled to the benefits under the treaty. Additionally, it may be possible for the third-country resident to repatriate funds to the third country from the entity under favorable conditions (i.e., it may be possible to reduce or eliminate taxes on the repatriation) either through relaxed tax provisions in the distributing country or by passing the funds through other treaty countries (essentially, continuing to treaty shop) until the funds can be repatriated under favorable terms.

passive income under a tax treaty is usually less than the statutory thirty percent rate\(^8\) applicable to residents of non-treaty countries, in many cases completely exempting the income from taxation.\(^9\) Thus, by redirecting his income flow through a tax treaty country, an investor may significantly reduce the United States tax on his income.\(^10\) In addition, the laws of many tax treaty countries set low tax rates or, in some cases, a rate of zero on dividends or interest paid to nonresident investors.\(^11\) By channelling funds through the country with the most favorable combination of tax treaty terms and internal tax laws (hence the "shopping" label), a nonresident alien investor is able to avoid most or all tax on United States source income.\(^12\)

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8 I.R.C. § 871(a) (1976).
9 According to the New York State Bar Association Committee, this channelling procedure regularly occurs with Canadian investments:

It is common knowledge, for example, that Canadian direct investment in the U.S. almost invariably is made through Netherlands holding companies since the U.S. withholding tax on dividends and interest paid to a Netherlands corporation (generally five percent and zero, respectively . . .) is substantially less than the U.S. withholding tax on interest and dividends paid to Canada (15% under the [1942 United States-Canada tax treaty]). Report on Proposed Treaty, supra note 4, at 284-85 n.95.

10 The Senate Foreign Relations Committee gave an example of such a tax avoidance scheme in its description of the tax treaty with Luxembourg, stating:

[If the convention were made applicable to Luxembourg holding companies, persons such as [a] Bahamian resident would be encouraged to make U.S. investments through a Luxembourg holding company so as to receive the benefit of the U.S. exemption from tax on interest and royalty income, and the reduction of tax on dividend income, as well as the benefits of article X(1) of the convention which insulates a resident of a third country from U.S. tax on receipt of dividends from Luxembourg corporations by providing that the United States will not tax the dividend or interest income of a resident of a third country which it received from a Luxembourg corporation.


11 For example, the Cayman Islands imposes no tax on payments to nonresident investors and has no corporate income tax. ERNST & WHINNEY, FOREIGN AND U.S. CORPORATE INCOME AND WITHHOLDING TAX RATES 4 (Dec. 1982).


The delay in the effective date provisions was not intended to permit a foreign investor to
While treaty shopping often encompasses instances of tax evasion as well as tax avoidance, this Comment focuses on legal forms of treaty shopping and the present efforts of the United States government to prevent abuse of bilateral income tax treaties by third-country residents.

The United States is attempting to limit severely the practice of treaty shopping through a two-pronged attack. First, Congress has revised portions of the Internal Revenue Code (Code) which focus on the investment activity of nonresident aliens. By increasing the reporting

rearrange existing U.S. real estate investments so as to come under a treaty which would exempt gain from the disposition of a [United States Real Property Interest] from tax under FIRPTA. In the [Economic Recovery Tax Act] Conference Report, the conferees stated their belief that most such restructuring transactions were prohibited under the broad power given Treasury under I.R.C. § 897(e)(2) to adopt regulations to prevent tax avoidance. They felt compelled, however, to emphasize the point in order to “avoid any misunderstandings.”


TAX HAVENS, supra note 4, at 159-62. The focus of this Comment is on avoidance of United States income taxes. A third-country resident who abuses a tax treaty also may be evading or avoiding the taxes of the other contracting state. It is not easy to define what constitutes illegal evasion and legal avoidance with respect to income taxes of United States treaty partners. For example, Professor Huiskamp of Erasmus University Rotterdam states:

But what is “illegal”? This depends on the law—the national laws. What proves to be against the law in country A, may be perfectly lawful in country B. So internationally we cannot identify a transaction, a treatment, a circumstance that is from an international point view illegal.

Theoretically, of course, it is possible to work with abstract concepts which have international validity. Scientifically the criterion of illegality may be formulated as the presence or absence of deceit or falsity in the provision of information by the taxpayer or third person to the tax authorities. We may also describe evasion without offering an exact definition: it may be difficult to describe a donkey, but we recognise one when we see it. In this sense evasion implies that the taxpayer fails to do something or does something wrong, for instance he gives no information to the fisc. If we want to apply this definition or general description in practice, again, there is difficulty. Has the taxpayer, in a concrete case, a reporting obligation or not?


If any citizen or resident of the United States does not reside in (and is not found in) any United States judicial district, such citizen or resident shall be treated as residing in the District of Columbia for purposes of this title relating to—
(a) jurisdiction of courts, or
(b) enforcement of summons.

I.R.C. § 7701(a)(39) (1982). Another example is Section 982 of the Code concerning foreign documentation. Under Section 982:
requirements for foreign investors, Congress gave the IRS tools to use in identifying third-country resident investors and domestic investors who are abusing United States bilateral tax treaties.\textsuperscript{15}

Second, since 1962 the Treasury Department has been attempting to control treaty shopping through specific anti-treaty shopping articles in tax treaties.\textsuperscript{16} The Treasury Department currently is seeking in its treaty negotiations with the British Virgin Islands\textsuperscript{17} and the Nether-


One purpose behind imposing a tax on gains from the disposition of real property held by foreign investors and requiring foreign investors to disclose their holdings in certain types of real property, see, e.g., Agricultural Foreign Investment Disclosure Act of 1978, §§ 1-9, 7 U.S.C. §§ 3501-3508 (Supp. V 1981), was to equalize the tax treatment of foreign and domestic investors. The congressional committee handling the bill stated the measure was not intended as "a penalty on foreign investors or to discourage foreign investors from investing in the United States." S. REP. NO. 532, 96th Cong., 1st Sess. 12-13 (1979); see also H.R. REP. NO. 1150, 96th Cong., 2d Sess. 170 (1980). An indirect benefit of these statutes might be a decrease in tax treaty abuse because many foreign investors were investing in United States real property and channelling their investments through treaty countries to avoid disclosure and reporting requirements.

\textsuperscript{16} In 1962, the Treasury Department was able to include in the United States-Luxembourg income tax treaty the first anti-treaty shopping article. The article was designed to limit the benefits of the treaty to residents or citizens of the contracting states by excluding treaty benefits to holding companies. Convention with Respect to Taxes on Income and Property, Dec. 18, 1962, United States-Luxembourg, art. XV, 15 U.S.T. 2355, T.I.A.S. No. 5726, reprinted in 1 TAX TREATIES (CCH) ¶ 5303, ¶ 5318 [hereinafter cited as United States-Luxembourg Convention]. See also infra notes 42-57 and accompanying text.

\textsuperscript{17} Recent events have highlighted the Treasury Department's efforts to stop treaty shopping
lands Antilles,\(^1\) both of which are tax havens, to include anti-treaty shopping provisions in the new income tax treaties with those countries. Similar negotiations have begun with Antigua-Barbuda.\(^2\) The aggressive approach now being taken by the United States,\(^3\) coupled with the increasing number of developing countries desiring tax haven status, indicates that the areas of international tax law governing treaty shopping will experience change at a much faster pace over the next few years.\(^4\)

Thus, the situation is ripe for addressing two questions. First,

and have focused national attention on the problem. On December 8, 1981, the Senate Committee on Foreign Relations voted to return a new United States-British Virgin Islands income tax treaty to President Reagan for renegotiation on the grounds that it was potentially subject to abuse by third-country residents. The Committee also voted to return for renegotiation a new income tax treaty with Cyprus. Senate Comm. on Foreign Relations, Return of Two Tax Treaties, S. Exec. Rep. No. 43, 97th Cong., 1st Sess. 1 (1981) [hereinafter cited as Report on Two Tax Treaties]. The tax treaties had been sent to the Senate for ratification as required by the United States Constitution. U.S. Const. art. II, § 2. The Senate Committee recognized the potential for abuse of these treaties, stating:

Both of these jurisdictions are tax havens. The pending treaties with both were designed to prevent, or at least limit the extent to which residents of third countries can use these treaties, in conjunction with favorable internal law provisions in those jurisdictions, to receive U.S. treaty benefits. We have concluded, on the basis of our review of these treaties that the opportunities which potentially remain for such use are too great for us to tolerate. We intend to raise our concerns with the Governments of both jurisdictions, and seek modifications in these treaties consistent with our present policy.

