Vanderbilt Journal of Transnational Law

Volume 29
Issue 2 *March 1996*

Article 1

1996

The United States Policy of Stringent Anti-Treaty-Shopping Provisions: A Comparative Analysis

Simone M. Haug

VANDERBILT JOURNAL OF TRANSNATIONAL LAW

VOLUME 29 MARCH 1996 NUMBER 2

The United States Policy of Stringent Anti-Treaty-Shopping Provisions: A Comparative Analysis

*Simone M. Haug**

ABSTRACT

Tax avoidance through international treaty shopping has become a subject of intense controversy in the international community. By shrewdly structuring businesses, corporations are currently able to take advantage of tax exemptions contained in tax treaties, though the countries that have joined the treaties never intended for them to benefit from such provisions. Many nations, including the United States, view this practice as tax treaty abuse. In response to such abuses, many countries are now incorporating strict anti-treaty-shopping provisions in their bilateral tax treaties.

Ms. Haug begins the Article by describing the practice of treaty shopping and, specifically, the various methods of tax

* Ludwig-Maximilians-Universität, München. 1. State exam (1993); LL.M., Saint Louis University Law School (1994). Ms. Haug is currently a legal intern (Rechtsreferendarin) with the State of Bavaria and research assistant for Professor Klaus Vogel, Ludwig-Maximilians-Universität. An earlier version of this Article was presented to the law faculty of Saint Louis University. The author owes special thanks to Professor Nancy H. Kaufman for her generous advice on this Article. Further thanks belong to Professor Stanislaw Frankowski, Director of the Saint Louis University Law School LL.M. Program, the Saint Louis Law School faculty and staff, and Carsten Alting.

treaty abuse. She then examines the different approaches countries are taking to prevent such abuses. After assessing the utility and feasibility of countries' attempts to combat treaty shopping, the author concludes that, while strict anti-treaty-shopping provisions in bilateral treaties may be somewhat effective, the only way to truly control tax avoidance is to harmonize the international tax system. To achieve this goal, the author argues, countries must either increase their treaty networks or enter into a multilateral tax convention. Due to countries' concerns that such a convention would adversely affect their sovereignty, however, Ms. Haug is not optimistic that such a solution will come to fruition.

TABLE OF CONTENTS

I. INTRODUCTION

Over the last fifteen years, treaty shopping has become a highly sensitive problem in the context of tax avoidance and evasion. Intergovernmental organizations like the Organization for Economic Cooperation and Development (OECD)[1] and the United Nations (U.N.)[2] developed official commentaries on the

1. In 1963, the Fiscal Committee of the OECD published the first model treaty, which included commentaries providing explanations and interpretations of the model. *Double Taxation Convention on Income and Capital* (OECD Draft 1963) [hereinafter *1963 OECD Model Treaty*]. Neither the model treaty nor its commentaries contained any anti-abuse provisions. But with fundamental changes taking place in the sophistication of tax avoidance and evasion methods, as well as the performance of cross-border transactions, the OECD reacted by adopting the 1977 Model Convention and commentaries. *Model Double Taxation Convention on Income and on Capital* (OECD 1977) [hereinafter *1977 OECD Model Treaty*]. The commentaries on the 1977 OECD Model Treaty include some suggestions about how to deal with treaty shopping. This version was updated in 1992 by integrating into the commentaries extensive recommendations concerning anti-treaty-shopping provisions. *Model Tax Convention on Income and on Capital* (1992) (revised on Sept. 1, 1995) [hereinafter *1995 OECD Model Treaty*].

2. In 1980, the United Nations (U.N.) Ad Hoc Group of Experts on Tax Treaties Between the Developed and Developing Countries drafted its own model

topic. In addition, the United States inserted anti-treaty-shopping clauses into its model treaty and domestic law.[3] The practical solution to treaty shopping is the subject of many controversies among OECD member states, tax practitioners, and commentators.[4]

The term "treaty shopping" refers to the use of bilateral tax treaties by a resident of a nontreaty country to obtain treaty benefits that would not otherwise be available but for the interposition of an entity (*e.g.*, a corporation) into one of the treaty countries.[5] Treaty shopping emerged out of the inconsistencies among domestic international tax regimes worldwide and the increasing economic interdependence of world trade.

The United States is a leader in setting policies to prevent treaty shopping, not only in substantive treaty provisions, but also in domestic law.[6] Even prior to the 1977 and 1981 U.S. models, U.S. treaty policy was concerned with limiting treaty benefits.[7] The 1977 draft of the first official[8] U.S. model treaty[9]

---

tax treaty, primarily with concern for the well-being of developing countries. U.N. DEP'T OF INT'L ECONOMICS & SOCIAL AFFAIRS, MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES, U.N. Doc. ST/ESA/102, U.N. Sales No. E.80.XVI.3 (1980) [hereinafter U.N. MODEL CONVENTION]. The U.N. model treaty commentaries include relatively mild language against treaty shopping. In 1983, the U.N. Ad Hoc Group of Experts on International Co-Operation in Tax Matters expressed its concern about the increasingly popular practice of treaty shopping. *See International Co-Operation in Tax Matters, Report of the Ad Hoc Group of Experts on International Co-Operation in Tax Matters on the Work of its First Meeting*, U.N. Doc. ST/ESA/128, U.N. Sales No. E.83.XVI.1 (1983) [hereinafter International Co-Operation in Tax Matters]. In 1987, the Group produced a more detailed guideline relating to the abuse of tax treaties. U.N. DEP'T OF INT'L ECONOMIC AND SOCIAL AFFAIRS, CONTRIBUTION TO INTERNATIONAL CO-OPERATION ON TAX MATTERS at 5, U.N. Doc. ST/ESA/203, U.N. Sales No. E.88.XVI (1988) [hereinafter 1987 Ad Hoc Group].

3. Treasury Department's Model Income Tax Treaty, June 16, 1981, 1 Tax Treaties (CCH) ¶ 211 (1990) [hereinafter 1981 U.S. Model Treaty].

4. *See* Jonathan Schwarz, *Survey of World Taxation*, FIN. TIMES, May 20, 1994, at 2.

5. AMERICAN LAW INSTITUTE [A.L.I.], FEDERAL INCOME TAX PROJECT: INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION II 150 (1992).

6. *International Tax Evasion/Tax Treaty Issues: Hearing Before a Subcommittee of the Committee on Government Operations, House of Representatives*, 100th Cong., 1st Sess. 346 (1987) (statement of Alan Granwell, former International Tax Counsel of the U.S. Treasury Department) [hereinafter *1987 Hearing*].

7. H. David Rosenbloom, *Tax Treaty Abuse: Policies and Issues*, 15 L. & POL'Y INT'L BUS. 763, 779-810 (1983).

8. An unofficial model for internal reference for treaty negotiators, which was never published, was in use soon after the conclusion of the U.S.-U.K. treaty in 1945. KLAUS VOGEL ET AL., UNITED STATES INCOME TAX TREATIES 87 (1989).

9. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, May 17, 1977, 1 Tax Treaties (WGL) ¶ 1,019 (1990) [hereinafter 1977 U.S. Model Treaty]. The Treasury

limited treaty benefits applicable to dividends, interest, and royalties if "special measures" resulted in substantially less tax than was generally imposed and if foreign ownership equaled or exceeded twenty-five percent of the capital of the company.[10] The limitation-on-benefits article in the 1981 Model Treaty,[11] however, is more complex and stringent than its 1977 predecessor. It applies to all entities, not just corporations, and denies all treaty benefits, not just benefits relating to dividends, interest, and royalties, unless the entity satisfies specified requirements. Since 1981, a limitation-on-benefits article has been inserted into every newly negotiated or renegotiated U.S. tax treaty. These measures, however, were not deemed sufficient to combat treaty shopping, especially in connection with the changes to U.S domestic law made by the 1986 Tax Reform Act.[12] The United States enacted, as part of its domestic law, a safeguard against the possibility of obtaining treaty relief from the newly introduced branch profits tax by anyone other than a "qualified resident" of a treaty partner. This elaborate domestic anti-treaty-shopping law, however, was surpassed in its sophistication by the anti-abuse provisions in the recent treaties the United States has made with Germany, Mexico, and, in particular, the Netherlands.[13] This high level of sophistication has led some experts to complain about the complexity of the limitation-on-benefits articles contained in those tax treaties and those expected to be included in a new version of the U.S. Model Income Tax Treaty.[14]

The elaborate limitation-on-benefits provisions in U.S. treaties and domestic law have caused officials in other countries, as well as practitioners in the United States, to characterize U.S. officials as paranoid concerning the issue of treaty shopping. For

---

Department intended to establish a uniform starting point for U.S. treaty negotiations, while trying to adapt it, as much as it seemed adequate from a U.S. policy point of view, to the revised OECD model, *1977 OECD Model Treaty*, *supra* note 1, that was published in the same year. *International Tax Treaties: Hearing Before the Committee on Foreign Relations, United States Senate*, 96th Cong., 1st Sess. 103 (1979) [hereinafter *1979 Hearing*].

10. 1977 U.S. Model Treaty, *supra* note 9, art. 16.

11. 1981 U.S. Model Treaty, *supra* note 3.

12. Pub. L. No. 99-514, 100 Stat. 2085 (approved Oct. 22, 1986).

13. David H. Rosenbloom, *Toward a New Tax Treaty Policy for a New Decade*, 9 AM. J. TAX POL'Y 77, 77-94 (1991). *See also* U.S.-Germany Income Tax Treaty, *signed* Aug. 29, 1989, 2 Tax Treaties (WGL) ¶ 39,030; U.S.-Mexico Tax Treaty, *signed* Sept. 18, 1992, 2 Tax Treaties (WGL) ¶ 62,100; U.S.-Netherlands Income Tax Treaty, *signed* Dec. 18, 1992, 3 Tax Treaties (WGL); ¶ 66,030.

14. Stanford G. Ross, *U.S. International Tax Policy: Where Are We? Where Should We Be Going?*, 1990 TAX NOTES INT'L 781.

example, former International Tax Counsel, David Rosenbloom,[15] coined the expression that "anything worth doing is worth overdoing" when describing the U.S. attitude toward treaty shopping.[16]

This Article analyzes whether the complex, detailed, and often rigid measures taken by the United States to combat treaty shopping are appropriate or overzealous. Part II provides background on treaty shopping, demonstrating how treaty shopping can have a detrimental effect both on the source country and on the undistorted flow of international investment. Part III reviews the available countermeasures to treaty shopping and the factors affecting the anti-treaty-shopping measures taken by particular jurisdictions. Part IV, through comparative analysis, demonstrates that varying positions on the behavior, as well as ways of regulating it, largely depend on the historical and economic situation of the individual country involved. Part V examines treaty shopping and the available countermeasures from a global perspective, paying particular attention to the unique position of the United States. Part VI concludes by suggesting that the United States should reconsider its effort to completely eradicate treaty shopping in favor of measures that, in the long-term, could better contribute to efficiency and simplicity.

II. THE ABUSE OF SOURCE TAX RELIEF

Treaty shopping is often referred to as "treaty abuse" or "tax avoidance," however, it has long been regarded as a legitimate instrument of international tax planning.[17] There is a general understanding that taxpayers are free to structure their economic actions in ways they deem most beneficial so long as they do not go beyond a tolerable point.[18] At what point legitimate tax

---

15. Mr. Rosenbloom was the International Tax Counsel at the Treasury Department during the years 1977-1981.

16. *See* Rosenbloom, *supra* note 13, at 84.

17. Some practitioners still consider treaty shopping to be perfectly legitimate. *See* Helmut Becker, *Treaty Shopping—A German Approach*, J. STRATEGY INT'L TAX'N 191 (1985).

18. This rule applies within all Western constitutional democracies. One of the classical opinions on this issue can be found in the United Kingdom tax case of *Westminster v. C.I.R.*, 19 T.C. 490, 520 (U.K. 1905). In *Westminster*, the court stated: "Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Act is less than it otherwise would be." *See also, e.g.*, Bass v. Commissioner, 50 T.C. 595 (U.K. 1968); Judgment of April 14, 1959, Bundesverfassungsgericht [BVerfG] [federal constitutional court], 9 Entscheidungen des Bundesverfassungsgerichts [BVerfGE] 237, 249 (F.R.G. 1959); Judgment of June 10, 1981 Conseil d' Etat, 33 Dr. Fisc. comm. 2187 (reg. n. 19.079) (Fr. 1981).

planning ends and tax avoidance or abuse begins, however, is often a matter of interpretation.[19]

In the international context, a taxpayer will always seek to diminish worldwide tax liability. While this is also true for business activities conducted in a single jurisdiction, there seems to be a much higher level of awareness of the tax consequences in international transactions.[20] There are two underlying reasons for this phenomenon. First, a taxpayer considering an investment abroad must find out whether he or she will be subject to double taxation resulting from an overlap of concurring residence and source taxation.[21] For reasons of competitiveness, a taxpayer may be obliged to find means of avoiding double taxation. For example, the taxpayer might take advantage of the source tax relief granted by a tax treaty. Second, differences in the taxation of a certain type of income at diverging tax rates in the international community provide many more possibilities to reduce the overall tax burden than when a business is conducted in a single jurisdiction.[22] The international investor may be able to minimize tax liability by basing the business in a low-tax jurisdiction by routing the investment through other jurisdictions, or by modifying the form of the investment.

A. *Avoiding Double Taxation*

1. Double Taxation

Double taxation occurs when the same item of income is taxed more than once. It can arise in two forms: 1) directly, when a single taxpayer is doubly taxed, or 2) economically, when the same income is taxed twice—even though technically two distinct taxable entities exist. The imposition of more than one

---

19. As opposed to tax evasion, which identifies tax reduction by illegal means, tax avoidance is used to describe the reduction of tax liability by legal means. Tax avoidance, however, has pejorative overtones, especially in the context of artificial arrangements, loopholes, anomalies, or other deficiencies of tax law.

20. MILTON GRUNDI, THE WORLD OF TAX PLANNING 2 (1984).

21. For example, an investor from Singapore, a country that does not yet have a treaty with the United States, may get taxed thrice when doing business in the United States: first, when the investor's profits are taxed by the United States; second, when the investor pays the branch profits tax; and third, when the investor gets fully taxed by the investor's home country, which lacks a foreign tax credit. Salil Tripathie, *U.S.-Dutch Treaty Wipes Out Asian Firms' Tax Perks*, BUS. TIMES, July 6, 1992, at 1.