Report on Two Tax Treaties, supra at 2.

\(^{1}\) The Treasury Department, in October 1982, began negotiations for a new income tax treaty with the Netherlands Antilles, a tax haven favored by both United States and foreign investors. Fialka, Closing a Loophole: Corporate Tax Haven In Netherlands Antilles Is Bracing for a Disaster, Wall St. J., Oct. 11, 1982, at 1, col. 6 (Midwest ed.). The Treasury Department lawyer heading the United States negotiating team is quoted as saying: "As it stands, a treaty with the Netherlands Antilles is a treaty with the world." Id. at 1, col. 6. See also infra notes 107-09 and accompanying text.

\(^{2}\) In November 1982, Antigua-Barbuda, a former United Kingdom colony announced that it was cancelling its income tax treaty with the United States. Wall St. J., Nov. 17, 1982, at 1, col. 5 (Midwest ed.). Antigua-Barbuda became an independent country on November 1, 1981, and since has been honoring the terms of the United States-United Kingdom income tax treaty which was in effect at that time. See infra note 35 and accompanying text. Antigua-Barbuda is in the process of revising its tax, banking and other investment laws to make the country a more attractive financial center.

\(^{3}\) Prior to 1970, Code changes affecting treaty shopping were infrequent and relatively minor. The Code revisions were merely a temporary inconvenience for investors and international tax lawyers, who were able to quickly circumvent the changes.

\(^{4}\) In July 1983, the Treasury Department announced that, effective January 1, 1984, it was cancelling the tax treaties in effect between the United States and 18 former colonies of the United Kingdom or Belgium. None of these treaties contained articles aimed at preventing treaty shopping. The countries or territories whose treaties were cancelled are: Anguilla, Barbados, Belize, Burundi, Dominica, the Falklands, Gambia, Grenada, Malawi, Montserrat, Rwanda, St. Christopher, St. Lucia, St. Vincent, Seychelles, Sierra Leone, Zaire and Zambia. Wall St. J., July 6, 1983, at 1, col. 5 (Midwest ed.).
what is the United States' current position regarding anti-treaty shopping techniques as a result of past attempts by Congress and the Treasury Department to prevent treaty shopping? And second, to what extent will anti-treaty shopping measures thus far proposed, coupled with the existing treaty provisions designed to limit treaty shopping, be effective in preventing treaty shopping without impairing the United States' efforts to achieve other goals through bilateral tax treaties? These questions are especially relevant in view of Congress' recent mandate to the Secretary of Treasury to develop procedures during the next two years designed to "limit treaty benefits to those persons who are justifiably entitled to such benefits."22

The following discussion addresses the first question by analyzing the development of anti-treaty shopping provisions in United States bilateral tax treaties. This historical analysis demonstrates that the Treasury Department has maneuvered the United States into a very weak position from which to combat treaty shopping, by failing to adopt and implement a consistent policy of including anti-treaty shopping provisions in United States income tax treaties. The second question is addressed by examining separately major anti-treaty shopping proposals and determining how, if at all, each proposal should fit into a coordinated attack on treaty shopping. Finally, this Comment concludes that treaty shopping can be reduced to an acceptable level only if the United States develops—and implements—a policy designed to achieve equity among all countries with respect to treaty provisions subject to abuse, so that the incentive to treaty shop is removed.

II. ANTI-TREATY SHOPPING PROVISIONS: EFFORTS TO CLOSE THE MARKET DOOR

Although special concern about treaty shopping has developed relatively recently, the possibility of treaty shopping has been acknowledged since the United States entered its first major income tax treaty with Sweden in 1939.23 This treaty with Sweden, and subsequent trea-

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22 H.R. REP. NO. 760, 97th Cong., 2d Sess. 593, reprinted in 1982 U.S. CODE CONG. & AD. NEWS 1365. An indication of Congress' concern about the impact of anti-treaty shopping provisions is contained in the instructions to the Secretary of Treasury as to other factors which should be considered in developing the provisions. These factors include:

- the extent to which any procedures would prevent abuse, the administrability of such procedures (including the ability of U.S. treaty partners to provide cooperation), any negative effect on investment in the U.S. by foreign persons which could be caused by increased costs of complying with the procedures, and the effect on U.S. investment abroad should U.S. treaty partners apply a similar method to that utilized by the United States.

Id. See also REPORT ON TWO TAX TREATIES, supra note 17.

23 While the United States did have an income tax treaty with France for a brief period before
ties with France, Canada and the United Kingdom,\textsuperscript{24} were entered into expressly to prevent "double taxation" and "fiscal evasion." Since the United States taxes its citizens' income regardless of whether they are residing in the United States or a foreign country at the time such income is received,\textsuperscript{25} two problems may arise. First, a United States citizen could have his income subjected to double taxation by having to pay income taxes both to the foreign government (the income source) and to the United States government.\textsuperscript{26} Alternatively, a citizen could attempt to escape paying any United States tax on foreign source income by simply failing to report the income to the IRS.\textsuperscript{27} The bilateral income tax treaties were designed to prevent these tax consequences

\begin{footnotesize}
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\item \textsuperscript{26} A United States citizen living in a foreign country, for example, could be subject to income tax in that country on all income earned there. In addition, he or she would have to pay United States income tax on that foreign source income. Although the Code contains a provision allowing the United States citizen a credit on his or her United States income tax for foreign taxes paid, I.R.C. § 901 (1982), if the foreign income tax exceeds the United States income tax, the citizen will still be liable for the excess foreign tax.
\item \textsuperscript{27} Although an exact definition of "fiscal evasion" is very difficult, see supra note 13, the following definition will suffice for the purposes of this Comment: "Illegally paying less in taxes than the law permits . . . ." \textit{BLACK'S LAW DICTIONARY} 1310 (rev. 5th ed. 1979) (definition of "tax evasion").
\end{itemize}
\end{footnotesize}
through the use of devices such as reciprocal tax benefits\(^\text{28}\) and disclosure clauses.\(^\text{29}\)

It was recognized by tax experts, however, that the income tax treaties might create new opportunities for tax avoidance and evasion, as well as eliminate tax avoidance and evasion possibilities. Such new opportunities could arise from the imperfect fit of a particular treaty with the laws of the United States, the other signatory country, or both countries. A 1949 study of income tax treaties concentrating on treaties between the United Kingdom and the United States, and between Canada and the United States, noted “[t]hat cooperation is needed particularly where the Convention itself may induce tax avoidance or evasion, as in the application of tax exemptions which may encourage taxpayers to retain contacts with the jurisdiction waiving the higher tax.”\(^\text{30}\)

While there was at least limited recognition by some experts that the treaties could create new avenues for tax avoidance, the Treasury Department did not take any significant action to limit treaty benefits to citizens or residents of the contracting countries until the 1962 United States-Luxembourg income tax treaty.\(^\text{31}\)

In retrospect, the failure to include in tax treaties clauses limiting benefits of the treaties to citizens or residents of the contracting states is probably one of the major factors contributing to the existence of widespread treaty shopping today. The importance of this omission is especially evident when considered in the context of the United States-United Kingdom income tax treaty.\(^\text{32}\) While the income tax treaty between the United States and the United Kingdom originally included only Great Britain and Northern Ireland,\(^\text{33}\) the Convention was extended in 1959 to cover twenty British territories.\(^\text{34}\) In subsequent years,


\(^{30}\) A. EHRENZWEIG & F. KOCH, INCOME TAX TREATIES 5-6 (1949).