22. GRUNDI, *supra* note 20, at 2.

tax on the same income has its roots in the generally acknowledged principle that jurisdiction to tax is a function of national sovereignty.[23] No international concept or norm that prohibits double taxation exists. Therefore, under international law a state is permitted to tax foreign transactions as long as there is a sufficient nexus between the taxpayer and the taxing state. This nexus arises from either a territorial or personal link[24] to the taxing jurisdiction and gives the state the authority to tax the income of either an individual or a legal entity on the basis of source and residency.[25]

Under the source principle, a state has the right to tax the income derived from any activity of a taxpayer within its territorial scope, regardless of whether the earner of the income has any other connection with the state (*e.g.*, is a resident of that country).[26] Tax systems that emphasize source taxation base their tax claims on the geographic area from which the income originates.[27]

The principle of residency, on the other hand, permits a state to tax the worldwide income of any person that has a substantial connection to that taxing jurisdiction and thus qualifies as a resident under the laws of that state.[28] Consequently, tax systems that favor residence taxation base their tax claims primarily on the personal connection of the taxpayer to the country.[29]

Having complete sovereignty to create a tax system, a state will adjust these principles to its needs and combine them under a consideration of its economic and political realities. Generally, a capital exporting country will emphasize the residence based taxation, whereas a capital importing country will favor a higher tax base under the source principle. As a consequence of these

---

23. VOGEL ET AL., *supra* note 8, at 17.

24. DAVID WILLIAMS, TRENDS IN INTERNATIONAL TAXATION 103 (1991).

25. Tax jurisdiction may be asserted under the principle of nationality, which is very controversial and has only been adopted by the United States and the Philippines—the latter following the U.S. pattern. Both countries tax citizens on their worldwide income, regardless of their residency. U.N. CENTER ON TRANSNAT'L CORP., INT'L INCOME TAXATION AND DEVELOPING COUNTRIES 9, U.N. Doc. ST/CTC/56, U.N. Sales No. E. 88. II.A.6 (1988); *see also* Richard D. Pomp, *The Experience of the Philippines in Taxing its Nonresident Citizens*, 17 N.Y. U.J. INT'L L. & POL. 245 (1985).

26. Mimi E. Gild, *Tax Treaty Shopping: Changes to the U.S. Approach to Limitation on Benefits Provisions in Developing Country Treaties*, 30 VA. J. INT'L L. 553, 555 (1990).

27. Yitzhak Hadari, *Tax Treaties and Their Role in the Financial Planning of the Multinational Enterprise*, 20 AM. J. COMP. L. 111, 115 (1979).

28. Robert A. Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 CORNELL L. REV. 18 (1993).

29. Hadari, *supra* note 27, at 115.

principles, more than one state can have concurrent jurisdiction over the same income creating an overlap, which leads to double taxation.[30] This overlap is likely to generate an excessive tax burden on the taxpayer. From a global view, the excessive tax burden may inhibit the free exchange of goods and services and thus may have a negative effect on the development of international capital flows.[31]

2. Avoiding Double Taxation

To remedy double taxation's detrimental effects, most developed countries seek to unilaterally[32] reduce or eliminate double taxation of their resident taxpayers by providing for a foreign tax credit or an exemption of foreign source income from tax.[33] Under the foreign tax credit method, double taxation is alleviated by allowing the taxpayer to offset the tax on foreign source income in the amount of foreign tax imposed on this income.[34] The credit for foreign income taxes, however, is limited to the effective tax rate of the country of residence. In contrast, the exemption system excludes foreign source income from the tax base in the case of dividends received by a parent corporation from a foreign subsidiary or income earned by foreign branches of resident corporations.[35]

---

30. Gild, *supra* note 26, at 556.

31. There are conflicts other than the source-residence conflict that can give rise to double taxation (*e.g.*, source-source or residence-residence conflicts). A source-source conflict may arise when two countries claim to be the source of one transaction. A residence-residence conflict may emerge when two countries emphasize primarily residence-based taxation and both consider themselves to be the "personal link" jurisdiction. *See, e.g.*, De Beers Consolidated Mines, Ltd. v. Howe, [1906] App. Case 455 (appeal taken from T.C.). For a discussion of differences in the source rules adopted in various national laws, see Robert J. Patrick, *General Report*, 65(B) CAHIERS DE DROIT FISCAL INTERNATIONAL [C.D. FISC. INT'L] 15, 18-28 (General Report of Robert J. Patrick) (1980).

32. Until recently, the prevailing view was that the source country would have to alleviate double taxation. Recently, however, the principle was established that the source country has the primary right to tax the income earned within its borders. CHARLES E. MCLURE ET AL., INFLUENCE OF TAX DIFFERENTIALS ON INTERNATIONAL COMPETITIVENESS 117 (1990).

33. Nations utilizing foreign tax credits include: the United States, the United Kingdom, and Japan. Most European countries, however, use variations of the exemption method.

34. BORIS T. BITTKER & LAURENCE LOKKEN, FUNDAMENTALS OF INTERNATIONAL TAXATION ¶ 69-3 (2d ed. 1991).

35. A third option is the deduction method, which treats the foreign tax as a production cost of the foreign income and reduces the tax base by the amount of tax paid in the foreign country. The effect is a reduction, but not an elimination, of double taxation. *See* VOGEL ET AL., *supra* note 8, at 17.

Bilateral tax treaties, however, are the most effective means of removing tax barriers that hinder the free flow of capital and technical know-how in the international community. The alleviation of double or excessive taxation is achieved either by giving exclusive tax jurisdiction over a certain type of income to one of the treaty countries or by allocating portions of the revenue between the two states. Generally, in treaties between two developed countries, the source country yields its right to tax the domestic income earned by the residents of the other country and reciprocally obtains the same right for its own residents. Through this system of reciprocity, an approximately neutral revenue effect may be achieved.[36]

However, not all states maintain treaty relationships with each other. As a result, an investor whose country does not have a treaty with the country in which the investor wants to do business is likely to use other countries' treaties in order to obtain source tax relief.

B. *The Incentive for Abuse—Tax Policy Considerations*

The opportunity for taxpayers to take advantage of source tax relief granted by the existence of a treaty arises from the dissimilarities among domestic international tax systems. These dissimilarities are exacerbated when states seek to gain an advantage by creating a favorable tax environment in order to attract foreign capital.

While the location of direct investment[37] is partly restricted by such factors as work-force quality, production costs, and infrastructure,[38] growing internationalization is creating greater mobility of persons and products. The growing mobility of capital coupled with the flexibility to choose a multinational's organizational structure may lead to an increasing influence of tax differentials in the determination of investment location.[39] As the economic integration of the world economy proceeds and the nontax barriers to cross-border investment vanish with growing

---

36. In tax treaties between developing and developed countries, the source country generally waives its jurisdiction over certain items of income or lowers the tax rate on the income, and the residence country compensates its residents for double taxation by granting a tax credit or an exemption. Thus, existing trade imbalances will be leveled out with respect to the levied tax and the revenue is more or less apportioned between the fiscalities. *See* A.L.I., *supra* note 5, at 10.

37. Direct investment is equity investment in real estate and service corporations; whereas portfolio investment means the diversified holdings of securities of enterprises of various types by an individual or institution.

38. MCLURE ET AL., *supra* note 32, at 43.

39. *Id.*

internationalization, investment decisions are increasingly influenced by tax considerations.

1. Intergovernmental Tax Competition

Governments, aware of the mobility of investment capital, engage in international tax competition. They seek to make their own countries as favorable for investment as possible in order to enhance economic growth and promote employment. In this context, two types of countries are to be distinguished: (1) those having a genuine tax system providing tax incentives to some distinguishable items or persons, and (2) those selling themselves and their services to persons trying to escape tax.[40]

Since investment decisions are made in an effort to maximize net profit after tax, an international investor will structure his or her business in order to achieve that goal, even if the resulting structure does not make sense economically for pre-tax profits. If a country provides tax privileges to a certain legal entity, or for certain forms of income, the incentive to take advantage of this special treatment will certainly affect investment decisions.

Although most of these countries otherwise have genuine tax systems, their policies of attracting investment provide fertile ground for artificial business arrangements, whose only purpose is to avoid taxation. Artificial structures take advantage of the fact that some countries,[41] provide favorable conditions for foreign investment by maintaining different tax treatment for various types of income. Such countries do not regard anti-abuse clauses in their tax treaties as crucial.[42]

---

40. WILLIAMS, *supra* note 24, at 35. States that are regarded as favorable locations for intermediary entities can be differentiated as follows: (1) states that have no or a very low income tax in general (*e.g.*, Bermuda and the Bahamas); (2) states that have no or a very low income tax with regard to a certain type of entity, like holding corporations (*e.g.*, Switzerland, Lichtenstein, and Luxembourg); and (3) states that assert taxation solely on the territoriality principle and, therefore, have no income tax on foreign source income (*e.g.*, Panama, Venezuela, and Liberia). *See* VOLKER KLUGE, DAS DEUTSCHE INTERNATIONALE STEUERRECHT 133 (3d ed. 1992).

41. For example, Luxembourg, which may for some purposes be considered a tax haven, is a high tax country of residence having a nominal tax rate of 57% of corporate tax, including business, wealth, local, and church tax. Luxembourg proves that a country that is a tax haven in some circumstances may be a high tax country in others. COMMERCE CLEARING HOUSE INT'L, 1990 INTERNATIONAL TAX HANDBOOK (1990).

42. Organization for Economic Co-Operation and Development, *Double Taxation Conventions and the Use of Conduit Companies*, *in* ISSUES IN INTERNATIONAL TAXATION, TAX AVOIDANCE AND EVASION 87, 102 (1987) [hereinafter 1987 OECD Report].

2. Differences in Bilateral Tax Treaties

The absence of a tax treaty between an investor's country of residence and the host country may induce the investor to structure the investment through a country that does have a treaty with the host country. Likewise, even where an investor's country of residence has a treaty with the host country, the investor may be able to achieve a better advantage through a different treaty.[43] In the context of bilateral tax conventions, each treaty is negotiated on a country-by-country basis and therefore different benefits are accorded to the residents of various treaty partners. The withholding rates applicable to interest, dividends, and royalties are subject to a wide range of diversity.[44]

The disparity among tax treaties provides an incentive for international investors to use the most beneficial treaty for their transactions. Thus, it is not only the absence of a tax treaty that promotes treaty shopping, but also differences in tax relief that constitute a major incentive for the use of other countries' tax treaties.

C. *The Occurrence of Treaty Shopping*

1. Development of the Treaty Shopping Concept

It is clear that the lack of conformity in domestic and conventional international tax rules provides fertile ground for extensive international tax planning. Tax planning in connection with income tax conventions is widely referred to as "treaty shopping," a term coined in the United States as a variation of the term "forum shopping" used in U.S. civil procedure.[45]

a. Definition

Treaty shopping occurs when a taxpayer, residing in a third country, takes advantage of the benefits of a treaty that would not normally be available to the taxpayer. The treaty shopper does so

---

43. 1987 Ad Hoc Group, *supra* note 2.

44. For example, U.S. treaties contain provisions reducing the interest tax rate from the statutory 30% withholding to 15% (Canada), 10% (Australia), 5% (Switzerland), and zero (Germany, France, the United Kingdom, etc.). Similarly, source tax reductions differ in German income tax treaties: the interest rates range from 25% (Thailand), 20% (Pakistan), 15% (Malaysia), 12.5% (Jamaica), 10% (Greece) to zero (France, the United States, etc.).

45. DELOITTE HASKINS & SELLS INTERNATIONAL, TREATY SHOPPING: AN EMERGING TAX ISSUE AND ITS PRESENT STATUS IN VARIOUS COUNTRIES 2 (Helmut Becker & Felix J. Warm eds., 1988) [hereinafter TREATY SHOPPING].

by creating a corporation in a country that has a favorable tax treaty with the target country.[46] In other words, treaty shopping is the practice of rerouting income through one or more artificial entities in different countries for the main or sole purpose of obtaining treaty benefits that are not directly available to the true earner of income.[47] From the United States and OECD points of view, treaty shopping occurs when a third country resident takes advantage of a bilateral treaty that is intended to benefit only residents of the contracting states.[48] In other countries, however, the term may be used more broadly, not necessarily involving a triangular arrangement.[49]

b. The Basic Situations

The Commentaries on the 1995 OECD Model Convention mention two principal means by which treaty benefits may be obtained: (1) the direct conduit method and (2) the stepping stone structure.[50] The direct conduit method is a way of shifting income through an interposed corporation in a country that has an advantageous tax treaty. For example, assume countries A and B have entered into a tax treaty that entitles their residents, including companies organized under their laws, to benefits with regard to income derived from the other country. Country C has no or a less favorable treaty with country A, but does have a favorable treaty with country B. When a resident of country C forms a corporation in country B, this conduit company,[51] being a resident of country B, is entitled to benefits under the bilateral A-B treaty. In addition, the income of the conduit company enjoys a special tax exemption under the domestic laws of country B (*e.g.*, a branch exemption in a parent-subsidiary relationship). The conduit company is thereby able to distribute its profits to the resident of country C under beneficial circumstances.[52]

---

46. *Id.* at 289.

47. 1987 Ad Hoc Group, *supra* note 2, at 2.

48. *See* 1995 OECD Model Treaty, *supra* note 1, para 22 (Commentary); *see also infra* note 149-50 and American Law Institute, *supra* note 4, at 150.

49. *International Tax Glossary*, 42 BULL. FOR INT'L FISCAL DOCUMENTATION [BIFD] 274, 276 (1988). *See also infra* note 174; *supra* note 65.

50. *1995 OECD Model Treaty*, *supra* note 1. However, the basic structures are thoroughly explained in an earlier report. 1987 OECD Report, *supra* note 42, at 88.

51. A company is considered a conduit when it pays out an amount of interest and royalties that is at least 90% of the amount of interest and royalties it receives.

52. *1987 OECD Report*, *supra* note 42, at 88.

The stepping-stone structure is similar to the direct conduit method. The difference is that the corporation in country B, a high tax country, is fully subject to tax and thus must pay tax on its interest, dividend, and royalty income. Since expenses are deductible in country B, however, the corporation avoids having substantial net income by paying out large amounts of interest, commissions, service fees, and similar expenses to a related company in a low-tax jurisdiction (*e.g.*, country C). The income from country A is thereby channeled from country A to country C at almost no tax cost due to the tax treaty between the high-tax countries, A and B, and the base reduction practiced by the conduit company in country B.[53]

The essential difference between the direct conduit method and the stepping stone is that the direct conduit makes use of an exemption from tax in the intermediary country, while the stepping stone reduces the tax liability in the intermediary country by means of a counterbalancing expense.[54] Stepping stone companies profit from three important elements: (1) the stepping stone company can deduct all of its expenses against its receipts; (2) the stepping stone country does not impose a significant withholding tax on the outbound payments; and (3) the stepping stone company's receipts must be received free of host-country withholding tax (or subject to significantly reduced withholding tax) by virtue of an existing tax treaty.[55]

As these examples illustrate, there are a great variety of arrangements that can yield tax treaty benefits.[56] There is the

---

53. *Id.*

54. 1987 Ad Hoc Group, *supra* note 2, at 4.

55. GRUNDI, *supra* note 20, at 72.

56. The following paragraphs offer examples that are not considered treaty shopping under the strict definition, which would require the use of a tax treaty by a third-country investor. They are, however, regarded as treaty shopping in the respective countries.