\(^{31}\) United States-Luxembourg Convention, supra note 16.

\(^{32}\) United States-United Kingdom Convention, supra note 24.

\(^{33}\) United States-United Kingdom Convention, supra note 24, at Introduction, 2 TAX TREATIES (CCH) ¶ 8103A.

\(^{34}\) Agreement Extending the Provisions of the Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Aug. 19, 1957 and Dec. 3, 1958, United States-United Kingdom, 9 U.S.T. 1459, T.I.A.S. No. 4141. The territories included in the extension were: Aden, Antigua (now Antigua-Barbuda), Barbados, British Honduras (now Belize), Cyprus, Dominica, Falkland Islands, Gambia, Grenada, Jamaica, Montserrat, Nigeria (Federation of), Rhodesia and Nayasland (Federation of; Northern Rhodesia is now
many of those territories declared themselves independent from the United Kingdom. Most of these new countries agreed to continue honoring the obligations and duties under the United States-United Kingdom income tax treaty existing at the time they declared independence. Many of these new countries also passed laws making them very attractive to investors—that is, tax havens.

As former British territories became tax havens while still party to income tax treaties which had been negotiated with a non-haven, the United Kingdom, the United States found itself in an awkward position. The new tax havens were not amenable to the inclusion of anti-treaty shopping provisions in their treaties because such provisions would reduce the income flow to their country. Of the twenty British territories which were brought under the United States-United Kingdom income tax treaty in 1959, twelve were listed as tax havens in a 1981 IRS report. Since that report, two of the tax havens, the British Virgin Islands (BVI) and Antigua-Barbuda, have begun to negotiate with the Treasury Department to protect their tax haven status. The disputes center on whether limitation of benefits provisions should be included in their tax treaties, and if included, what form it should take. In addition, the United States exercised its privilege to cancel the bilateral tax treaties in effect with eighteen countries whose treaties arose out of United States-United Kingdom and United States-Belgium tax treaties, thereby taking the offensive against treaty shopping. Since

Zambia, Southern Rhodesia is Zimbabwe, and Nyasaland is now Malawi), St. Christopher, Nevis and Anguilla, St. Lucia, St. Vincent, Seychelles, Sierra Leone, Trinidad and Tobago and the Virgin Islands (known as the British Virgin Islands). Id. at 1460-61.

Those countries which assumed the obligations of the United States-United Kingdom income tax treaty in effect at the time they declared independence are: Antigua-Barbuda, Barbados, Gambia, Grenada, Jamaica, Seychelles, Sierra Leone and Trinidad and Tobago.

Antigua-Barbuda, Barbados, Grenada and Seychelles are classified as tax havens by the IRS. Tax Havens, supra note 4, at 177.

TAX HAVENS, supra note 4, at 177. Those twelve countries are: Antigua-Barbuda, Barbados, Belize (formerly British Honduras), British Virgin Islands, Dominica, Falkland Islands, Grenada, Montserrat; St. Christopher, Nevis and Anguilla; St. Lucia, St. Vincent and Seychelles.

Fialka, supra note 18, at 14, col. 3; Wall St. J., Nov. 17, 1982, at 1, col. 5.

See supra note 21. Article XXIV of the 1945 United States-United Kingdom Convention stated:
The present Convention shall continue in effect indefinitely but either of the Contracting Parties may, on or before the 30th day of June in any year after the year 1946, give to the other Contracting Party, through diplomatic channels, notice of termination and, in such event, the present Convention shall cease to be effective . . . .

the number of investors and the amount of funds affected by the cancellations were rather small, whereas the potential for abusing the treaties was great, the Treasury Department acted wisely by cancelling the treaties.

III. AN OVERVIEW OF TREATY PROVISIONS LIMITING BENEFITS: 1960-1964

A. Luxembourg Treaty and the Netherlands Antilles Protocol

On December 18, 1962, the United States signed an income tax treaty with Luxembourg. This treaty was the first to contain an arti-
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cle specifically aimed at limiting benefits under the treaty to those persons who were citizens or residents of one of the contracting states.43 Article 15 provided that "[t]he present Convention shall not apply to the income of any holding company entitled to any special tax benefit under Luxembourg Law . . . or to any income derived from such companies by any shareholder thereof."44 Holding companies were thought to be the primary device through which residents of countries with low or nonexistent income tax rates would channel income to avoid paying the United States thirty percent tax on passive income—that is, dividends, interest, and royalties.45 As the Senate Foreign Relations Committee stated in its report on the treaty:

[I]f income were received by a Luxembourg holding company whose shareholders reside in a third country, and the provisions of this convention were made applicable to such companies, it would be possible for interest and royalty income to be completely exempt from tax in the United States, in Luxembourg, and also in the country of residence of the corporate shareholder if the third country in which the shareholder resides does not have an income tax. Moreover, the reduced U.S. tax rate on dividend would be the sole tax burden on dividend income.46

Article 15 remedied this situation by excluding Luxembourg holding companies from the treaty benefits, thereby subjecting holding compa-

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43 United States-Luxembourg Convention, supra note 16, art. 15. Article 15 states:
The present Convention shall not apply to the income of any holding company entitled to any special tax benefit under Luxembourg Law of July 31, 1929, and Decree Law of December 27, 1937, or under any similar law subsequently enacted, or to any income derived from such companies by any shareholder thereof. In the event that substantially similar benefits are granted to other corporations under any law enacted by Luxembourg after the date of signature of the present Convention, the provisions of the present Convention shall not apply to the income of any such corporation or to any income derived from such corporation by any shareholder thereof. The expression "substantially similar benefits" shall be deemed not to include tax reduction or exemption granted to any corporation in respect of dividends derived from another corporation, 25 percent or more of the stock of which is owned by the recipient corporation.

44 Id.

45 I.R.C. § 871(a)(1) (1976). Section 871 states:
There is hereby imposed for each taxable year a tax of 30 percent of the amount received from sources within the United States by a nonresident alien individual as

(A) interest (other than original issue discount as defined in section 1232(b)), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income . . . .

46 Senate Comm. on Foreign Relations, Report on the Income Tax Convention Between Luxembourg and the United States, S. Exec. Rep. No. 10, 88th Cong., 2d Sess. 2, reprinted in 2 Tax Treaties (CCH) ¶ 5348 at 5329. In an example contained in the report, Bahamas (another favorite tax haven) was used to demonstrate how a third-country which had no income tax could serve as a base for investors taking advantage of a United States income tax treaty. If there had been no exemption for holding companies in the Luxembourg treaty, Bahamians would have been able to invest in the United States through a Luxembourg holding company and pay no income tax to the United States. Id. at 5329-30.
nies to the thirty percent tax on passive income.\textsuperscript{47}

Two issues noted in the Senate Foreign Relations Committee report on the Luxembourg treaty indicate why the limitations article failed to prevent treaty shopping. These issues also have become recurring considerations in the Treasury Department's attempts to stop treaty shopping. The first issue concerns a basic tenet of tax treaty negotiation: The longer a country has enjoyed tax haven status and a liberal tax treaty, the more difficult it becomes from a political standpoint to curtail the scope of tax avoidance activities in that country.\textsuperscript{48}

The report stated, however, that the use of Luxembourg holding companies to receive income from the United States had not been widespread before the treaty; consequently, excluding holding companies from the treaty would not "significantly affect the U.S. balance-of-payments position."\textsuperscript{49}

The second, and more important issue raised in the report was that inclusion of the holding company exemption in the United States-Luxembourg treaty made it inconsistent with the United States-Netherlands Antilles Protocol.\textsuperscript{50} The Protocol did not contain a provision regarding "secondary liability," generally defined as dividend and interest payments of a holding company to its shareholders.\textsuperscript{51} Under Article 15 of the Luxembourg treaty, Luxembourg holding companies or their shareholders could not take advantage of any tax benefits flowing from the treaty.\textsuperscript{52} Under the terms of the United States-Netherlands

\textsuperscript{47} See supra notes 43 & 45.