There are two structures principally used by U.S. investors to exploit peculiarities of the Dutch and German tax systems. The "Same Country Holding" takes advantage of a provision that exempts from tax dividends and capital gains received from an affiliated Netherlands company when the Netherlands parent company holds at least 5% of the shares. *See* TREATY SHOPPING, *supra* note 45, at 12. Dutch treaties, however, require a participation in a Netherlands company of at least 25% in order for a foreign person to be eligible for full or partial refund of Netherlands withholding tax under the treaty. *Id.* Investors, therefore, who cannot directly attain the 25% participation requirement will form a wholly owned Netherlands corporation, which in turn invests in another Netherlands company. The interposed company is exempt from tax under the participation exemption and at the same time qualifies for treaty benefits. *Id.*

A "Quintet Structure" is often used in connection with German treaties because Germany suspends treaty benefits for a foreign investor holding more than 25% of a German corporation. In order to avoid this, a foreign company will form five subsidiaries under the law of the treaty country, each subsidiary holding potential to channel funds tax-free or tax-reduced through several intermediary countries by using different forms of interposed entities (*e.g.*, partnerships, trusts, etc.).[57] The income involved may change its character several times during the transfer (*e.g.*, from dividend to interest income, or vice versa).[58]

The described treaty shopping structures have three common characteristics. First, the beneficial owner or owners of the treaty shopping entity are not residents of the country where the entity is created. Second, little, if any, real economic contact with or presence in the jurisdiction of the interposed entity exists. Finally, either the legal entities or the income involved is subject to little or no tax in the treaty jurisdiction of their residence.[59]

2. Treaty Shopping as a Tax Planning Instrument

Generally, treaty shopping situations arise in circumstances where a treaty partner imposes low tax on its residents or special classes of residents. For example, holding companies may pay no taxes on certain classes of income and, in addition, may have no withholding tax on the payment of income to nonresidents.[60]

a. Definition and Function of Base and Conduit Companies

"Base companies" and "conduit companies" are both classical instruments established for the sole or predominant purpose of

---

less than 25% of the German corporation, thus avoiding suspension of treaty benefits. Becker, *supra* note 17, at 193.

57. Until the termination of the U.S.-Antilles treaty, U.S. persons with illegal money would use a highly sophisticated system that began with the creation of a trust account in Antigua to launder. Treasury Department News Release B-1033 followed by Treasury Department News Release B-1046 at 80. This trust fund was then used to invest in a holding company in the Cayman Islands with bearer shares, which in turn capitalized an Antilles company. The latter then reinvested in a U.S. corporation, thereby returning the money to its U.S. source, laundered and almost untraceable. However, this example does not constitute treaty shopping under the strict definition because the U.S. resident would be eligible for treaty benefits. *See* RICHARD A. GORDON, TAX HAVENS AND THEIR USE BY U.S. TAXPAYERS—AN OVERVIEW, A REPORT TO THE COMMISSIONER OF INTERNAL REVENUE BY THE ASSISTANT ATTORNEY GENERAL (TAX DIVISION) AND THE ASSISTANT SECRETARY OF THE TREASURY (TAX POLICY), (1981) [hereinafter GORDON REPORT].

58. Converting the character of the income might be very useful in circumstances where a back-to-back loan is not possible because of special domestic tax provisions (*e.g.*, arms-length or thin capitalization provisions). Interest from the source country might be accumulated in a tax haven branch and then paid out as a dividend, which, under many systems, is exempt from tax.

59. A.L.I., *supra* note 5, at 151.

60. *1987 Hearing*, *supra* note 6, at 352.

tax minimization. By making use of tax advantages granted by a certain country, these intermediary entities generally reside in jurisdictions having extensive treaty networks, often no-tax or low-tax jurisdictions, or a jurisdiction with special treatment of certain types of entities or income. A base company is a company through which certain activities are carried out on behalf of related companies in high-tax countries.[61] A base company seeks to minimize tax in the country of residence—the country in which the investor actually resides, while the main function of the conduit company is to serve as a pass-through entity that redistributes the income it receives from a related company in one country to its shareholders in another country.[62] The conduit company seeks to obtain tax advantages in the source country—the country in which the economic substance of the investment is located. In most cases, the same structure can be used to achieve both objectives.[63] In either case, the interposed entity will seek to minimize tax. Thus, many treaty shopping entities can be regarded as both base companies and conduit companies, depending upon which of the companies' transactions are involved.

b. Government Response to Treaty Shopping

Most members of the OECD, including the United States, regard treaty shopping principally as a means of reducing source-based taxation, solely affecting the source country.[64] Other forms of tax avoidance (*i.e.*, the reduction of residence taxation through the use of base companies) are considered to be subject to domestic rules for determining which facts give rise to tax liability.[65] For the United States, this position is easy to

---

61. *International Tax Glossary*, *supra* note 49, at 25.

62. *Id.* at 57.

63. 1987 OECD Report, *supra* note 42.

64. David H. Rosenbloom, *Derivative Benefits: Emerging U.S. Treaty Policy*, 2 INTERTAX 83 (1994). *See infra* note 174.

65. 1995 OECD Model Treaty, *supra* note 1, para. 22. Utilization of "subpart F type" provisions, transfer pricing, or substance-over-form provisions may provide ways of dealing with abusive treaty-based tax avoidance. Subpart F provisions are named after the pattern set by §§ 951-64 in subpart F of the U.S. Internal Revenue Code (I.R.C.). These provisions are designed to frustrate the manipulative use of controlled foreign corporations by U.S. persons to minimize federal income tax. Subpart F treats the earnings of such a corporation as if the ratable share of the earnings generated overseas had been distributed to the U.S. shareholders. I.R.C. §§ 951-964 (1988).

The term "transfer pricing" refers to the determination of prices to be charged, especially within a multinational enterprise for transactions between various group members. Since these prices are not freely negotiated, and thus may deviate from prices agreed upon by nonassociated trading partners, they lead to a maintain by inserting a specific savings clause in each of its treaties. The savings clause restricts the personal scope of the treaty and preserves the right of the United States to tax its citizens and corporations independently of the treaty. For countries that do not use a savings clause, the anti-base-company legislation may have treaty implications.[66]

c. Nature of Intermediary Entities

An important aspect of treaty shopping is the nature and degree of the activity performed in the interposed entity.[67] Some companies function merely as "shell" companies, having no staff or business operations. These are often managed by unrelated local trust companies. Others, in comparison, constitute the regional centers for multinational enterprises formed for the purpose of centralizing banking or insurance activities for the whole group. There is no consensus, however, as to what degree of activity an interposed entity must undertake in order not to be considered a base or conduit company. Depending on which tax expert is consulted, a treaty shopping entity can range from a letter-box company[68] to a holding company with extensive management functions.[69] The decisive element for its characterization as a treaty shopping entity is the motive of its creation—whether the entity has largely[70] or solely[71] been established for reasons of tax minimization. Though the creator's true motive is often difficult to determine, the degree of activity of an

---

particular tax issue in cross-border transactions. This occurs because the tax authorities would like to adjust these prices to at-arm's-length prices. Several tools have evolved for achieving this purpose (*e.g.*, cost-based methods).

66. 1987 OECD Report, *supra* note 42, at 71.

67. The nature and degree of the activity performed by the interposed entity is particularly relevant to the discussion of anti-treaty-shopping measures. *See infra* notes 111-45, 226-48 and accompanying text.

68. A letter-box company is a company that has only complied with the bare essentials for organization (incorporation and registration) in a particular country without having an office, business assets, or employees in that country. Such a company only has an address (often a bank or an attorney) to which the mail can be directed. The actual commercial activities are carried on in another country.

69. KORMANN, DIE STEUERPOLITIK DER INTERNATIONALEN UNTERNEHMUNG 218 (2d ed. 1970).

70. *Id.* at 215.

71. According to Volker Kluge, an abusive intent should not be presumed when a multinational decides, for economic reasons, to centralize its participation in several countries in a single subsidiary, which then is located in a low-tax country. KLUGE, *supra* note 40, at 135.

interposed entity can certainly serve as evidence of the creator's intent, although it is not conclusive.

Another indicator of tax avoidance may be the nature of the entity. While production companies are not likely to be set up for purposes of tax avoidance, companies created for holding,[72] financing,[73] and licensing[74] are classic planning options, functioning as intermediary entities without an economic interest in their countries of residence.

---

72. For example, under prior law, a Japanese multinational could set up a Dutch holding company that had the function of holding the shares of the parent's subsidiary in the United States. The Dutch holding company, completely passive in nature, would be established for the sole purpose of reducing taxes on dividends and capital gains. Under this arrangement, dividend payments received from the U.S. subsidiary by the Dutch holding company could be reduced to 5% under the U.S.-Netherlands treaty then in effect. 1947 U.S.-Netherlands Treaty, 2 Tax Treaties (CCH) ¶ 6258. In addition, the dividends could be accumulated tax free in the Dutch holding company due to the participation exemption under Dutch law, and then reinvested to buy other assets of the same kind. The Netherlands and the United States, however, have since concluded a new treaty under which the Japanese multinational's holding company would not likely be eligible for a reduced withholding rate. U.S.-Netherlands Income Tax Treaty, *signed* Dec. 18, 1992, art. 26, 2 Tax Treaties (CCH) ¶ 6103 (entered into force Dec. 31, 1993).

73. Finance companies could be structured basically in the same way as holding companies, except that the Dutch intermediary would provide debt capital to the U.S. subsidiary, which the Netherlands corporation had in turn received from its Japanese parent. By means of this back-to-back loan arrangement—a minimum spread of 12.5 basis points—the U.S. subsidiary could enter into a debtor-creditor relationship with its parent in Japan through a completely passive intermediary. (The Netherlands has a rule comparable to the U.S. transfer pricing rules under § 482 of the I.R.C. However, they apply a far lower standard than the United States, deeming 12.5 basis points sufficient. This results in a difference between 10 and 9.875% on a back-to-back loan). A somewhat different type of finance subsidiary might have held the Japanese multinational's participation in North America and Europe. The Dutch finance subsidiary could operate as the financial center for all of the intragroup financial relationships within these geographic regions. The Dutch finance subsidiary could issue loans and provide banking activities for the group by means of a fully equipped staff that managed its operations. It is doubtful that companies of this kind would be regarded as base or conduit companies. The place of effective management would usually be situated in the country where the base company was incorporated. *See* Joseph C. Amico, *Planning Under Article 26 of the 1992 U.S.-Netherlands Tax Treaty*, 6 TAX NOTES INT'L 1333 (1993).

74. For example, assume that the Japanese multinational developed a new product, patented in favor of the Dutch licensing company. The Dutch licensing company would license to the whole group of subsidiaries and function as the pivot for the licensing operations with respect to North America and Europe.

d. The Evolving Practice of Treaty Shopping

Until recently,[75] one of the most common types of conduit structures involved the Netherlands as a base country for conduit companies, either alone or in connection with the Netherlands Antilles.[76] The Netherlands, despite having a normal tax rate structure,[77] makes an ideal host country for multinationals seeking to reduce withholding tax at source and minimize tax in the country of residence, while paying as little tax in the Netherlands as possible. The advantage of the Netherlands is its extensive treaty network[78] combined with its flexible, narrow tax base, especially relating to specific income items such as dividends, capital gains, interest, and royalties.

For example, under Netherlands domestic legislation, if a Netherlands company holds at least five percent of the shares of another Netherlands company, the dividends and capital gains are exempt from tax.[79] Furthermore, interest and royalties are deductible and may narrow the tax base by means of earnings-stripping.[80] Finally, income attributable to an offshore branch of a Dutch company is exempt from Netherlands tax (branch exemption) because the Netherlands uses the exemption method

---

75. The new U.S.-Netherlands tax treaty, which replaced the existing treaty signed in 1948, includes such a complex and complicated limitation-on-benefits clause. U.S.-Netherlands Income Tax Treaty, *signed* Dec. 18, 1992, art. 26, 2 Tax Treaties (CCH) ¶ 6103 (entered into force Dec. 31, 1993). Under that clause, third country users will basically have no chance to engage in treaty shopping with the Netherlands as a base country. However, it still leaves the possibility for U.S. residents to treaty shop by using the Dutch connection. Amico, *supra* note 73.

76. When focusing on dividend payments, the Netherlands received a major part of the payments ($332 million), compared to dividends paid to Germany ($124 million), France ($213 million), and Japan ($63 million), a fact that is related to the status of the Netherlands as the most important host country for multinationals. GORDON REPORT, *supra* note 57, at 177. The Netherlands is surpassed only by Switzerland, which in respect to dividend payments to tax haven countries is at the top with $984 million. *Id.*

77. The Netherlands has a tax rate on corporations of 35% and a top rate for individuals of 60%. Adrian J.M. Timmermans, *General Report*, *in* CAHIERS DE DROIT FISCAL INTERNATIONAL, INTERPRETATION OF DOUBLE TAXATION CONVENTIONS 439 (1993) [hereinafter DOUBLE TAXATION CONVENTION]. In order to be considered a tax haven, a country's tax rates must be 5% or less. *Id.*

78. As of October 1992, the Netherlands had active treaties with 46 countries. *Id.* An additional three treaties had been concluded, but were not yet in force. *Id.* With three other countries, the Netherlands had fiscal agreements and an additional two needed to be ratified. *Id.*

79. *Id.*

80. *Id.*

rather than the credit method to alleviate double taxation.[81] These provisions made the Netherlands an excellent place for reducing international taxation and were used for investment in the United States on a wide scale until the renegotiation of the U.S.-Netherlands treaty in 1993.

Focusing on the United States treaty network, it appears that a large part of foreign direct and portfolio investment in the United States and U.S. companies' access to foreign capital markets[82] historically were regularly structured through tax haven jurisdictions. Although the United States never negotiated any treaties with tax havens, such treaty relationships did develop by extension of certain U.S. treaties to dependencies of U.S. treaty partners.[83] Some of those former dependencies built their entire legal frameworks on the exploitation of the treaty network acquired through the earlier colonial relationship.[84]

Probably the most widely utilized treaty relationship, both by third-country users and U.S.-based multinationals seeking access to the Eurobond market, was with the Netherlands and the Netherlands Antilles.[85] For decades[86] one of the most popular

---

81. The requirements of the exemption were satisfied when the branch had "some" tax levied on it. Dutch law exempts profits if the resident corporation's foreign branch has been "subject to tax," regardless of the rate. Amico, *supra* note 73.

82. Prior to the Deficit Reduction Act of 1984, Pub. L. 98-369, 98 Stat. 494 (1984), the 30% withholding tax on gross payments of portfolio interest constituted a barrier to entering the Eurobond market.

83. By 1983, more than 21 tax treaties with dependencies were terminated. The only treaty renegotiated has been the one with Barbados. 1 Tax Treaties (CCH) ¶ 1103.

84. Examples are the Netherlands Antilles and the Cayman Islands.

85. See *supra* note 77-81 and accompanying text regarding the economic importance of transactions structured over the Netherlands Antilles.

86. Even if the use of the Antilles to get access to the Eurobond market may not be regarded as treaty shopping in a pure legal sense, economically it had the same effect. As opposed to the usual definition of treaty shopping, where a third-country user takes advantage of a treaty to which the user's country of residence is not a party, the "beneficial owner" of the purported treaty shopping entity, a U.S. resident, would have been entitled to treaty benefits under the provisions of the U.S.-Antilles treaty. 1955 Protocol, 2 Tax Treaties (CCH) ¶ 6236. However, this unusual structure was due to a peculiarity of the Eurobond market.