\textsuperscript{48} See Philippines Report, supra note 15.

\textsuperscript{49} Senate Comm. on Foreign Relations, supra note 10. United States tax laws affect the United States balance-of-payments position by varying the incentives for investors to keep or bring capital into the United States; or alternatively, to keep or send capital out of the United States. As the capital flow out of the United States increases relative to the capital flow into the United States, the United States balance-of-payments position moves further in the direction of a deficit. A relative increase of capital flowing into the United States moves the balance-of-payments position towards a surplus. Thus, any tax law or treaty provision which would make foreign investment in the United States unfavorable should be avoided if the United States wants to protect its balance-of-payments position. Because there had been very little investment in the United States through Luxembourg holding companies, a treaty provision denying tax advantages for funds invested through such holding companies would have only a slight negative effect on the capital flow into the United States. The Senate Committee did not believe the slight decrease in capital flow would significantly affect the United States balance-of-payments position. Id.


\textsuperscript{52} See supra note 43.
Antilles Protocol of 1963, however, only holding companies—not the holding companies' shareholders—were precluded from taking advantage of the treaty benefits. Thus, the secondary liability payments were eligible for treaty benefits. Noting this difference between the treaty and the Protocol, the Senate Foreign Relations Committee provided an explanation in its report:

Although it would be consistent with the approach taken in the pending Luxembourg Convention to make Article XII of the convention with the Netherlands inapplicable in the case of dividends paid by Netherlands Antilles corporations to nonresident shareholders, to do so could cause an adverse effect on the U.S. balance-of-payments position. Since it is estimated that a large portion of the assets held by Netherlands Antilles corporations (estimated at approximately $1 billion) is held by corporations which derive 50 percent or more of their gross income from sources within the United States, it is feared that repeal of Article XII could cause a substantial liquidation of U.S. assets held by these corporations so as to avoid the statutory 50-percent rule which would be applicable in the absence of the present convention.

While the Senate Committee could only speculate as to the effects, if any, of the difference between the treaties, viewed from a current perspective, it is evident that treaty shopping continued. Third-country resident shareholders were, in effect, encouraged to make investments through the Netherlands Antilles and to steer away from investments through Luxembourg. A 1981 IRS study on tax havens, which lists the Netherlands Antilles third in terms of United States gross income paid to nonresident aliens and foreign corporations during 1978, supports this contention. Although Luxembourg is listed fourth in this study, only one behind the Netherlands Antilles, comparison of the gross income figures reveals a substantial gap between the two. Luxembourg received $21,066,000 in United States gross income, whereas the Netherlands Antilles received $190,759,000—more than eight times

55 TAX HAVENS, supra note 4, at 177.
56 Sixteen countries are listed by the IRS as tax havens: Antigua-Barbuda, Barbados, Belize, British Virgin Islands, Dominica, Falkland Islands, Grenada, Luxembourg, Montserrat, Netherlands, Netherlands Antilles, St. Christopher, Nevis and Anguilla; St. Lucia, St. Vincent, Seychelles, and Switzerland. TAX HAVENS, supra note 4, at 177. Of those countries, Luxembourg is fourth in terms of total United States gross income paid to nonresident aliens and foreign corporations in tax haven countries during 1978. The total United States gross income paid to nonresident aliens and foreign corporations in Luxembourg during 1978 was a total of $21,066,000 ($14,195,000 in dividends, $5,968,000 in interest, and $904,000 in other payments). Id. at 177. Because Luxembourg had a population of only 360,000 in 1978, NEWSPAPER ENTERPRISE ASSOCI-
the amount received by Luxembourg. While, undoubtedly, there are many factors which contribute to this extreme difference, one important factor is the inconsistency between the treaty provisions limiting benefits. Almost by definition, treaty shopping occurs when there are differences among the treaties as to their effect on nonresident alien income.

B. Sweden

A Supplementary Convention with Sweden, also signed in the early 1960s, updated many of the provisions in the United States-Sweden income tax treaty. The Convention changed the tax rates on dividends and interest flowing between the United States and Sweden, but did not add an exclusion covering holding companies. There was no explanation in the Senate Finance Committee report on the Supplementary Convention about why a limitation of benefits article was not included in the agreement. Since Sweden was not recognized generally as an attractive tax haven, one possible explanation for not including such an article is that it would have become applicable only if Sweden changed its internal tax laws so as to become a tax haven. The fact that such a change was unlikely, and indeed did not occur, could have been an incentive to leave such an article out of the negotiating documents and thereby reduce the number of controversial items. Moreover, the United States may have been assuming that if Sweden did move to become a tax haven, a restrictive article could be added to the treaty. The fallacy of such a position, however, should have been


58 Senate Comm. on Foreign Relations, Report on the Supplementary Convention Between the United States and Sweden, S. Exec. Rep. No. 10, 88th Cong., 2d Sess. 53, reprinted in 2 Tax Treaties (CCH) ¶ 7351B. The Technical Memorandum of the Treasury Department concerning the treaty, however, notes that the Sweden treaty approached the double taxation problem differently than the United States tax treaty with the Netherlands. The Treasury Department stated:

The approach to avoidance of double taxation thus adopted differs from that employed in the Netherlands convention in that in the latter convention outright exemption from taxation in one or the other of the two contracting states was provided with respect to items of income such as royalties, income from real property, Government salaries and compensations, private pensions, and life annuities. It appears that the payments were not solely for the benefit of citizens and residents of Luxembourg, but also for residents of other countries. Id. at 150.

Id. at 7329. The Netherlands treaty, therefore, encouraged third-country residents to form holding companies in the Netherlands to receive income from the United States tax free. Because the treaty with Sweden did not provide a tax exemption, there was less of an incentive to form a Swedish holding company, and therefore less need to exempt holding companies from the treaty.
evident to the Treasury Department from the difficulty it had encountered while negotiating the inclusion of a limitations article in the Netherlands Antilles Protocol of 1963 and from the Senate Foreign Relations Committee's warnings regarding the Luxembourg treaty. The Treasury Department eventually did adopt the position that limitations articles are to be included in new treaties, and it is now faced with the monumental task of getting a limitations article incorporated into treaties with tax havens.

C. Japan

Other examples of Treasury Department actions inconsistent with the anti-treaty shopping provision of the Luxembourg treaty were the 1954 United States income tax treaty with Japan and the later Protocol between the same countries. As was customary for the period, no provision was included to limit benefits under the 1954 treaty. In August 1962, the two countries signed a Protocol which updated several articles of the treaty, particularly those concerning dividends and interest. The Protocol, however, also did not include any article to limit benefits, and no reason was given in the Senate report on the Protocol as to why there was such an omission. Because Japan, like Sweden, was not considered a tax haven when the Protocol was signed, and presently is not classified as a tax haven by the IRS, it is likely the Treasury Department followed the same logic hypothesized in the previous section concerning the Sweden Protocol, in not negotiating for an article to limit benefits in the Japan treaty or Protocol.