The Eurobond market is tax free to the lender, with the result that the payor pays tax on the payee's income. The U.S. payor who wanted access to finance opportunities in the Eurobond market therefore would have been obliged to pay 30% withholding tax under I.R.C. §§ 1441, 1442 on the payees' interest income. To circumvent this obligation, the U.S. payor established an entity on the Antilles that was not subject to withholding tax under the treaty since it satisfied the limitation-on-benefits provision. Legally, therefore, this phenomenon cannot be identified as treaty shopping. Economically, however, it had the same effect because, from the U.S. Treasury's point of view, third-country residents, as the recipients of the income, saved the tax. *See Tax Evasion Through the Netherlands* structures was the "Dutch sandwich," which involved a combination of tax base reduction and a tax haven. The term "Dutch sandwich" describes a chain of corporations linked together by a Netherlands corporation. For example, a foreign investor would create a Netherlands Antilles corporation, which in turn owned a Netherlands subsidiary, which in turn owned an Antilles creditor corporation. Channeling interest income received from a U.S. payor through those entities would enable the Antilles corporation and, finally, the third-country user to avoid U.S. withholding tax.[87] The less complicated structure of the "open-faced sandwich" involved an Antilles company that owned a Netherlands subsidiary, which in turn owned a U.S. corporation. This structure was widely used by foreign investors as a holding company structure for U.S. investments in order not to take advantage of the U.S.-Netherlands Antilles tax convention.[88]

Although, at present, many of those structures are no longer applicable to the United States, less developed countries tend not to bar third country users from obtaining treaty benefits. Less developed countries are more concerned about encouraging investment. For example, Cyprus offshore companies are still widely used for investing in Russia or other Eastern European countries.[89] This tax minimization structure certainly has assisted less developed countries in attracting investment by guaranteeing that an already risky return will not be burdened with tax.

Antilles and Other Tax Haven Countries: Hearing Before the Subcomm. of the Comm. on Government Operations, 98th Cong., 1st Sess. 22-29 (1983) [hereinafter *1983 Hearing*] (statement of William J. Anderson, Director of General Government Division).

87. RICHARD A. WESTIN, THE TAX LEXICON 158 (1989). *See also* Eugene L. Vogel et al., *Inward Investments in Securities and Direct Operations Through the British Virgin Islands: How Serious a Rival to the Netherlands Antilles Island Paradise*, 34 TAX L. REV. 321, 402 (1979).

88. "Interest on bonds, notes, debentures, securities, deposits or any other form of indebtedness (including interest from mortgages or bonds secured by real property) paid to a resident or corporation of one of the Contracting States shall be exempt from tax by the other Contracting State." U.S.-Netherlands Tax Convention, *signed* Jan. 1, 1947, art. VIII, 2 Tax Treaties (CCH) ¶ 6203 (extended by the protocol between the United States and the Netherlands to the Netherlands Antilles, effective on Nov. 10, 1955, 2 Tax Treaties (CCH) ¶ 6236).

89. Cyprus offshore companies with income from sources outside Cyprus pay only 4.25% tax, which is one tenth of the normal company rate. MARSHALL J. LANGER, PRACTICAL INTERNATIONAL TAX PLANNING 81-1 (3d ed. 1996).

3. Scope and Economic Impact

A high level of sophistication has been achieved in methods of profiting from existing tax treaties not directly available to the investor. The use of treaty shopping as a tax planning device has become so important that a computer system has been developed, containing a database of 185 countries' tax rates and provisions as well as over 800 international tax treaties.[90] The system shows tax advisers the most efficient way of repatriating profits and income from international transactions by exploiting the existing worldwide treaty network.[91]

Although treaty shopping practices may provide some insight into the scope of tax avoidance in the context of international tax planning, the apparent impact of the use of tax treaties on investment flows is startling. For example, in 1988, forty-two percent of foreign investment on the Madrid stock exchange came from the United Kingdom, in contrast to eighteen percent from Germany, fifteen percent from Switzerland, and eight percent from France.[92] Only five percent of the investment was held directly by U.S. investors.[93] Those figures seemingly characterize U.K. investors as the leading force on the Spanish market. It becomes apparent, however, that this data does not reflect the genuine investment position. The explanation is that there was no income tax treaty between the United States and Spain,[94] and therefore most of the investment flows from the United States and other overseas investors were channeled through London in order to take advantage of existing tax treaties. Similarly, the remarkable percentage of Swiss investment can be attributed to some German investment activities directed to Spain through Swiss corporations.

The Office of Tax Analysis at the U.S. Treasury Department released some interesting statistics about international

90. Clive Wolman, *Computer Guide to Tax Avoidance*, FIN. TIMES, Oct. 10, 1985, at 1. In one instance, the system was used to analyze a British company receiving interest income in the amount of 19.5 million British pounds from Brazil, Belgium, Italy, and South Korea. *Id.* The program concluded that the corporation could save 2.1 million British pounds by passing the income received from Brazil and Italy through a subsidiary set up in Germany, and the income from Belgium and South Korea through a Netherlands subsidiary. *Id.* The latter was then to be channeled through another Finnish company. *Id.* The system also pointed out several other possibilities that might not be as efficient, but might better fit the needs of a particular multinational. *Id.*

91. *Id.*

92. HANDELSBLATT, June 29, 1988, at 32 (F.R.G.).

93. *Id.*

94. The income tax treaty with Spain was signed on February 22, 1990, and entered into force in November 1990. U.S.-Spain Income Tax Treaty, *signed* Feb. 22, 1990, 3 Tax Treaties (CCH) ¶ 79,550.

investment behavior in the late 1970s, when treaty shopping was beginning to be recognized as a growing problem.[95] By comparing U.S. payments to foreign persons in 1977, one discovers several astonishing facts. The payments made to persons in the Netherlands Antilles ($160 million) exceeded payments made to persons in Germany ($115 million), a major trading partner of the United States.[96] Payments to Switzerland ($680 million) exceeded the payments made to all major industrialized countries such as the Netherlands ($347 million), France ($250 million), Germany ($115 million), and Japan ($135 million).[97] Obviously, these figures constitute a departure from the economic reality of the capital flows.

The discrepancy becomes even more apparent with respect to interest payments from the United States. Antilles residents received $127 million, whereas only $18 million was paid to residents of Germany, $102 million to residents of the United Kingdom, $51 million to residents of France, and $35 million to residents of the Netherlands.[98] Keeping in mind that the Netherlands Antilles is an island with no more than 250,000 inhabitants, it is clear that the major part of the interest received by investors resident in the Netherlands Antilles did not remain on that tiny island. In 1983, payments of all kinds of income to Antilles residents were $2.1 billion, which accounted for nineteen percent of the total U.S. payments to all countries in that year.[99] Interest payments to Antilles residents exceeded the sum of interest payments made to the residents of Canada, Germany, France, and the United Kingdom by some $120 million.[100] Of the total U.S. source based interest payments made to creditors around the world, 33.4% were made to residents of the Antilles.[101] In 1984, after the United States repealed the withholding tax on portfolio interest,[102] the interest payments to the Netherlands Antilles declined.[103] The United States repeal of its withholding tax on portfolio interest made the use of an Antilles intermediary for the receipt of interest unnecessary in most cases.

95. Marshall J. Langer, *Tax Treaties Creating Tax Haven Situations*, 11 TAX NOTES 667 (1980).
96. *Id.* at 668.
97. *Id.*
98. GORDON REPORT, *supra* note 57, at 177.
99. *1987 Hearing*, *supra* note 6, at 28.
100. *Id.* at 9.
101. *Id.* at 28.
102. *See* I.R.C. §§ 871(h), 881(c) (1994).
103. *1987 Hearing*, *supra* note 6, at 28.

D. *The Problems of Treaty Shopping*

These figures show the extent to which investment flows have been distorted for the purpose of saving taxes. It can be argued that it is not treaty shopping, but rather the dissimilarity of tax systems, the overlapping tax jurisdictions leading to double taxation, and intergovernmental tax competition that are primarily responsible for the distortion of the economic flows. Thus, the investor, in order to preserve competitiveness, must find ways to deal with the discontinuities among national tax regimes, and does so by using tax treaties to reduce source country tax. Since the main objective of tax treaties is to provide free flows of international trade and investment, some commentators argue that it does not matter whether the desirable result is achieved by the direct or indirect use of tax treaties. While this view may seem reasonable to investors, it does not take into account the interests of the source country.[104]

1. Revenue Loss

Treaty shopping results in tremendous revenue losses for the source country.[105] For example, in 1981, about $9.6 billion of U.S. source income was paid to foreign persons.[106] Out of that $9.6 billion, $6.5 billion, or sixty-eight percent, was received by persons residing in five countries: the Netherlands, Netherlands Antilles, the United Kingdom, Canada, and Switzerland.[107] Three of these five countries qualified as tax havens or quasi-tax-havens.[108] The Antilles residents received the most income, approximately $1.4 billion,[109] and had the least amount of tax withheld, about $26.6 million.[110] Netherlands residents received $1.339 billion, with only $88 million being withheld. Swiss residents received payments of only $1.2 billion, but had $221

---

104. According to the U.S. definition, treaty shopping is solely a problem of the source country. In accordance with this view, other types of treaty abuse (such as actions to reduce residence taxation and its influence on the residence country) are not subject to analysis. *See* A.L.I., *supra* note 5, at 150.

105. Unfortunately, no statistics exist about the amount of revenue lost to treaty shoppers. Therefore, the only way to find out the average revenue loss is to compare out-flowing payments of U.S. source income with the amount withheld from these payments. *See 1983 Hearing*, *supra* note 86, at 7 (opening statement of Chairman Barnard).

106. *Id.*

107. *Id.*

108. *Id.*

109. According to W.J. Anderson, Director of General Government Division, this figure excludes Eurobonds. *Id.* at 18.

110. *Id.*

million in tax withheld.[111] The reason Swiss recipients attracted the highest amount of U.S. withholding tax is that the Swiss tax authorities, during the course of their normal activities, would verify whether the recipient of the income was in fact a Swiss resident.[112] If not, Switzerland would withhold a thirty percent tax from the payee and remit the tax to the United States.[113] Had the other states been as thorough about discerning whether the recipients of U.S. source income were true residents of their countries, the United States would have collected many more tax dollars. Although no exact figures exist about lost revenue, it can likely be assumed that the United States lost a substantial sum to the Netherlands and the Antilles. The fact that, in 1981, sixty-eight percent of U.S. source income flowed to only five U.S. treaty countries, three of which were considered tax havens, indicates that many third-country investors took advantage of an existing treaty network for their investments in the United States. The assumed revenue loss is a significant amount that a state cannot afford to ignore.[114] Furthermore, if no efficient safeguards for the

---

111. $126 million was withheld directly by U.S. agents, while Switzerland collected additional taxes of over $95 million. *Id.* at 15. The higher amount of direct U.S. withholding is likely attributable to the stricter limitation-on-benefits provision in the U.S.-Swiss treaty. *Id.*

112. This effort was due to the anti-treaty-shopping legislation adopted by Switzerland. Bundesratsbeschluss betr. die ungerechtfertigte Inanspruchnahme von Doppel-Besteuerungsabkommen [abuse ordinance], Dec. 14, 1962, 1962 as 1622, *amended by* Kreisschreiben der Eidgenoessischen Steuerverwaltung, Dec. 31, 1962. These provisions were initially designed to prevent resident entities of Switzerland, under non-Swiss control, from abusively claiming treaty benefits in a foreign state under a Swiss treaty. *Id.* The provisions were directed at conduit companies or profit accumulating base companies by denying treaty benefits unless residents of Switzerland are "predominantly interested." *Id.* In other words, the Swiss legislation actually protects the treasuries of its treaty partners from Swiss-resident, but not Swiss-owned, companies. The adoption of these unilateral measures was driven by the international criticism of the special tax regimes in Swiss tax law granted to specific legal structures and the resulting pressure put on Switzerland by foreign treaty-partner countries to renegotiate or terminate existing tax treaties. Under these circumstances, Switzerland feared that its reputation as a tax haven would lead to a weakened bargaining position in further treaty negotiations and have a detrimental effect on its role as a major financial center. *See generally* H. Masshart, *Die ungegechtfertigte Inanspruchnahme von Doppelbesteuerungsabkommen*, 31 ARCHIV FÜR SCHWEIZERISCHES ABGABENRECHT 226 (1962/63); *see also* Max Widmer, *Die schweizerischen Massnahmen gegen den Missbrauch von Doppelbesteuerungsabkommen*, 40 STEUER UND WIRTSCHAFT 382 (1963); GERHARD KRAFT, DIE MISSBRÄUCHLICHE INANSPRUCHNAHME VON DOPPELBESTEUERUNGSABKOMMEN 74 (1991).

113. *1983 Hearing*, *supra* note 86, at 16.

114. "It appears that we are losing billions of dollars in taxes which are slipping through our fingers, whereas [U.S.] citizens in this country are being held to such a rigid performance of their tax obligations. . . ." *Id.* at 15 (statement of William G. Anderson, Director of General Government Division).

same country were inserted into the respective treaties, the revenue loss would increase with the growing trade and investment volume, leaving a far larger tax deficiency for the United States.

2. The Impediment of the Principle of Reciprocity

The underlying principle of all bilateral tax treaties, the principle of reciprocity, is impeded when a third-country resident derives benefits from a treaty intended to serve only the interests of residents of the contracting states. This deficiency in reciprocity results when a third-country resident derives benefits through the interposition of a treaty-protected entity, while the source country's residents are not necessarily able to obtain similar benefits from the third country.[115] This may have an adverse effect on both the source country's government and its resident investors.

In general, both parties to a tax treaty make concessions on their source based tax. The source country fully or partially relinquishes its right to tax domestic source income earned by residents of the other party and reciprocally obtains the same concessions for its own residents. For example, the U.S. Treasury Department generally assumes the neutrality of tax treaties in their revenue effect, which means that one provision resulting in a loss of revenue will be offset by other provisions increasing revenue.[116] When treaties, concluded on the assumption of a particular level of actual and potential income and capital flows between two countries, are used by third-country residents, the level and balance of the anticipated capital flows are distorted to the extent that the U.S. government loses income by reducing its source based tax, as well as by allowing U.S. taxpayers to claim a foreign tax credit for taxes paid on income from the nontreaty countries.

One state's renunciation of the right to tax a certain type of income in a tax treaty is usually based on the right to tax such income by the other party to the treaty. Thus, the purpose of the treaty is to alleviate double taxation when a beneficiary of one contracting state derives income from sources within the other state. In circumstances where unintended beneficiaries are free to choose the location of the intermediary entity, however, treaties

---

115. *1987 Hearing*, *supra* note 6, at 5.

116. Rosenbloom, *supra* note 7, at 774 n.34. The 1975 U.S-U.K. Treaty, *signed* Dec. 31, 1975, 3 Tax Treaties (WGL) ¶ 89,030, however, resulted in a substantial revenue gain for the United States. *See* SENATE FOREIGN RELATIONS COMM., REPORT ON THE INCOME TAX TREATY WITH THE U.K., S. EXEC. REP. NO. 18, 95th Cong., 2d Sess. (1978).

designed to eliminate double taxation are frequently being utilized to eliminate taxation altogether. This is especially true in combination with tax haven situations. This result goes beyond the treaty's purpose.

It is certainly not in the interest of either treaty partner to allow a loophole in the treaty to prevent tax from being levied by either state, in particular when it concerns persons who have no significant economic nexus with the country in which the treaty-protected entity is located. In addition, any deviation from provisions of the source country's domestic tax law should be limited to the intended beneficiaries, otherwise the objective of the legislation enacting such provisions is subverted.

Further, there is no justification for the fact that the unintended application of a bilateral tax treaty combined with the use of no- or low-tax jurisdictions may result in a lower tax burden for a third-country investor than for a resident of one of the treaty countries.[117] This may lead to a competitive disadvantage for the intended beneficiaries of the treaty, because they are not able to structure their investments tax-free or at a comparable low rate.