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59 See supra text accompanying notes 51-57.
60 See supra note 54 and accompanying text.
61 See infra text accompanying notes 75-98.
64 Id., art. III, 16 U.S.T. at 699, T.I.A.S. No. 5798, reprinted in 2 Tax Treaties (CCH) ¶ 4472 at 4411-5.
65 Id., art. IV, 16 U.S.T. at 700, T.I.A.S. No. 5798, reprinted in 2 Tax Treaties (CCH) ¶ 4472 at 4411-5.
67 Tax Havens, supra note 4, at 177.
IV. A PERIOD OF OMISSION: 1965-1969, TAX TREATIES WITHOUT LIMITATIONS ARTICLES

During the period 1965 to 1969, the United States signed seven income tax treaties with different nations. None of these agreements contained an article specifically dealing with the limitation of benefits under the applicable treaties. In retrospect, the failure to include such an article in any of the treaties was a major omission by the Treasury Department. If the Treasury Department was operating with the belief that a limitation of benefits article should be included only when it was very likely the treaty would be abused, then this omission is understandable, although not excusable. Of the seven countries with which agreements were signed during this period, only the Netherlands was listed by the IRS in 1981 as a tax haven.

While the Treasury Department chose not to negotiate for the inclusion of articles limiting benefits, all of the agreements negotiated during the 1950s and 1960s provided excellent opportunities for refining a limitation of benefits article. Since most of the countries in-

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69 Belgium, Canada, France, Germany, Netherlands, Trinidad and Tobago, and the United Kingdom. *See supra* note 69.

70 TAX HAVENS, *supra* note 4, at 177.

71 Such an article, interacting with other treaty articles relating to dividends, interest and royalties would operate in a way so as to severely limit treaty shopping. For example, Article 16 of the Treasury Department's June 16, 1981 Model Income Tax Treaty states:

1. A person (other than an individual) which is a resident of a Contracting State shall not be entitled under this Convention to relief from taxation in the other Contracting State unless

   (a) more than 75 percent of the beneficial interest in such person is owned, directly or indirectly, by one or more individual residents of the first-mentioned Contracting State; and

   (b) the income of such person is not used in substantial part, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons who are residents of a State other than a Contracting State and who are not citizens of the United States.

For the purposes of subparagraph (a), a company that has substantial trading in its stock on a recognized exchange in a Contracting State is presumed to be owned by individual residents of that Contracting State.

2. Paragraph 1 shall not apply if it is determined that the acquisition or maintenance of
volved were not tax havens and were not intent on becoming tax havens, they would not have been threatened by the inclusion of such an article. In addition, a limitation of benefits article would not have seriously affected the cash flow between the United States and any of the other contracting states. These other states were not tax havens, therefore there would not have been a balance-of-payments problem.

The most significant loss from the Treasury Department’s failure during this period to negotiate for inclusion of limitation of benefits articles was the wasted opportunity to develop a model article. The United States has attempted to improve its treaty development process by using past agreements as models for subsequent agreements concerning the same issues. A limitation of benefits article developed during this period and included in all treaty agreements would have served as a functional model for the Treasury Department in its negotiations with tax havens.

A highly effective limitations article could have resulted from the process of developing a model article and then negotiating for its inclusion in tax treaties. The more effective the article developed, the more benefit the Treasury Department would derive from having the foresight to engage in the development process. In addition, the Treasury Department could have strengthened its negotiating position regarding inclusion of such an article in treaties with tax havens if the Department already had included such articles in all other treaties. Tax haven countries are apt to be more resistant to an article which will be included only in their treaties than an article which is a standard part of every United States income tax treaty.

It may be argued that the above criticisms of the Treasury Department’s treaty negotiation plan are of academic, but little practical, value. They are especially relevant, however, as the Treasury Department now enters another period of extensive negotiations for income tax treaties.

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such person and the conduct of its operations did not have as a principal purpose obtaining benefits under the Convention.

3. Any relief from tax provided by a Contracting State to a resident of the other Contracting State under the Convention shall be inapplicable to the extent that, under the law in force in that other State, the income to which the relief relates bears significantly lower tax than similar income arising within that other State derived by residents of that other State. Reprinted in IRS, TAX HAVEN INFORMATION BOOK 112 (1982). The Organization for Economic Co-operation and Development (O.E.C.D.) also has a model tax treaty but it does not contain a comparable article. See 1 TAX TREATIES (CCH) § 151.

72 See generally, Rosenbloom & Langbein, supra note 24.

73 For example, the Treasury Department presently is renegotiating the Netherlands Antilles treaty, and the British Virgin Islands treaty has been withdrawn from consideration by the President so that it may be renegotiated. See supra note 17.
V. AN OVERVIEW OF TREATY PROVISIONS LIMITING BENEFITS

Treaties signed in the 1970s evidence the Treasury Department’s renewed concern about treaty shopping. In its attempt to find a model article which will effectively prevent treaty shopping, the Treasury Department has employed and revised many versions of Article 16, the “Investment or Holding Companies” article.74

A. Trinidad and Tobago

Article 16 first appeared in the United States-Trinidad and Tobago income tax treaty signed January 9, 1970.75 Article 16 stated:

A corporation of one of the Contracting States deriving dividends, interest, or royalties from sources within the other Contracting State shall not be entitled to the benefits of Article 12 (Dividends), 13 (Interest), or 14 (Royalties) if—

(a) By reason of special measures granting tax benefits to investment or holding companies the tax imposed on such corporation by the first-mentioned Contracting State with respect to such dividends, interest, or royalties is substantially less than the tax generally imposed by such Contracting State on corporate profits, and,

(b) Twenty-five percent or more of the capital of such corporation is held of record or is otherwise determined, after consultation between the competent authorities of the Contracting States, to be owned, directly or indirectly, by one or more persons who are not residents of the first-mentioned Contracting State (or, in the case of a Trinidad and Tobago corporation, who are citizens of the United States).76

74 See, e.g., Treasury Department's June 16, 1981 Model Income Tax Treaty, Article 16, supra note 72. One commentator has noted that it would be more appropriate to name this article: "Limitation on Treaty Benefits." Report on Proposed Treaty, supra note 4, at 289 n.98.

75 Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion, Jan. 9, 1970, United States-Trinidad and Tobago, 22 U.S.T. 164, T.I.A.S. No. 7047, reprinted in 2 Tax Treaties (CCH) ¶ 7608 [hereinafter cited as United States-Trinidad and Tobago Convention].

Trinidad and Tobago is a former British territory included in the 1958 agreement between the United States and the United Kingdom.\(^{77}\) That agreement extended benefits of the income tax treaty between those countries to British territories, and became effective for Trinidad and Tobago as of January 1, 1959.\(^{78}\) On August 31, 1962, Trinidad and Tobago became an independent nation;\(^{79}\) it agreed, however, to honor the articles of the United States-United Kingdom income tax treaty which were in effect at that time.\(^{80}\) On January 1, 1966, the United States treaty with Trinidad and Tobago was terminated, the government of Trinidad and Tobago having revoked its agreement to the treaty.\(^{81}\) A limited income tax treaty between the two countries was signed on December 22, 1966,\(^{82}\) and it continued in force from December 19, 1967 until December 31, 1969.\(^{83}\) The present income tax treaty between the countries which includes the "Investment or Holding Company" article became effective December 30, 1970.\(^{84}\)

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\(^{77}\) See supra note 32.

\(^{78}\) \textit{Id.}

\(^{79}\) 2 \textit{TAX TREATIES} (CCH) \$ 7602 at 7603.


\(^{81}\) 2 \textit{TAX TREATIES} (CCH) \$ 7602 at 7603.


\(^{83}\) 2 \textit{TAX TREATIES} (CCH) \$ 7602 at 7603.