3. Reduction of the Incentive to Conclude Tax Treaties

If residents of third countries that have no tax treaty or a less favorable tax treaty with the source country can still obtain source basis tax benefits, these third countries will be under less pressure to enter into a treaty with the source country. They will lack motivation to form their own treaties, since their residents are able to shop for benefits in the existing treaty network at minimal cost and without the third country having to grant any reciprocal rights.[118] Undoubtedly such incentives would have a detrimental effect on the source country, especially with regard to its ability to expand its income tax treaty network and its ability to renegotiate its existing treaties on more favorable terms.

For example, in the case of the United States, treaty shopping denies U.S. investors the advantages that they would receive from an expanded U.S. treaty network. While a third country user can obtain the benefits of a U.S. treaty indirectly through treaty shopping, U.S. residents investing in the third country might not be able to obtain reciprocal benefits in a similar situation.[119] The U.S. government would have to credit the full amount of tax paid

---

117. GORDON REPORT, *supra* note 57, at 158.
118. Rosenbloom, *supra* note 7, at 775.
119. *1987 Hearing*, *supra* note 6, at 349.

by its residents to the third country, while at the same time foregoing the amount of U.S. tax that should have been collected from the third country's investors. A similar situation applies to the renegotiation of treaties. When a treaty partner's residents can obtain more favorable benefits under another treaty, U.S. residents have to be satisfied with the less advantageous benefits of the existing treaty.

If a third country, whose residents are able to treaty shop, is nonetheless willing to enter into treaty negotiations, the third country's bargaining position is generally enhanced, making it difficult for the source country to obtain concessions in negotiations.[120] Since the third country is accustomed to having the most favorable benefits under another treaty for its investors, it will want to be granted the most advantageous provisions for its treaty or otherwise refuse to conclude one. It is not always possible, however, to make the same concessions to every country, since the outcome of the negotiations largely depends on the specific situation between the negotiating countries.

Besides eliminating double taxation and thus providing a more favorable investment environment for the residents of contracting states, treaties are designed to provide an exchange of information.[121] The possibility for a taxpayer involved in cross-border transactions to engage in tax avoidance or evasion is substantially diminished when a mutual exchange of information is provided. Therefore, one important aspect of tax treaties is to assist the tax authorities in dealing with international auditing problems.[122] In this respect, the expansion of a country's treaty network is indispensable, but may be inhibited by treaty shopping.

Taking all these factors into account, it is clear that treaty shopping has a detrimental effect on the source country's revenue, as well as its position within the international community. In the last two decades, treaty shopping has become a widely employed tax planning device with significant economic impact. It is understandable, therefore, that a source country would fight treaty shopping with all possible means at its disposal.

---

120. *Id.* at 350.

121. Even though treaties exist that deal only with exchange of information (such as U.S.-St. Lucia Agreement for the exchange of information with respect to taxes, Apr. 22, 1991, 1 Tax Treaties (CCH) ¶ 268), tax treaties usually provide the best basis for an exchange of information.

122. A.L.I., *supra* note 5, at 54.

III. COUNTERMEASURES TO THE EXISTING TREATY SHOPPING PRACTICE

As a result of the problems created by treaty shopping, the present prevailing view is that this common practice should be restrained. The commentaries of the OECD Model Convention explicitly emphasize that a tax treaty should not facilitate tax evasion and therefore should include safeguards to prevent its abuse.[123] Yet, it took almost four decades for the OECD to recognize the extent of the treaty shopping problem.[124] Now, however, the commentaries of the OECD and the U.N. Ad Hoc Group of Experts for Co-Operation in Tax Matters (U.N. Ad Hoc Group of Experts)[125] recommend the insertion of specific provisions dealing with the abuse of treaty benefits by third party users. The 1995 OECD Commentary contains detailed suggestions on how to phrase anti-treaty-shopping provisions in order to provide some help to OECD member countries, and to accomplish certain continuity and conformity for a common international interpretation.[126] Furthermore, the Commentaries refer to the discussion whether and under which prerequisites treaty shopping can be curtailed if the treaty in question does not contain such anti-treaty-shopping clauses.[127] The following discusses the possible ways to deal with treaty shopping in tax treaties as well as in domestic law.

A. *Introduction to the Concepts of Limitation-on-Benefits Provisions in Tax Treaties*

Before creating anti-treaty-shopping clauses, it is first necessary to identify the situations and structures in which treaty shopping transactions occur and then find adequate solutions to

---

123. *1995 OECD Model Treaty*, *supra* note 1, art. 1, ¶ 7 (Commentary).

124. For further discussion, see KLAUS VOGEL, DOUBLE TAXATION CONVENTIONS: A COMMENTARY TO THE OECD-, UN-, AND U.S.-MODEL CONVENTIONS FOR THE AVOIDANCE OF DOUBLE TAXATION OF INCOME AND CAPITAL WITH PARTICULAR PREFERENCE TO GERMAN TREATY PRACTICE 9 (1991).

125. The U.N. Model Convention and its commentaries were developed by the U.N. ESCOR's Ad Hoc Group of Experts on Tax Treaties Between the Developed and Developing Countries, which completed its work in 1980 without paying too much attention to treaty abuse. For this purpose, the Ad Hoc Group of Experts on International Co-operation in Tax Matters was organized to gradually work out proposals for international cooperation to combat tax evasion and avoidance. The first substantive suggestions in terms of full-blown anti-treaty-shopping provisions were made in 1987 and resemble the provisions of the OECD commentaries. *See International Co-Operation in Tax Matters*, *supra* note 2.

126. *1995 OECD Model Treaty*, *supra* note 1.

127. *Id.*

confer benefits only to the entities entitled to them.[128] The OECD suggests taking into account the extent to which actual benefits may be obtained by conduits, the legal context in both contracting states, and the degree to which bona fide investors might unintentionally be affected.[129] The U.N. and OECD models themselves (and not only the commentaries) utilize two types of anti-treaty-shopping measures: the limitation on residence status test in Article 4 of the respective models, and the beneficial ownership test in Articles 10-12.[130]

1. Limitation on Residence Status Test

In all treaty shopping structures, interposed entities in one or more treaty countries provide advantages for a third country taxpayer that would otherwise not have been available in a direct transaction. This possibility for tax planning has its roots in the concept that residents of the contracting states are entitled to the benefits of the treaty.[131] Thus, if the interposed entity is treated as a resident of a contracting state under the domestic law of that state, it has the authority to claim rights under the bilateral tax convention. The U.S., OECD, and U.N. model treaties[132] each provide detailed interpretations of the term "resident of a contracting state."[133] A person qualifies as a resident if the person is subject to taxation under the laws of the state "by reason of [the person's] domicile, residence, place of management or any other criterion of a similar nature."[134]

The OECD Model, however, excludes from the definition of the term "resident of a contracting state" any "person who is liable

128. 1987 OECD Report, *supra* note 42, at 95.

129. *Id.*

130. *1995 OECD Model Treaty*, *supra* note 1; U.N. Model Convention, *supra* note 2.

131. The OECD and U.N. models employ the same wording to determine the scope of the treaty: "This Convention shall apply to persons who are residents of one or both of the contracting states." *1995 OECD Model Treaty*, *supra* note 1, art. 1; U.N. MODEL CONVENTION, *supra* note 2, art. 1. The U.S. model, additionally, contains a savings clause that restricts the personal scope of the treaty as determined by Article 1(1) and retains the rights of the United States to tax its citizens and incorporated entities as if the treaty had not come into effect. 1981 Model Treaty, *supra* note 3.

132. *1995 OECD Model Treaty*, *supra* note 1; 1981 U.S. Model Treaty, *supra* note 3; U.N. MODEL CONVENTION, *supra* note 2. In addition, the U.S. model contains the terms "citizenship" and "place of incorporation," both of which are derived from its domestic law. 1981 U.S. Model Treaty, *supra* note 3.

133. *1995 OECD Model Treaty*, *supra* note 1, art. 4; U.N. MODEL CONVENTION, *supra* note 2; 1981 U.S. Model Treaty, *supra* note 3.

134. *1995 OECD Model Treaty*, *supra* note 1, art. 4; U.N. MODEL CONVENTION, *supra* note 2; 1981 U.S. Model Treaty, *supra* note 3.

to tax in that state in respect only of income from sources in that state or capital situated therein."[135] The commentaries explain that this situation can arise with regard to individuals (*e.g.*, in the case of foreign diplomatic and consular staff), but also in the case of foreign-held companies exempted from tax in the intermediary country on their foreign income by special privileges designed to attract conduit companies.[136] The OECD acknowledges that this provision might be interpreted so broadly as to exclude all residents of countries adopting a territorial principle in their taxation.[137] Therefore, the provision must be interpreted restrictively, which, absent any specification, might render it totally ineffective. The same result was reached by the U.N. Ad Hoc Group of Experts, which pointed out that a court might regard this treaty provision as being inapplicable to companies.[138]

Thus, under the general rules, a conduit is regarded as a person or entity resident in the state of conduit and entitled to claim benefits even though the true recipient of the income would not be eligible for favorable treatment. Since this situation is not deemed to be satisfactory, various approaches are being proposed to prevent the abuse of treaty provisions. One radical suggestion is the abstinence approach. Since treaty shopping often involves the interposition of companies in low-tax countries or tax havens, one effective solution is to refrain from concluding treaties with such countries. This approach, however, is neither feasible nor desirable in all cases. Although in treaty practice most countries, including the United States, have already terminated many treaties with tax havens,[139] it sometimes seems desirable to maintain treaty relations with such countries (*e.g.*, for purposes of information exchange). Also, the abstinence approach is not a solution with respect to countries not considered tax havens that have favorable domestic investment laws that further the spread of conduit companies (*e.g.*, the Netherlands). Thus, a restriction of the general application of the residence rule is arguably necessary.

135. *1995 OECD Model Treaty*, *supra* note 1, art. 4(1).

136. *Id.*

137. *1995 OECD Model Treaty*, *supra* note 1.

138. U.N. DEP'T OF INT'L ECONOMICS AND SOCIAL AFFAIRS, CONTRIBUTION TO INTERNATIONAL CO-OPERATION IN TAX MATTERS, U.N. Doc. ST/EA/203, U.N. Sales No. E.88.XVI 9 (1988).

139. The United States had 21 tax treaties with tax havens, all of which were terminated in 1986. Only the treaty with Barbados, 1 Tax Treaties (CCH) ¶ 1103 (Feb. 28, 1986), has been renegotiated. Other countries do not have any treaty relations with tax havens. *1987 Hearing*, *supra* note 6, at 352.

2. The Beneficial Ownership Test

Articles 10, 11, and 12 of the OECD and U.N. models, which deal with reducing rates of withholding tax on interest, dividends, and royalties, limit the benefits available under the treaty to the "beneficial owner" of the income.[140] Under these models, if an entity establishes a conduit company in order to take advantage of reduced withholding tax rates, it would be unable to qualify for treaty relief because it would not be the beneficial owner of the income. The term "beneficial owner," however, is not a precise legal term.[141] It also is not a term that can be interpreted by referring to the domestic law of the contracting states. Few, if any, countries offer a definition of this term in their domestic laws. The OECD commentaries only refer to the matter by providing that treaty benefits should not be available when a third person—an intermediary, such as an agent or nominee—is interposed between the beneficiary and the payor.[142] This reference may be interpreted, for purposes of obtaining treaty benefits, to mean that the real, economic title should prevail over the formal, legal title with regard to dividends, interest, or royalties. In other words, effect should be given to the substance rather than the form of the transaction.[143] Thus, treaty relief for those types of income should not be available for entities that function as conduits between the payor and a person not covered by the scope of the treaty.

In practice, however, the beneficial owner language in the interest, dividends, and royalty articles constitutes a relatively superficial inquiry. Absent a sham corporation[144] or conduit company, whose function is limited to that of a nominee or agent, an incorporation is given effect, even if the corporation is wholly owned by a third-country resident. Therefore, the source country has to show that the treaty-protected entity is a sham or a conduit company, acting as a mere intermediary with very narrow

140. *1995 OECD Model Treaty*, *supra* note 1; U.N. MODEL CONVENTION, *supra* note 2.

141. The International Bureau of Fiscal Documentation maintains the position that the terms "beneficial owner" and "economic owner" can be equated, in contrast to legal owner. The Committee on Fiscal Affairs initially considered adopting the term of "final recipient" instead of "beneficial owner." VOGEL, *supra* note 124, at 456.

142. *1995 OECD Model Treaty*, *supra* note 1, art. 10, para. 12; art. 11, para. 8; art. 12, para. 4.

143. See discussion on the U.S. domestic law regarding "substance versus form," *infra* notes 189-200 and accompanying text.

144. The discussion on the United States domestic concept of a "sham company" shows that this term requires an extremely narrow definition. *See infra* notes 290-91 and accompanying text.

powers. In practice, this is difficult for the source country to prove and raises questions of categorization. The mere fact that a corporation's main function is holding assets or rights is not in itself enough to classify it as an intermediary.[145] It is doubtful whether a company operating as the financial center for an international group could be regarded as a conduit, even though its principal purpose is to profit from treaty benefits to which its owners would not be entitled. Apparently, therefore, the beneficial owner test does not provide sufficient means to curtail treaty shopping.

3. Additional Provisions Designed to Eliminate Treaty Shopping

The Fiscal Committee of the OECD recognized that the existing model clauses did not effectively combat treaty shopping practices and it therefore developed several additional approaches to the problem. The commentaries on the 1977 OECD Model suggested that the negotiating states should define more specifically who should be entitled to treaty benefits.[146] To help identify the beneficial owner, several objective tests, which were to be included in an express limitation-on-benefits provision, were suggested by the OECD commentaries and the U.N. Ad Hoc Group of Experts at its 1987 meeting.[147] Various forms of these tests have been adopted by several states in their treaty practices.[148]

The theory behind the limitation-on-benefits provisions is to provide treaty benefits only to entities having a sufficient nexus with the country of residence. This can either be determined by looking at the direct and indirect owners or beneficiaries of the entity or by focusing on the economic ties between the entity and the treaty country.

a. Direct or Look-Through Approach

The "direct" or "look-through" approach focuses on the direct and indirect owners or beneficiaries of an entity and allows treaty benefits to a corporation only insofar as the company is owned by residents of one of the contracting states.[149] Interestingly, in an

145. 1987 OECD Report, *supra* note 42, at 93.
146. *1977 OECD Model Treaty*, *supra* note 1, art. 10, para. 22.
147. 1987 OECD Report, *supra* note 42, at 93.
148. *See* discussion *infra* notes 369-72 and accompanying text.
149. The suggested wording of such a safeguarding clause reads as follows:

earlier draft of the OECD commentaries on the look-through approach, only residents of the other contracting state could qualify for treaty benefits.[150] The 1994 update of the commentaries, however, includes residents of either state.[151] This change has a significant impact on whether reduction of residence country tax by means of treaty shopping is viewed as abusive. Under the 1994 wording, an entity resident in one contracting state that is owned by residents of the other contracting state can claim treaty benefits in that other state.

Since the wording is directed against conduit companies, the commentaries to the OECD Model suggest that every state wishing to adopt such a provision should determine "the criteria according to which a company would be considered as owned or controlled by nonresidents."[152] This determination can be achieved by requiring a specified portion of shares to be held by residents of one of the contracting states in order for a company to qualify for treaty benefits.[153] However, while these provisions are relatively straightforward, they only focus on one aspect of conduit structures and may have no effect on stepping-stone strategies. For example, a way to circumvent this provision would be to create a corporation with very small equity capital held by genuine residents. Under such a scheme, the real capital would be provided in the form of debt, the interest on which would flow to nonresidents.