\(^{84}\) Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion, Jan. 9, 1970, United States-Trinidad and Tobago, 22 U.S.T. 164, T.I.A.S. No. 7047, \textit{reprinted in 2 TAX TREATIES} (CCH) \$ 7608. The history of the Trinidad and Tobago income tax treaty, when
The Treasury Department chose to reverse its policy of not including limitations articles in treaties, by including such an article in the 1970 tax treaty with Trinidad and Tobago. The report of the Senate Foreign Relations Committee concerning that treaty\textsuperscript{85} contains no direct explanation as to why Article 16 was included. In portions of the report concerning other sections of the treaty, however, the Committee expressed concern about certain issues which may have prompted the Treasury Department to negotiate for inclusion of Article 16. In particular, the Committee disclosed that it did not want to include provisions in the treaty which would "provide a tax incentive for increasing the flow of technology from the United States to Trinidad and Tobago."\textsuperscript{86} The Committee believed it was not appropriate to encourage American investment abroad at a time when the United States was facing severe domestic problems and a balance-of-payments deficit.\textsuperscript{87} As noted previously, the balance-of-payments problem was the major reason for not including secondary liabilities in the article excluding benefits to holding companies under the United States-Netherlands Antilles income tax protocol signed October 23, 1963. \textsuperscript{88} It is interesting to contrast, then, how Congress has viewed Article 16 as a tool for controlling the United States balance-of-payments position. The Senate Foreign Relations Committee argued that inclusion in the Netherlands Antilles treaty of an "Article 16" incorporating secondary liability would negatively affect the United States balance-of-payments position by decreasing the flow of funds from United States investors to the Netherlands Antilles. When the treaty with Trinidad and Tobago was negotiated, however, the Committee took the position that failure to include an Article 16 incorporating secondary liability would negatively viewed in the context of treaty shopping, highlights many points important to the issue of treaty shopping in general. First, as noted before, supra note 34 and accompanying text, many of the present tax havens which are party to an income tax treaty with the United States were British territories. Second, although not an absolute rule, most of the former British territories agreed to honor the articles of the United States-United Kingdom income tax treaty in effect at the time the territories became independent nations. \textit{See supra} note 33. Third, many of these nations subsequently terminated their assumed income tax treaty with the United States: namely, Antigua-Barbuda, Cyprus, Jamaica, and Trinidad and Tobago. Of these countries, the last three recently have negotiated new tax treaties with the United States and Antigua-Barbuda currently is negotiating a new tax treaty. Finally, Trinidad and Tobago is one of the few former British territories which presently is not classified by the IRS as a tax haven. \textit{TAX HAVENS, supra} note 4, at 177-78. \textsuperscript{85} \textit{SENATE COMM. ON FOREIGN RELATIONS, REPORT ON THE CONVENTION BETWEEN THE UNITED STATES AND TRINIDAD AND TOBAGO, S. Exec. REP. No. —, — Cong., — Sess. —, reprinted in 2 TAX TREATIES (CCH) ¶ 7656.} \textsuperscript{86} \textit{Id.} at —, 2 TAX TREATIES (CCH) ¶ 7656 at 7632. \textsuperscript{87} \textit{Id.} \textsuperscript{88} Protocol, Oct. 23, 1963, United States-Netherlands, 15 U.S.T. 1900, T.I.A.S. No. 5665, \textit{reprinted in 2 TAX TREATIES (CCH) ¶ 5832B. See supra text accompanying note 51.}
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affect the United States balance-of-payments position.\textsuperscript{89} With respect to the Trinidad and Tobago treaty, one of the goals was to limit the flow of funds out of the United States. The Senate Foreign Relations Committee had become very concerned about any provisions in United States income tax treaties which could draw significant amounts of funds away from the United States. As the Committee stated:

[T]his reservation [to exclude the tax incentive] will not preclude further consideration by the Committee and the Senate of the concept of providing investment tax incentives in bilateral agreements. It does, however, have the effect of putting the Administration on notice that such a concept will not be approved until our domestic and international economic and political situations show a marked improvement.\textsuperscript{90}

The Treasury Department was somewhat more explicit than the Senate Foreign Relations Committee concerning why Article 16 was included in the Trinidad and Tobago treaty. The brief description focused on the purpose of Article 16 as a means of preventing "the potential abuse which could occur if one of the States provided preferential rates of tax for investment or holding companies."\textsuperscript{91} This explanation does not, however, shed any light on why the Treasury Department believed it was necessary to begin including such articles in treaties negotiated in the 1970s. In any event, the inclusion of Article 16 in the United States-Trinidad and Tobago income tax treaty marked the beginning of a new era in the Department's approach to preventing treaty shopping.

B. Jamaica

One of the most recent developments resulting from the United States' efforts to incorporate anti-treaty shopping provisions in bilateral tax treaties is the new tax treaty with Jamaica signed on May 21, 1980.\textsuperscript{92} The limitation of benefits provision, included in the treaty as

\textsuperscript{89} The Senate Committee's contradictory positions regarding inclusion of Article 16 in these treaties highlights one of the fundamental problems involved in negotiating tax treaties. Because the treaties are used to implement fiscal policies as well as tax policies, a conflict may arise between the policy approaches of each area. While the Senate resolved the conflict in this case by favoring a consistent position on the balance-of-payments issue, it did so at the expense of a consistent tax policy.

\textsuperscript{90} Senate Comm. on Foreign Relations, supra note 86, at —, reprinted in 2 Tax Treaties (CCH) ¶ 7656 at 7632-33.

\textsuperscript{91} Technical Explanation by Treasury Department, reprinted in 2 Tax Treaties (CCH) ¶ 7655 at 7626-27.

Article 17,93 is the most restrictive the Treasury Department has ever included in an income tax treaty. Prior limitation provisions had focused on excluding benefits to third-country residents by limiting treaty benefits to those residents of a contracting state who met an ownership requirement. In the peculiar negative inference language used by the Treasury Department in the United States treaty with Trinidad and Tobago:

A corporation of one of the Contracting States... shall not be entitled to the benefits [of the treaty concerning dividends, interest or royalties] if—

(b) twenty-five percent or more of the capital of such corporation is held of record or is otherwise determined to be owned... by one or more persons who are not residents of the first-mentioned Contracting State.94

Article 17 of the Jamaica treaty significantly stiffens the test by raising the requisite ownership level to seventy-five percent or more. Article 17 states:

1. A person (other than an individual) which is a resident of a Contracting State shall not be entitled under this Convention to relief from taxation in the other Contracting State unless

   (a) more than 75 percent of the beneficial interest in such person is owned, directly or indirectly, by one or more individual residents of the first-mentioned Contracting State.95

The treaty with Jamaica clearly represents an attitude in the Treasury Department to "get tough" on the issue of treaty shopping. This new attitude, however, does not necessarily mean that the end of treaty shopping is near. Only two other treaties have been negotiated which include provisions as restrictive as Article 17 of the Jamaica treaty, and neither of these treaties has been ratified by the Senate.96 In

93 — U.S.T. —, T.I.A.S. No. 10206, reprinted in 2 Tax Treaties (CCH) at ¶ 4386Q.
94 United States-Trinidad and Tobago Convention, supra note 76, 22 U.S.T. at 180, T.I.A.S. No. 7047, reprinted in 2 Tax Treaties (CCH) ¶ 7608 at ¶ 7624.
95 United States-Jamaica Convention, supra note 93, — U.S.T. —, T.I.A.S. No. 10206, reprinted in 2 Tax Treaties (CCH) ¶ 4386 at 4386Q.

   (1) A person (other than an individual) which is a resident of one of the Contracting States shall not be entitled under this convention to relief from taxation in the other Contracting State unless:

   (a) more than 75 percent of the beneficial interest in such person (or in the case of a
addition, none of the countries subject to these strict provisions has been classified by the Treasury Department as a tax haven. Since treaty shopping involving non-tax haven countries is minimal, the effect of these new strict provisions on treaty shopping will be minimal.