> A company which is resident of a Contracting State shall not be entitled to relief from taxation under this Convention with respect to any item of income, gains or profits unless it is neither owned nor controlled directly or through one or more companies, wherever resident, by persons who are not residents of a Contracting State.

1995 OECD Model Treaty, *supra* note 1, para. 13 (commentary). This means that the entity must be owned ultimately by one or more individual residents of one or both contracting states, thereby excluding the possibility that the rule might be circumvented by having a two-tier structure in the treaty country.

150. The former version of Article 1, para. 13 of the 1992 OECD Commentary follows:

> A company which is a resident of a Contracting State shall not be entitled to relief from taxation under this Convention with respect to any item of income, gains or profits unless it is neither owned nor controlled directly through one or more companies, wherever resident, by persons who are not residents of the *first-mentioned state*.

1995 OECD Model Treaty and commentaries, *supra* note 1, art. 1, para. 13 (emphasis added). In the 1994 update, the paragraph was amended by replacing the words "first-mentioned state" with "a Contracting state." *Id.*

151. *Id.*

152. *Id.*

153. *Id.*

b. Base-Erosion or Channel Approach

The "base-erosion" or "channel" approach seeks to prevent one of the main treaty shopping practices—the reduction of a conduit corporation's tax base.[154] Under the channel approach, a corporation resident in one of the contracting states will not be permitted to claim benefits under the treaty if a certain percentage (usually fifty percent) of such corporation's gross income is used to pay interest or royalties to residents of third countries. This approach focuses on companies with high gross receipts but that have very low taxable income as a result of high expenses paid to nonresidents, providing the most efficient instrument in the combat of stepping-stone structures, which otherwise are very difficult to single out.

c. Exclusion Approach

The "exclusion" approach denies tax treaty benefits to companies that enjoy a special tax regime in their country of residence.[155] These types of tax-exempt (or nearly tax-exempt) companies, usually specifically defined in the commercial or tax laws of the country of residence, are granted tax privileges that give them a status similar to that of nonresidents.[156] Thus, if a state creates special privileges for certain kinds of companies in

---

154. The safeguarding clause suggested by the OECD reads as follows:

> Where income arising in a Contracting State is received by a company which is a resident of the other Contracting State and one or more persons who are not resident of that other Contracting State
>
> (a) have directly or indirectly or through one or more companies, wherever resident, a substantial interest in such company, in the form of a participation or otherwise, and
>
> (b) exercise directly or indirectly, alone or together, the management or control of such company,
>
> any provision of this Convention conferring an exemption from, or a reduction of, tax shall not apply if more than 50 percent of such income is used to satisfy claims by such persons (including interest, royalties, development, advertising, initial and travel expenses, depreciation of any kind of business assets including those on immaterial goods, processes, etc.).

1995 OECD Model Treaty, *supra* note 1, art. 1 (commentary, ¶ 19).

155. A way to phrase such an anti-abuse clause, as suggested by the 1995 OECD Commentaries, is as follows: "No provision of the Convention conferring an exemption from, or reduction of, tax shall apply to income received or paid by a company as defined under Section . . . of the . . . Act, or under any similar provision enacted by . . . after the signature of the Convention." *1995 OECD Model Treaty*, *supra* note 1, art. 1 (commentary, ¶ 15).

156. An example is the Luxembourg Holding Company.

its tax law, countermeasures must be taken to prevent those privileges from being utilized in connection with the benefits offered by a tax treaty.[157] The easiest way to prevent such tax treaty abuse would be to simply exclude these companies from the scope of the treaty. Even if applied in its full range,[158] however, this countermeasure does not seem to interfere greatly with certain conduit companies that carry on bona fide business.[159]

d. Subject-to-Tax Approach

The "subject-to-tax" approach allows tax relief in the source country if the recipient of the income pays tax on the respective income in the recipient's country of residence. The idea behind this approach is that the objective of a treaty is to eliminate double taxation and not to provide double exemption from tax. Neither the U.N. Ad Hoc Group of Experts nor the OECD model commentaries recommends this approach for several reasons. First, deserving entities such as charities, pension funds, or entities that are exempt from tax under domestic law for a specific reason (*e.g.*, to encourage economic development in a specific area), might be barred from obtaining treaty relief. Second, this countermeasure would not be able to impede stepping-stone structures[160] or any other manipulation of tax rules in tax haven countries. Third, it is relatively difficult to administer because the tax rules, including, for example, tax thresholds and deduction allowances, vary too much between countries to find an equitable solution.[161]

157. 1987 OECD Report, *supra* note 42, at 97.

158. As suggested by the OECD, the impact of such a provision can be minimized if the treaty provision is limited to specific types of income, such as dividends, interest, royalties, and capital gains. *1995 OECD Model Treaty*, *supra* note 1. Under such provisions, companies, as defined in the anti-abuse provision, would remain entitled to profit from the nondiscrimination (Art. 24), mutual agreement procedure (Art. 25), and exchange of information (Art. 26) provisions. *Id.*

159. 1987 Ad Hoc Group, *supra* note 2, at 12.

160. In general, if a taxpayer is relieved from tax because of personal allowances (deductions) or because losses can be offset on other income, the taxpayer would still be regarded as being subject to tax. Thus, "subject-to-tax" provisions are directed against persons enjoying an exemption from tax on actual income rather than a de facto exemption from tax when they have a net loss.

161. *1995 OECD Model Treaty*, *supra* note 1, art. 1 (commentary).

e. Bona Fide Provisions

The idea behind limitation-on-benefits provisions is to bar only those entities from treaty relief that are established with the intention of obtaining treaty benefits. The following four approaches might often result in severe restrictions for entities not created for treaty shopping purposes. Therefore, the commentaries of the 1995 OECD Model Treaty emphasizes that any approach has to be supplemented by provisions guaranteeing treaty benefits in bona fide situations.[162]

i. Stock Exchange Test

Under the stock exchange test, relief may be granted to any publicly traded company that is traded on a recognized stock exchange in one of the treaty countries.[163] The rationale behind this test is that such a company is less likely to be set up for the purpose of abusing a tax treaty. Thus, there is a general presumption that there is an actual, commercial reason, independent of tax considerations, for the company to be organized in its country of residence. In addition, since ownership changes frequently and there is a wide range of different owners, an efficient control of the ownership would almost be impossible. The OECD commentaries and the U.N. Ad Hoc Group of Experts suggest that the stock exchange test functions as a blanket exception to all of the other more general approaches (base erosion, channel approach, etc.).[164]

ii. Active Trade or Business Test

Another provision designed to protect bona fide arrangements is the "active trade or business test," which considers whether the resident company of a contracting state is engaged in substantive business operations and genuine commercial activity.[165] The

---

162. *Id.*, art. 1, para. 21.

163. The 1995 OECD Model Treaty, suggestion reads as follows:

> The foregoing provisions shall not apply to a company which is a resident of a Contracting State if the principal class of its shares is registered on an approved stock exchange in a Contracting State or if such company is wholly owned—directly or through one or more companies each of which is a resident of the first-mentioned State—by a company which is a resident of the first-mentioned State and the principal class of whose shares is so registered.

1995 OECD Model Treaty, *supra* note 1, art. 1, para. 21(d).

164. *Id.*; 1987 Ad Hoc Group, *supra* note 2, at 17.

165. The *1995 OECD Model Treaty*, *supra* note 1, art. 1, para. 21(b), suggestion reads as follows: "The foregoing provision shall not apply where the

active trade or business test, which is discussed in the 1995 OECD commentaries,[166] is the core of the bona fide concept. The conduct of an active trade or business demonstrates the genuineness of an operation. The draw-back of this provision, however, is that it is extremely difficult to define what constitutes an active trade or business.[167]

iii. Motive Test

The "motive test,"[168] which shares the same goal as the active trade or business test, requires a company to demonstrate that its principal purpose, the conduct of its business, and the income derived from the business are motivated primarily by ordinary commercial considerations rather than the desire to obtain tax relief.[169] Therefore, anti-treaty-shopping provisions may provide that no treaty relief will be granted if the sole, main, or principal purpose of certain transactions is the reduction of source tax.

Because the prerequisites for obtaining treaty relief are dependent on the subjective intent of the taxpayer and not on objective criteria, the motive test is very problematic in its application. "Sound business reasons" regarding a transaction or business structure is a rather vague criterion for identifying an intent to abuse a treaty. Therefore, in many cases, the primary purpose of a structure or transaction will be excluded from a rational judgment and its interpretation will be a matter of arbitrariness. The test, however, is still useful in those instances where sound business reasons are quite obvious and the intent of tax treaty abuse unlikely.

---

company is engaged in substantive business operations in the Contracting State of which it is a resident and the relief from taxation claimed from the other Contracting State is with respect to income which is connected with such operations."

166. *Id.*

167. Henk P.J. Goossen, *Limiting Treaty Benefits*, 20 INT'L TAX J. 31 (1993).

168. This test may be an exception to the general ownership and base-erosion provisions in the OECD commentaries. *1995 OECD Model Treaty*, *supra* note 1, art. 1, para. 21(a).

169. The anti-treaty-shopping clause in the OECD model is as follows:

> The foregoing provision shall not apply where the company establishes that the principal purpose of the company, the conduct of its business and the acquisition or maintenance by it of the shareholding or other property from which the income in question is derived, are motivated by sound business reasons and thus do not have as primary purpose the obtaining of any benefits under this Convention.

Id.

iv. Alternative Relief Test

Another variation on the bona fide provisions is the "alternative relief test," suggested by the OECD commentaries. The alternative relief test focuses on the ability of the taxpayer to obtain similar or better treaty benefits from an alternative treaty.[170] If the intermediate jurisdiction does not offer any special benefits the investor could not otherwise obtain, forming an entity in that jurisdiction and asserting rights under its tax treaties disproves the notion that the interposition of the entity was motivated by treaty benefits.[171]

B. *Implementation of Anti-Treaty-Shopping Provisions in Domestic Law*

Besides inserting specific anti-treaty-shopping provisions into the tax treaties, the issue can also be addressed by legislative means, namely by incorporating anti-avoidance rules into domestic tax law. Domestic legislative measures aimed at restraining treaty shopping can exist in many forms. Some measures are of a general character and may apply to all kinds of tax avoidance and evasion, whether in national or international transactions. Other measures are very specific, involving complex rules that define the concrete situations in which the benefits of an international tax treaty can be obtained. Depending on their scope and application, however, domestic anti-avoidance rules are controversial with regard to their effect on the international legal obligation created by a treaty. In other words, a domestic anti-avoidance provision may result in a unilateral treaty override, violating the well established international law principle of *pacta sunt servanda*.[172]

A large controversy exists within the international community as to whether general domestic anti-avoidance rules are applicable in the context of a treaty. In most countries, courts tend to apply domestic abuse rules in circumstances involving tax

170. The anti-abuse clause of the *1995 OECD Model Treaty*, *supra* note 1, art. 1, para. 21(e), states that the term "nonresidents of a Contracting State" shall "not be deemed to include residents of third states that have income tax conventions in force with the Contracting State from which relief from taxation is claimed and such conventions provide relief from taxation not less than the relief from taxation claimed under this Convention."

171. Rosenbloom, *supra* note 64.

172. A.L.I., *supra* note 5, at 73. The principle means that agreements of the parties to a contract must be observed.

treaties,[173] but often only in specific areas (*e.g.*, involving avoidance schemes that make improper use of rules of domestic law or involving resident taxpayers).[174] A dissenting view holds that domestic anti-avoidance rules cannot be applied to treaty situations, especially where the treaty itself contains provisions aimed at counteracting its improper use.[175]

The different views are largely dependent on the understanding of a treaty's purpose. Two basic views of the nature of the treaty and the interpretive freedom of applying its provisions can be differentiated. According to the principles adopted in Articles 31 and 32 of the Vienna Convention,[176] most states agree that "common interpretation is equally binding on the two parties" and therefore interpretation of a treaty should be confined to its express terms.[177] Some commentators argue that there is "no justification for reliance on general legal principles of domestic law in interpreting treaty law, or for closing loopholes within treaties by reference to domestic law."[178]

Other nations and commentators take a contractual approach to tax treaty interpretation.[179] Tax treaties, it is argued, are concluded in a context of constant interaction, over a period of time, and with the intent that they be flexible.[180] The negotiating parties, according to this view, had a certain intent regarding their tax policy and economy. A treaty, therefore, must

---

173. *See* applicability of Germany's Abgabenordnug (AO) § 42 *infra* Part IV.B.3.

174. In contrast to the United States, which appears to take the position that treaty shopping by its own residents is not generally a problem and which has enacted domestic legislation against other forms of tax treaty abuse by its own residents (*e.g.*, through the use of base companies), Germany has a long line of cases involving resident taxpayers who own Swiss base companies claiming benefits under the German-Swiss treaty, to reduce residence taxation. The German tax court, however, refused to apply anti-avoidance principles to base companies whose parents were not resident taxpayers. Ruling as of Oct. 29, 1981, Bundesfinanzhof [BFH] [supreme tax court], 1982 Bundessteuerblatt, Teil II [BStBl.II] 150 (F.R.G.).

175. *1995 OECD Model Treaty*, *supra* note 1, art. 1, para. 23.

176. The United States signed the Vienna Convention, but never ratified it. Vienna Convention on the Law of Treaties, May 23, 1969, 1155 U.N.T.S. 331 (entered into force Jan. 27, 1980) [hereinafter Vienna Convention]. The United States strongly objected to the rigid terms of its provisions. *See* Maria Frankowska, *The Vienna Convention on the Law of Treaties Before U.S. Courts*, 28 VA. J. INT'L L. 281, 330 (1988).

177. Klaus Vogel, *Double Taxation Treaties and Their Interpretation*, 4 INT'L TAX & BUS. LAW. 1, 70 (1986).

178. *Id.*

179. The United States is one of the major advocates of this theory. Stanley I. Katz, *United States National Reporter*, *in* DOUBLE TAXATION CONVENTIONS, *supra* note 77, at 615, 649.

180. *Id.*

be sufficiently flexible to adapt the statutory text to relevant developments and changes, not only in respect to teleological interpretation but even further.[181] Contrary to the approach in which a state surrenders its sovereignty with respect to the treaty's provisions once it becomes a signatory, the contractual approach provides for a "retention of independence and autonomy of interpretation and enforcement."[182]

Although few countries apply their domestic anti-avoidance rules to situations within the scope of a treaty, when it occurs, it leads to a conflict between national tax law and treaty law.[183] In dealing with the excessive tax planning associated with tax treaties, a conflict arises: whether and to what extent domestic anti-abuse rules or principles should prevail over the legal wording of the treaty. In contrast to domestic legislation, tax treaties involve the consent of a second party that may not agree to the unilateral interpretation of a certain treaty provision.