These provisions do serve to signal tax haven countries that the Treasury Department has recognized the problem as significant and is willing to take actions to prevent it. The inclusion of the strict provisions also gave the Treasury Department an opportunity to refine the terms of the provision before attempting to include it in a treaty with a tax haven. It remains to be seen whether the Treasury Department will move quickly to capitalize on this experience and pressure a tax haven to accept a strict limitation of benefits provision.

VI. POLICY CONSIDERATIONS AND ANTI-TREATY SHOPPING PROPOSALS

Historically, the Treasury Department’s efforts to restrict treaty shopping have focused largely on the inclusion of anti-treaty shopping provisions in treaties. As shown previously, these efforts have been governed by a number of considerations including the political stability of treaty partners and the United States’ balance-of-payments position. Political and economic fluctuations have inhibited the Treasury Department in conducting international tax treaties, 28 J. of Tax’n 277 (1968). Addressing the issue of tax treaties with less developed countries, Surrey states: [Latin
ury Department's ability to develop a consistent policy regarding the emphasis to be placed on anti-treaty shopping efforts and the means to restrict treaty shopping once goals had been set. A noteworthy example of this inconsistency is the different approaches used in the Netherlands Antilles and Luxembourg treaties.\textsuperscript{101}

Having demonstrated the ineffectiveness of the Treasury Department's past approach to restricting treaty shopping, the second issue to be addressed is the effectiveness of the major anti-treaty shopping measures thus far proposed. Five methods for general prevention have been suggested.\textsuperscript{102} These approaches are: (1) termination of income tax treaties with tax havens; (2) source country taxation; (3) treaty provisions aimed at excluding certain entities (e.g. holding companies) from benefits under the treaty; (4) second withholding tax; and (5) legislative revisions of the Code.

A. Termination of Tax Treaties

In the most drastic of the alternatives proposed, the United States would terminate all present treaties with tax havens and refuse to sign future treaties with any existing or potential tax havens.\textsuperscript{103} Although this extreme remedy has many possible negative side effects, the Treasury Department adopted this approach in 1983 by announcing that it would cancel income tax treaties with eighteen former British colonies as of January 1, 1984.\textsuperscript{104}

Many tax haven countries have come to depend on the strong inflow of foreign investment as major factors in their economies. It can be argued that the United States never intended to provide through...
treaties the means by which these "financial industries" could flourish. Nevertheless, the existence of these industries and the dependence of many tax haven countries on these industries for their continued well being weigh against any United States action which would have a negative effect on their financial stability and economic development. Moreover, because many tax havens are undeveloped Latin American countries, the United States has been interested in encouraging their economic development as a means of improving United States export trade.\(^{105}\)

A recent example which has received widespread attention is the United States income tax treaty with the Netherlands Antilles.\(^{106}\) The United States has entered into negotiations with the Netherlands Antilles government to produce a new income tax treaty which will curtail much of the tax avoidance occurring under the present treaty. The Netherlands Antilles government, which estimates that it receives fifty million dollars each year from foreign investment activity, argues that a drastic tightening or termination of treaty provisions could severely damage the country, possibly leading to an overthrow of the government.\(^{107}\) While undoubtedly such claims are exaggerated, the Treasury Department must take into account the potential ramifications of termination. Since the Netherlands Antilles serves as a conduit both for extensive investment in the United States by foreign corporations, and for United States corporations raising capital abroad,\(^ {108}\) any political instability could have a severe negative impact on domestic financial operations.

Alternatively, restructuring or terminating the tax treaty with the Netherlands Antilles could serve as an example to other tax havens. If the United States does not take a firm position with a notorious tax haven such as the Netherlands Antilles, the governments of other tax havens may be less inclined to cooperate with the United States during treaty negotiations. Treaty shopping flourishes when there are significant differences among tax treaties; therefore the United States' failure to include strict limitation articles in treaties with even a few tax havens could severely hamper future efforts to restrict treaty shopping.

\(^{105}\) Surrey, supra note 100.

\(^{106}\) The Netherlands Antilles is ranked third by the IRS in terms of United States gross income paid to nonresident aliens and foreign corporations. Tax Havens, supra note 4, at 177. Its population, however, is only 245,000 and it has few natural resources. Fialka, supra note 18, at 1, col. 6.

\(^{107}\) Harold Henriquez, former tax commissioner of the Netherlands Antilles and its chief negotiator during the treaty talks, has cautioned that increased treaty restrictions could lead to a government overthrow by groups with "leftist sympathies." Fialka, supra note 18, at 1, col. 6.

\(^{108}\) Tax Havens, supra note 4.
While terminating the United States tax treaty with the Netherlands Antilles could have a major negative impact on the United States financial market, terminating a treaty with one of the minor havens should result in less severe ramifications. Terminating such a treaty could have a major impact on the tax haven, however, if it results in a decline of investments channelled through the country. The tax haven might, therefore, be more accommodating towards inclusion of some anti-abuse provisions in its treaty if it could still derive some benefit from being a party to the treaty.

B. Source Country Taxation

The tax treaties to which the United States is a party are designed to give the country where the taxpayer resides the primary right of taxation. Thus, if an investor resides in Luxembourg but receives her income in the form of dividends from a United States corporation, the United States-Luxembourg income tax treaty gives Luxembourg the first right of taxation. The investor receives a tax credit from the United States for any such tax paid.

Under the source country taxation proposal, the United States would have the first right of taxation in the above example. This would significantly reduce treaty shopping as income would be taxed under the regular rates in the source country (the United States) for that type of income, as opposed to the present low or nonexistent tax rates available in tax havens. The treaty would only affect the tax by providing a tax credit for residents of one contracting state paying tax in the other contracting state. Since lower tax rates would not be available under the treaty and the credit would only benefit residents, the incentive to abuse the treaty would be eliminated.

While this suggestion appears to be generally workable, one major hurdle to its adoption is the potential negative effect on the balance-of-payments position. If a treaty provision could affect investor decisions so as to increase the United States balance-of-payments deficit, there is

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110 I.R.C. § 164(a)(3) (1976) states:
   (a) GENERAL RULE—Except as otherwise provided in this section, the following taxes shall be allowed as a deduction for the taxable year within which paid or accrued:
   (3) State and local, and foreign, income, war profits, and excess profits taxes.
111 TAX HAVENS, supra note 4, at 171.
likely to be strong resistance to ratification of the treaty. The United States balance-of-payments deficit will tend to be increased to the extent that capital investment which flows from the treaty country into the United States is less than capital investment, made by United States investors, which flows from the treaty country to other parts of the world. In view of the present state of the United States economy, such a deficit would present a political liability which no administration would want to incur. Further, the continued existence of one or more tax havens with favorable tax treaties would defeat any changes made in other treaties, as investors would simply change the country through which they channel funds.

C. Exclusionary Treaty Articles

Suggestions in the area of exclusionary treaty articles generally center on improving the effectiveness of Article 16. As described above in the overviews of past and present versions of Article 16, attempts to improve its effectiveness have not met with great success. The proposals concentrate on increasing the necessary percentage of domestic ownership in a corporation and reducing the amount of passive income a company may receive while remaining eligible for treaty benefits. Changes in these variables continue to meet with some limited success, but it is now obvious the existence of an “Article 16” in a treaty is not sufficient to prevent third-country residents from taking advantage of the treaty. To the extent such an article will not conflict with other anti-abuse measures and can still provide a limiting effect, however, the United States should include it as part of a package approach to handling the problem.