To avoid this conflict with domestic law, the OECD model treaty suggests that tax treaties include a provision similar to Article 3(2), which contains a general rule for domestic interpretation of terms that are used in a treaty but are not therein defined. That article states: "As regards the application of the Convention by a Contracting State any term not defined therein shall, unless the context otherwise requires, have the meaning which it has under the law of that State concerning the taxes to which the Convention applies." Article 3(2), however, only applies to the interpretation of a treaty term if the term itself is used in the convention and is ambiguous.[184] If the treaty itself identifies the persons entitled to treaty benefits by providing that all residents of the contracting states, including legal entities, are entitled to treaty benefits, then treaty benefits to a legal entity cannot be denied solely on the basis that its owners are not residents.[185] Article 3(2) intends interpretation by domestic law to be a means of *ultima ratio*,[186] and to be construed narrowly without allowing the use of general principles and legal concepts. This, however, is not the view of all states. In particular, the United States[187] and Canada understand Article 3(2) to refer to

---

181. *Id.*

182. *Id.*

183. TREATY SHOPPING, *supra* note 45, at 8.

184. Klaus Vogel & Rainer G. Prokisch, *General Report*, *in* DOUBLE TAXATION CONVENTIONS, *supra* note 77, at 55, 78.

185. TREATY SHOPPING, *supra* note 45, at 8.

186. *Ultima ratio* means the last resort.

187. An article similar to Articles 3(2) of the 1981 U.S. Model Treaty, *supra* note 3, which in turn has almost the same wording as Art. 3(2) of the *1995 OECD*

domestic law of the contracting states in a general way, which implies the use of legal concepts and tradition.[188]

Another justification for applying domestic law in connection with a tax treaty may be the implicit intent of the contracting states to grant each other the right to interpret the treaty in accordance with the economic substance of a transaction or structure rather than in accordance with its form.[189] This implicit intent can be presumed if both contracting states have such principles or rules in their domestic laws because then they can be expected to agree on the mutual application of the corresponding principles to the treaty.[190] In other words, the substance over form approach of domestic anti-abuse clauses may be applied legitimately to situations within the scope of a treaty if both contracting states consider the standard to be applicable under domestic law. The deficiency of this solution, however, is that it would be difficult to identify the common threshold because of the various degrees of abuse concepts.

It is also argued that there exists a "general legal principle recognized by civilized nations" under which an artificial, inappropriate structure or transaction should be evaluated according to its substance rather than its form.[191] This general principle assumes a universal anti-avoidance standard that allows the application of a common rationale developed in case law[192] or the even more cautious application of anti-avoidance rules.[193]

Model Treaty, *supra* note 1, is included in all U.S. tax treaties, except for the ones entered into with South Africa, 3 Tax Treaties (CCH) ¶ 8203, Sweden, 3 Tax Treaties (CCH) ¶ 8801, and the Russian Federation, 3 Tax Treaties (CCH) ¶ 8003. The models state: "As regards the application of the Convention by a Contracting State, any term not defined therein shall, unless the context otherwise requires, or the competent authorities agree to a common meaning pursuant to the provisions of Art. 25 (Mutual Agreement Procedure) have the meaning which it has under the laws of that state concerning the taxes to which the Convention applies." 1981 U.S. Treaty, *supra* note 3.

188. Vogel, *supra* note 184, at 78.

189. *Id.*

190. Bernd Fahrholz, *Schranken der Steuergestaltung bei grenzüberschreitenden Finanztransaktionen: Abkommensrecht und innerstaatliches Recht*, *in* JOHANN W. GADDUM ET AL., ZINSEN IM INTERNATIONALEN STEUERRECHT 51, 53 (1985); Jörg M. Mössner, *Selbständigkeit juristischer Personen und Kapitalgesellschaften im internationalen Steuerrecht*, 32 RECHT DER INTERNATIONALEN WIRTSCHAFT [R.I.W.] 208, 211 (1986).

191. Klaus Vogel, *Steuerumgehung nach innerstaatlichem Recht und nach Abkommenrecht*, 62 STEUER UND WIRTSCHAFT 369, 378 (1985).

192. VOGEL, *supra* note 124, at 56.

193. *Id.* at 56.

Some countries have express anti-avoidance clauses that are generally applicable to their tax system as a whole.[194] Transactions undertaken for tax purposes, if they are based on artificial or unusual constructions that would not have been used apart from tax considerations, cannot qualify for beneficial treatment under domestic law.[195] These general abuse provisions void any tax benefit obtained in a transaction contrary to the basic principles of tax law or disallow advantages received by transactions that contravene the principal understanding of the law.[196]

The efficiency of general anti-avoidance provisions largely depends on how they are interpreted by the courts. In some states, the courts only rely on the literal wording of the law and therefore construe the anti-avoidance rules narrowly,[197] unless specific legislation clarifies the meaning. Different approaches have been developed either by taking into account the principle of substance over form[198] or the notion of abuse of law (*abus de droit, fraus legis*).[199] The prerequisites for proving the existence of abuse vary among the nations, including the frequency with which a transaction is considered to be abusive. Over the years, most states have shifted from a very narrow interpretation of the tax laws to a broader and more frequently applied anti-abuse legislation.[200]

---

194. For example, Austria: Bundesabgabenordnung § 22 ; France: Livre de Procedure Fiscale, art. L 64; Germany: Abgabenordnung [AO] § 42; the Netherlands: Algemene Wet Rijksbelastingen, art. 21; Spain: Ley General Tributaria, art. 24(2). *See* VOGEL, *supra* note 124, at 53.

195. VOGEL, *supra* note 124, at 52.

196. *E.g.*, Germany's AO § 42. It provides that "the tax law may be bypassed through the misuse of structural possibilities provided by the law." For a detailed discussion of anti-avoidance measures, see LANGER, *supra* note 89, at 54-1.

197. In the United Kingdom, a judge is strictly bound by the literal wording of the statute especially in regard to tax law. *See* Cape Brandy Syndicate v. Comm'r of Inland Revenue, 12 T.C. 358, 366 (1920). Until very recently, the British courts, following the House of Lords decision in *ICC v. Duke of Westminster*, 19 T.C. 490, 510 (U.K. 1905), insisted on strict, formal interpretations of tax laws.

198. Those principles developed primarily in U.S. case law. *See, e.g.*, Gregory v. Helvering, 293 U.S. 465, 469 (1935).

199. This principle has been adopted by civil law countries, including France, Germany, the Netherlands, Switzerland, and Austria. VOGEL, *supra* note 124, at 53.

200. Similarly, Article 31 of the Netherlands tax code has rarely been applied since the general principle of *fraus legis* (abuse of law) prevailed. Recently, however, the provision has become more important. Hoge RAAD, 20 953 BNB 1982/243, 20 954 BNB 1982/244, 20 991 1982/245.

A unilateral treaty-override is most likely to occur when domestic provisions are explicitly directed against treaty shopping because the courts will have to apply domestic law rather than treaty law. Many OECD member states[201] consider it legitimate for domestic legislation to override international treaties and for such legislation to be binding on the courts.[202] Domestic legislation, however, only overrides treaties if it is enacted after the conclusion of the treaties and if there is an express legislative intent to override the statute.[203] Only Switzerland,[204] the United States,[205] and, very recently, Germany[206] include anti-abuse

---

201. For example, in the practice of the United States, Germany, and Italy, *lex posterior* (later-in-time rule) prevails over treaties, although the constitutions of Germany and Italy are silent on what happens to a *lex posterior* rule. Eric Stein, *International Law: Toward Internationalization of Central-Eastern European Constitutions*, 88 AM. J. INT'L L. 427, 431 (1994). In France, however, the treaty always prevails and a later-in-time statute cannot override a treaty. Karl Josef Partsch, *International Law and Municipal Law*, *in* 10 ENCYCLOPEDIA OF PUBLIC INTERNATIONAL LAW 238, 248 (Rolf Dolzen et al. eds., 1988).

202. VOGEL, *supra* note 124, at 55.

203. *See, e.g.*, RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 115(1)(a) (1987).

204. In 1962, Switzerland inserted a provision in its domestic law that denies treaty benefits to corporate residents in which (a) nonresidents have a "substantial interest;" and (b) the corporation's debt to nonresidents is higher than six times its equity capital surplus reserves, or (c) the interest paid on borrowings from nonresidents is higher than the average interest rate on debt obligations issued by the Swiss Confederation, plus two percentage points, or (d) more than 50% of treaty benefited income (dividends, interest, and royalties) derived by the corporation from the other country is used by the corporation to satisfy claims of nonresidents to interest, royalties, development expenses, or depreciation on any kind of business assets, or (e) expenses connected with such income are not met exclusively from that income, or (f) the corporation fails to distribute at least 25% of the relevant income. Bundesratsbeschluss betreffend Massnahmen gegen die ungerechtfertigte Inanspruchnahme von Doppelbesteuerungsabkommen des Bundes as of Dec. 14, 1992, Sammlung der Eidgenössischen Gesetze [AS] 1962 (abuse ordinance) (amended by Kreisschreiben der Eidgenössischen Steuerverwaltung as of Dec. 31,1962).

205. The United States confined the anti-treaty-shopping measures in its domestic law to specific applications, most notably the U.S. branch profits tax. Section 884(e) of the Internal Revenue Code denies treaty benefits to a foreign corporation seeking a reduced rate of, or exemption from, the branch profits tax unless the taxpayer is a "qualified resident" of the treaty country. I.R.C. § 884(e) (1988). *See also* I.R.C. § 883(c) (1988) (anti-treaty-shopping measures applicable to foreign corporations engaged in shipping and air transport).

206. Missbrauchs-bekaempfungs-und Steuerbereinigungsgesetz [Anti-Abuse and Technical Corrections Act], Bundesratsdrucksache 788/93m, amended by Drucksache 12/6 123 (F.R.G.). The new legislation adds to Einkommensteuergetz [EStG] [internal revenue code] § 50(d)(1)(a) (F.R.G.), which denies treaty benefits to the

> extent that persons have interests in the foreign company who would not be entitled to tax relief if such persons received the income directly, and there do not exist any business or other adequate reason for the

provisions specifically aimed at treaty shopping in their domestic tax laws.

The decision to employ specific limitation-on-benefits provisions, general anti-treaty-shopping clauses, or general anti-abuse rules in domestic law to combat treaty shopping largely depends on a country's understanding of the fulfillment of international obligations. The implementation of an explicit, complex limitation-on-benefits provision in domestic law may create unilateral treaty overrides, an undesirable result with regard to international obligations under a treaty. Such statutes, however, even though constituting an override, do not raise particular problems with respect to interpretation because the scope of the statutes is made relatively clear.[207]

General anti-abuse provisions, in contrast, raise the question whether the domestic law can be interpreted and applied to circumstances arising under a treaty. The likelihood that courts may be reluctant to look beyond the literal wording of the treaty affects the efficiency of general abuse provisions in the case of treaty shopping. Therefore, it may be doubted that these general provisions will have any influence regarding the restriction of treaty shopping.

To avoid both conflicts with international obligations in the case of specific anti-treaty-shopping statutes in domestic law and legal uncertainty combined with possible weakness of general abuse rules, it is best to implement such provisions into the treaties. Consequently, there will be no violation of the principle of *pacta sunt servanda* because the avoidance provisions are then a result of the parties' negotiations.

---

interposition of the foreign company and the foreign company does not conduct its own business activity.

The German domestic anti-treaty-shopping provision is discussed in some detail *infra* Part IV.B.3.

207. Katz, *supra* note 179, at 620.

IV. A COMPARATIVE VIEW: THE CONCERN ABOUT TREATY ABUSE AND ITS PREVENTION

A. *The United States*

1. Historical Background

After World War II, Europe and Japan lay in ruins. As they attempted to recover from the destruction brought by the war, the United States overwhelmingly dominated the world economy.[208] In the first three postwar decades, the United States became the largest first lender of capital and accounted for a weighty share of world income, trade, and capital flows.[209]

Foreign direct investment in the United States was relatively insignificant compared to U.S. direct investment abroad.[210] Therefore, during this period, U.S. tax policy focused on its outbound investment rather than on inbound, foreign, direct investment.[211] Its international tax policy emphasized international competitiveness and the aim of achieving nondiscriminatory tax treatment of U.S. and foreign-based multinationals abroad, a policy known as capital import neutrality.[212]

In the 1960s, becoming aware that its capacity as a capital exporting country was not unlimited and that foreign resources were needed to finance domestic investment, several legislative proposals were initiated to attract foreign capital.[213] The United States also sought to discourage U.S. investment abroad, fearing that its trade balance surplus would adversely affect its balance of payments and reduce U.S. employment.[214] As a consequence, in 1964, the Interest Equalization Tax Act[215] restricted portfolio

---

208. In 1959, U.S. companies dominated 11 of the 13 major industries and thus made up a significant share of the world gross product. ROBERT A. RAGLAND, U.S. INTERNATIONAL TAX POLICY FOR A GLOBAL ECONOMY E-2 (1991).

209. Of the world's 20 largest industrial corporations, the number of U.S. headquartered corporations in 1960 was 18, as compared to only 9 in 1988. *Id.*

210. From 1955 to 1959, U.S. direct investment abroad constituted $75.5 billion. INTERNATIONAL MONETARY FUND, WORLD BANK 1990 (1990).

211. The 1954 Foreign Investment Incentive Act encouraged private investment abroad for the purpose of promoting U.S. industry and reducing government expenditures for foreign economic assistance. RAGLAND, *supra* note 208, at E-2.

212. *Id.*

213. *Id.*

214. *Id.*

215. Interest Equalization Tax Act, Pub. L. No. 88-563, 78 Stat. 809 (1964).

investment by U.S. persons in long-term debt obligations of foreign issuers.

In 1966, the Foreign Investors Tax Act[216] made portfolio investment in U.S. markets attractive for foreigners by exempting portfolio gains from tax. To further encourage domestic investment, the goal of U.S. tax policy became the achievement of uniform tax treatment of the domestic and foreign operations of U.S. persons—a shift to a policy of capital export neutrality.[217] The shift to capital export neutrality was most prevalent in the enactment of the controlled foreign corporation provisions in 1962.[218] These provisions had the effect of imposing current U.S. tax on certain classes of income earned by U.S.-owned foreign subsidiaries.

The Foreign Investors Tax Act made the United States a sort of tax haven for foreign portfolio investment. In so doing, it had a siphoning effect on worldwide capital flows. This incentive provided for an opportunity to invest in a secure economic and political environment based on a strong and stable currency without having to pay any tax on gains thus derived, especially with respect to Latin American capital resources.[219] It also created new tax planning incentives for portfolio investment and opportunities for direct investment.[220]

In the 1970s, a reversal of the U.S. international investment position took place and the role of the U.S. economy changed dramatically. By the 1980s, the United States became the world's largest debtor, with both a colossal trade deficit and a sky-rocketing rise in its importation of capital.[221] The U.S. Congress faced the potential revenue losses associated with the growing ability of foreign-owned businesses to reduce their tax liabilities either by taking advantage of existing domestic tax law or by making use of established treaty networks.[222]

---

216. Foreign Investors Tax Act, Pub. L. No. 89-809 (1966).

217. RAGLAND, *supra* note 208, at E-3.

218. I.R.C. § 951 et seq. (1988); Pub. L. 87-834, 76 Stat. 1006 (1962).

219. Many Latin American states do not tax their residents on foreign income. *See generally* CHARLES W. MCLURE, U.S. TAX LAWS AND CAPITAL FLIGHT FROM LATIN AMERICA (National Bureau of Economic Research Working Paper No. 2687, 1988).

220. Richard J. Safranek & M. Celeste Pickron, *Reaping the Profits*, INT'L FIN. L. REV., Nov. 1992 (special supp.), at 67.

221. Peter R. Merill & Robert J. Patrick, *U.S. International Tax Policy for a Global Economy*, TAX NOTES INT'L, Jan. 20, 1992, at 137.