D. Second Withholding Tax

The concept of a second withholding tax refers to a tax on payments of dividends or interest by a holding company to its shareholders. Also known as a tax on secondary liability payments, it was briefly considered earlier in the discussion of the differences between the Netherlands Antilles Protocol of 1963 and the United States-Luxembourg treaty. United States income tax treaties generally contain

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113 For an explanation of balance-of-payments accounting, see D. Eiteman & A. Stonehill, Multinational Business Finance 76-89 (3d ed. 1982).
114 See supra text accompanying note 54.
115 See supra text accompanying notes 69-98.
116 TAX HAVENS, supra note 4, at 171-72.
117 See supra text accompanying notes 42-56.
118 Id.
provisions in which the United States agrees not to impose a tax on dividends and interest paid to shareholders by a foreign corporation receiving United States source income. An agreement by the United States not to impose a tax on secondary liability is an important benefit to third-country residents taking advantage of a United States tax treaty, but does not provide any significant advantage to the residents of the tax haven. Residents of the tax haven will be taxed by their country on distributions by the holding company. Since third-country residents will not be taxed in either contracting state, their income can be effectively taxed only if the tax is imposed on the distribution before it reaches them. If the waiver of secondary liability tax provisions were removed from the treaties, treaty shopping could be inhibited.

A legislative approach suggested for partially dealing with this problem is the imposition of a withholding tax on the United States branch of a foreign corporation. According to the IRS, "a tax equal to the withholding tax imposed on fixed and determinable United States source income would be imposed on the branch when it remits income to its foreign office." The tax on United States source income could be determined relatively easily. In addition, the withholding tax would be administered by United States tax officials rather than foreign tax officials. Provisions could be made to waive this tax if the foreign country is not a tax haven; this waiver then would serve as an incentive for countries not to seek tax haven status.

E. Internal Revenue Code Revisions

The final major approach suggested for preventing treaty shopping

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119 In many cases the tax haven does impose a tax on dividends and interest paid by resident corporations of the tax haven to nonresident shareholders. In those cases where the tax haven imposes such a tax, usually at a very low rate, the United States does not have the right to impose a tax on the secondary liability. It is only when there is no second withholding tax that the waiver issue arises. See, e.g., PRICE WATERHOUSE, INFORMATION GUIDE: DOING BUSINESS IN THE NETHERLANDS ANTILLES 30 (Oct. 1979) ("[n]o withholding taxes on dividends and interest paid to foreign shareholders by a Netherlands Antilles corporation"); PRICE WATERHOUSE, INFORMATION GUIDE: DOING BUSINESS IN THE GRAND DUCHY OF LUXEMBOURG 64 (Mar. 1977) ("[H]olding companies do not deduct withholding tax on dividends or bond interest paid.").

120 The third-country resident already has limited the amount of United States tax he or she must pay on income by forming a corporation in a country party to a United States tax treaty, which country imposes a low rate of tax on passive income. In addition, the country imposes no tax on distributions by resident corporations to nonresident shareholders. If the United States agrees not to impose any secondary liability tax, the third-country resident is able to accept dividends from his or her foreign corporation without paying United States tax. See also supra text accompanying notes 7-12.

121 TAX HAVENS, supra note 4, at 176.

122 Id.
is to revise portions of the Code so as to provide less disparity between United States tax laws and certain provisions in the laws of tax havens. One proposal is to reduce the thirty percent rate imposed on passive income to foreign investors. The lower the tax rate, the less the incentive to avoid it. Proponents argue that the treaties generally reduce this rate anyway so that a reduction in the statutory rate is not a novel idea. Reduction of the statutory rate and elimination of treaty provisions which reduce that rate would place foreign investors on roughly the same footing regardless of their country of residence. Since all countries would be subject to the same rate, there could be no treaty shopping for a rate decrease. In fact, it has been suggested that if a country was deemed to be an undesirable tax haven in other respects, the tax rate could be set higher to serve as a disincentive for channeling funds through the haven. It seems unlikely, however, that it would be possible to fine tune tax rates by setting different rates for each country.

The disadvantages of legislative treatment of the problem arise from the limited flexibility in amending the Code as compared to the extensive flexibility in negotiating treaties. A better match between United States tax laws and the tax laws of a foreign country can be achieved if done through treaty negotiations rather than applying a statutory rate based on some average. In addition, Treasury Department negotiators can take into consideration other factors when negotiating a treaty which may affect the United States' willingness to match the foreign country's tax rates. This is the possible disincentive effect described above.

An anti-abuse section has been suggested as an addition to the Code. Such a section would permit the IRS to withhold treaty benefits when persons who were not intended to be beneficiaries of a treaty sought to take advantage of it. Also, it could permit the IRS to act on new forms of abuse not contemplated when the treaty was written. A section such as this, coupled with the new jurisdiction provided in Sec-

123 TAX HAVENS, supra note 4, at 175.
125 TAX HAVENS, supra note 4, at 175. For example, if the tax rate were set at 15% on United States source dividends, interest and royalties paid to nonresident aliens and foreign corporations, and the United States wanted to direct investment away from the Netherlands Antilles, the tax rate could be set at 30% for residents of that country.
126 See TAX HAVENS, supra note 4, at 175.
127 See supra note 125 and accompanying text.
128 See TAX HAVENS, supra note 4, at 176.
tion 7701(a),\textsuperscript{129} might be very effective, but it would significantly increase the cost of administering benefits under a treaty. In general, legislative approaches to the treaty shopping problem should be viewed cautiously; activity in the area of foreign relations should be left to the executive branch.

VII. Conclusion

Since the 1930s, the United States has entered into income tax treaties involving more than forty countries and fifteen territories. During that time, however, the United States has not developed an effective means to prevent third-country residents from abusing United States bilateral income tax treaties. The most significant development to date has been the “Investment or Holding Company” (or “Limitation of Benefits”) article included in many treaties. As was demonstrated earlier,\textsuperscript{130} this provision has had little success in preventing treaty shopping.

Recently, the concern about treaty shopping has increased as modern developments in the practice of international tax law have made the benefits of treaty shopping more available to sophisticated investors. This increased concern has prompted several suggestions as to techniques for curtailing treaty shopping, but none of these suggestions has yet emerged with a dominant backing.

Rather than choosing one technique to use in fighting treaty shopping, a more effective approach, and one with a higher chance of success, would be to combine several of the techniques. Thus, including a limitation of benefits article in each new treaty or supplementary agreement would permit the Treasury Department some flexibility in designing the terms of the article so as to be most effective when working in combination with the laws of each particular nation. Any provisions concerning enforcement should be enacted as legislative additions to the Code. This will provide greater uniformity in enforcement under the various treaties and supplemental agreements, and will allow Congress to maintain uniformity in the many Code enforcement provisions. Certainly the most important area in which to achieve this uniformity is in the applicable rate structures. Even a slight difference between treaty rates will serve as an incentive for investors to establish a resident corporation in the state with the most favorable rate.

Finally, an article should be added to every treaty now being ne-

\textsuperscript{129} I.R.C. § 7701(a) (1982) (enacted as part of TEFRA). \textit{See supra} note 14 and accompanying text.

\textsuperscript{130} \textit{See} text following note 42.
gotiated which designates what actions are to be taken when abuse is uncovered and allocates enforcement duties between the United States and its treaty partners. If the other contracting states share the risk of financial losses by allowing treaty shopping to continue, there will be an incentive for those states to cooperate with IRS agents in uncovering abuse. For example, disclosure laws in foreign states which would require corporations to reveal their percentage of foreign ownership (though not necessarily the names of those owners) with a provision for noncompliance, would be helpful.

While adoption of these recommendations alone will not ensure the abolition of treaty shopping activity, they will most likely diminish the chances of successful tax avoidance through treaty shopping and make the risks associated with failure so high that it will no longer be a recommended tax planning method. In the long run, this will accomplish the result sought by the IRS.

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