222. *Id.*

2. Anti-Treaty-Shopping Measures in the U.S. Model Treaties and in Treaty Practice

a. The Development of Anti-Avoidance Provisions in U.S. Tax Treaties

Because U.S. treaty policy in the post-WWII years heavily favored residence rather than source based taxation, the United States sought primarily to reduce taxation at the source. In consideration of the economic situation of the first three post-war decades, the reduction or elimination of source tax granted on a reciprocal basis was most advantageous to the United States.[223] Therefore, the negotiators focused mainly on the reduction of source based taxation in their treaties. By promoting U.S. tax policies on a country-by-country basis, negotiators were not concerned about the impact of having substantially different provisions with other treaty partners.[224] For a long time, the United States accepted, or at least did not heavily oppose, the growing ability of third-country users to obtain treaty benefits.[225]

The first limitation-on-benefits provision, which dates back to the 1945 treaty between the United States and the United Kingdom,[226] had a rather limited function and ability to prevent treaty abuse. It denied a reduced tax rate for intercompany dividends when the "relationship . . . of the corporations ha[d] been arranged or . . . maintained primarily with the intention of securing such reduced rate."[227] Since there was little guidance for an interpretation and since the provision, lacking any objective determinants, focused on the state of mind of the person who had "arranged and maintained" the corporate structure, the provision merely gave the courts a basis for decision in these cases.[228]

---

223. *Id.* at 137, 142.

224. If each treaty had accorded treaty partners more or less the same benefits in the United States, it would have given rise to fewer issues insofar as investors from treaty countries were concerned.

225. K. Kooiman, *Art. 16: The U.S. Attitude to Treaty Shopping*, 1983 BIFD 195, 196.

226. *Id.*

227. U.S.-U.K. Income Tax Treaty, *signed* Apr. 16, 1945, art. VI, 3 Tax Treaties (CCH) ¶ 89,100, at 89,107.

228. The "arranged and maintained test" was used in some other treaties concluded in the 1950s. *See, e.g.*, U.S.-Austria Income Tax Treaty, *signed* Oct. 25, 1956, art. VI, 1 Tax Treaties (WGL) ¶ 16,100, at 16,106; U.S.-Ireland Income Tax Treaty, *signed* Sept. 13, 1949, art. VI, 2 Tax Treaties (WGL) ¶ 51,100, at 51,107; U.S.-Switzerland Income Tax Treaty, *signed* May 24, 1951, art. VI, 3 Tax Treaties (WGL) ¶ 82,100, at 82,107.

The first specific anti-avoidance provision was inserted in the 1962 U.S.-Luxembourg treaty and it excluded Luxembourg holding companies nonreciprocally from the scope of the convention due to Luxembourg's favorable domestic-holding-company laws.[229] A similar, but fundamentally different, provision was inserted in the 1963 protocol with the Netherlands with respect to the Netherlands Antilles.[230] Unlike a tax-favored Luxembourg entity, a tax-favored Antilles entity could avoid the limitation on benefits by declining the special advantages offered by the Antilles domestic law.[231]

In the 1970s, starting with the 1970 Finland treaty,[232] similar provisions excluded investment or holding companies from obtaining any relief.[233] Those provisions proved to be more efficient in preventing the specifically identified abuse situation; however, they were not directed against global treaty shopping structures because these features had not yet grown to such proportions that broad-based remedies were necessary.

b. The U.S. Model Conventions and Their Influence on Treaty Policy

In 1977, the first U.S. model treaty was released.[234] Article 16 of the 1977 U.S. Model Treaty imposed an ownership test, but only on dividends, interest, and royalties. It denied treaty benefits if (1) twenty-five percent or more of the treaty-protected entity was owned by nonresidents of the treaty partner, and (2) the treaty partner's tax on such payments was substantially less than the treaty partner's tax on general business profits.[235]

The shift to the 1981 model anti-treaty-shopping provisions is substantial. The 1981 model treaty[236] includes a fairly detailed

---

229. U.S.-Luxembourg Treaty, 2 Tax Treaties (CCH) ¶ 5601.

230. 1963 Protocol with the Netherlands, 2 Tax Treaties (CCH) ¶ 6239.

231. Rosenbloom, *supra* note 7, at 783.

232. 1 Tax Treaties (CCH) ¶ 2845.

233. U.S.-Iceland Income Tax Treaty, *signed* May 7, 1975, art. 27, 2 Tax Treaties (WGL) ¶ 46,100, at 46,127; U.S.-Egypt Income Tax Treaty, *signed* Aug. 24, 1980, art. 24, 1 Tax Treaties (WGL) ¶ 34,100, at 34,124; U.S.-Morocco Income Tax Treaty, *signed* Aug. 1, 1977, art. 24, 2 Tax Treaties (WGL) ¶ 64,100, at 64,124; U.S.-Korea Income Tax Treaty, *signed* June 4, 1976, art. 17, 2 Tax Treaties (WGL) ¶ 57,100, at 57,117; U.S.-Norway Income Tax Treaty, *signed* Dec. 3, 1971, art. 20, 3 Tax Treaties (WGL) ¶ 69,030, at 69,050.

234. 1977 U.S. Model Treaty, *supra* note 9.

235. *Id.*

236. 1981 U.S. Model Treaty, *supra* note 3, art. 16. The U.S. Treasury Department has been working on a revised U.S. model, but to date has not released the results of its endeavors.

provision designed to curtail treaty shopping. It contains a limitation-on-benefits provision that is applicable to all treaty benefits and includes a stock ownership test in connection with a base-erosion test, publicly traded test, business purpose test, and a tax-favored income clause.[237]

The ownership or look-through test incorporated in the U.S. model requires a specified portion of shares to be held by residents of one of the contracting states in order for a company to qualify for treaty benefits.[238] Under this test, a corporation qualifies as a resident if at least seventy-five percent of its shares are held by residents of the contracting state.[239] The ownership requirement varies in the actual treaty practices of the United States because negotiators recognize the unusually high threshold of a seventy-five percent ownership in the model. Most recent U.S. treaties include a fifty percent test.[240] Since the proportion of shares should reflect the true ownership, however, the test has to take into account the ownership of nonvoting and preference shares. Otherwise, arrangements might be made to allot all voting shares to residents, while providing that a large portion of the profits be distributed to nonresident, nonvoting shareholders. As an example, the United States most recent treaty with Mexico declares:

> A person that is a resident of a Contracting State and derives income from the other Contracting State shall be entitled . . . to relief from taxation . . . only if . . . more than 50 percent of the beneficial interest in such person (or in case of a company, more than 50 percent of the number of shares of each class of the company's shares) is owned, directly or indirectly, by persons entitled to the benefits of this Convention. . . ."[241]

While the recent U.S. practice has been to broaden the class of qualifying shareholders to include residents of either treaty country, the existing U.S. model treaty adopts the narrower rule that a company resident in a contracting state must be owned by individuals resident in that state in order to claim treaty benefits.

---

237. *Id.*

238. *Id.*

239. Under Article 16 of the 1981 U.S. Model, the ownership test is satisfied if "more than 75% of the interest in such person is owned, directly or indirectly, by one or more individual residents of the first-mentioned Contracting state." *Id.* art. 16(1).

240. *See, e.g.*, U.S.-Germany Income Tax Treaty, *signed* Aug. 29, 1989, art. 28(1)(e)(aa), 2 Tax Treaties (WGL) ¶ 39,030, at 39,058 (The ownership test is satisfied if "more than 50% of the beneficial interest in which (or in the case of a company, more than 50% of the number of shares of each class of whose shares) is owned, directly or indirectly, by persons entitled to benefits of this Convention.").

241. U.S.-Mexico Income Tax Treaty, *signed* Sept. 18, 1992, art. 17(1)(f)(i), 2 Tax Treaties (WGL) ¶ 62,100, at 62,118.

The recent change in anti-abuse provisions indicates that the new phrasing is solely aimed at third country residents attempting to obtain treaty benefits. For this purpose, shareholders who are residents of either country do not appear to engage in the type of abuse at which the provision is aimed—ownership by third country residents.[242]

The U.S. model also includes the base-erosion test, which is now one of the main U.S. anti-treaty-shopping provisions. The base-erosion test is almost always employed in connection with the look-through test.[243] The 1981 U.S. Model, however, lacks specificity in identifying the threshold of income being eroded from the base.[244] It denies treaty relief under Article 16(1)(b) when a "substantial amount" of income is being eroded, but does not define that term.[245] Only with reference to recent treaty practice can "substantial amount" be interpreted to mean more than fifty percent.[246] The base-erosion test evolved in recent U.S. treaties, becoming more complex and elaborate. For example, in the U.S.-Mexico treaty, an entity is only entitled to treaty relief if it satisfies both of the following conditions: (1) the ownership test, and, (2) that "less than 50 percent of the gross income of such person is used directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons not entitled to the benefits of this Convention. . . ."[247]

The U.S. model does not explicitly mention the exclusion approach, but it has occasionally been incorporated into U.S. treaties. The most recent example is the U.S.-Netherlands treaty, which completely excludes conduit companies, most likely

242. Joint Committee on Taxation explanation of the proposed U.S.-Czech Republic income tax treaty, Oct. 26, 1993, *reprinted in* 1 Tax Treaties (WGL) ¶ 30,132.

243. The U.S. treaties with Australia, 1 Tax Treaties (WGL) ¶ 15,000, Italy, 2 Tax Treaties (WGL) ¶ 53,000 and New Zealand, 3 Tax Treaties (WGL) ¶ 67,000, do not contain the base-erosion test.

244. 1981 U.S. Model Treaty, *supra* note 3.

245. *Id.*

246. The following treaties refer to "more than 50% of income being eroded from the base": U.S.-Belgium Income Tax Treaty, *signed* July 9, 1970, 1 Tax Treaties (WGL) ¶ 20,500; U.S.-China Income Tax Treaty, *signed* Apr. 30, 1984, 3 Tax Treaties (WGL) ¶ 72,000; U.S.-Finland Income Tax Treaty, *signed* Sept. 21, 1989, 2 Tax Treaties (WGL) ¶ 37,000; U.S.-France Income Tax Treaty, *signed* Aug. 31, 1994, 1 Tax Treaties (WGL) ¶ 38,000; and U.S.-Germany Income Tax Treaty, *signed* Aug. 29, 1989, 2 Tax Treaties (WGL) ¶ 39,000.

247. U.S.-Mexico Income Tax Treaty, *signed* Sept. 18, 1992, art. 17(1)(f)(ii), 2 Tax Treaties (WGL) ¶ 62,000, at 62,118.

established for tax avoidance purposes, from the scope of the treaty.[248]

Under the 1981 U.S. Model, the stock exchange or publicly traded test entitles a company to a presumption that it is owned by individual residents of a contracting state if the company has substantial trading on a recognized stock exchange of either contracting state.[249] While the OECD commentaries and the U.N. Ad Hoc Group of Experts view the stock exchange test as a blanket exception to all other provisions, the 1981 U.S. Model considers the publicly traded test to be an exception to the ownership test, while the base-erosion test is still applicable.[250]

Most post-1981 U.S. treaties, however, contain no base-erosion test for publicly traded companies and thus function as a complete safe harbor.[251] For example, the U.S.-Mexico treaty grants treaty benefits to persons resident in one contracting state who derive benefits from the other contracting state if the person

---

248. A person is entitled to treaty benefits "[if] the company is not a conduit company." U.S.-Netherlands Income Tax Treaty, *signed* Dec. 18, 1992, art. 26(1)(c)(iii)(c), 3 Tax Treaties (WGL) ¶ 66,030, at 66,056. However, there is one exception:

> [A] conduit may qualify for benefits if it is publicly traded and the base reduction payments do not exceed 70% of the total income to [E.C.] members and 30% to others. Under Article 26(1), a person is eligible for treaty benefits when a conduit . . . satisfies the requirements [that] . . . at least 30% of the aggregate vote and value of all of its shares is owned, directly or indirectly, by five or fewer companies resident in the Netherlands, the principal classes of the shares of which [are listed on a recognized stock exchange located in either country, and] at least 70% of the aggregate vote and value of all of its shares is owned, directly or indirectly, by five or fewer companies that are residents of the United States or of member states of the European Communities, the principle classes of shares of which are substantially and regularly traded on one or more recognized stock exchanges [and] . . . such company satisfies the conduit base reduction test. . . .

Id. art. 26(1)(C)(iv), (1)(C)(iii)(A), (1)(C)(iii)(B).

249. VOGEL ET AL., *supra* note 8, at 61 (Commentary on Art. 16).

250. *See* 1995 OECD Model Treaty, *supra* note 1; U.N. MODEL CONVENTION, *supra* note 2; 1981 U.S. Model Treaty, *supra* note 3.

251. Two treaties require that a publicly traded company still satisfy the base-erosion test of Article 16(1)(b). U.S.-Cyprus Income Tax Treaty, *signed* Mar. 19, 1984, art. 26, 1 Tax Treaties (WGL) ¶ 29,126; U.S.-Jamaica Income Tax Treaty, *signed* May 21, 1980, art. 17, 2 Tax Treaties (WGL) ¶ 55,117. The other post-1981 treaties function as a complete safe harbor, without additional requirement, under the limitation-on-benefits article. *E.g.*, U.S.-Australia Income Tax Treaty, *signed* Aug. 6, 1982, art 16(1)(a), 1 Tax Treaties (WGL) ¶ 15,046; U.S.-Barbados Income Tax Treaty, *signed* Dec. 31, 1984, art. 22(1)(a), 1 Tax Treaties (WGL) ¶ 20,122 (*entered into force* Feb. 28, 1986); U.S.-Italy Income Tax Treaty, *signed* Apr. 17, 1984, Protocol Art. 2(1)(a), 2 Tax Treaties (WGL) ¶ 53,060; U.S.-New Zealand Income Tax Treaty, *signed* July 23, 1982, art. 16(1)(a), 3 Tax Treaties (WGL) ¶ 67,046.

is either "a company in whose principal class of shares there is substantial and regular trading on a recognized securities exchange located in either of the states" or "a company which is wholly owned, directly or indirectly, by a resident of that contracting state in whose principle class of shares there is such substantial and regular trading on a recognized securities exchange located in either of the states."[252] In the U.S.-Netherlands treaty, however, the presumption of a publicly traded company, being less likely to be formed for purposes of tax treaty abuse, was not deemed to be valid in the case of indirect ownership.[253] As a result, a conduit base reduction test was included in the Dutch treaty.[254]

Even though the idea behind an activity requirement is clear, the reason why the active trade and business test is not contained in the 1981 U.S. Model might be that the situations to which this test may be applied remain uncertain—leaving the flexibility to distinguish bona fide residents to the tax authorities.[255] Although a vague rule, this provision has been included in U.S. domestic law[256] and in recent U.S. treaties[257] without providing any advance definition of what constitutes an active trade or business. However, the application of the active trade and business test to Dutch intermediate holding companies using the Netherlands as a base for international financial services was too uncertain.[258] Therefore, it was crucial for the Netherlands during the negotiation of its treaty with the United States to provide an advance distinction between base companies engaged in banking or licensing activities and pure flow-through entities, which, in extreme cases, were created for a single

---

252. U.S.-Mexico Income Tax Treaty, *signed* Sept. 18, 1992, 2 Tax Treaties (WGL) ¶ 62,100.

253. U.S.-Netherlands Treaty, *signed* Dec. 18, 1992, Art. 26(5)(d), 3 Tax Treaties (WGL) ¶ 66,030.

254. *Id.* "[T]he conduit base reduction test means . . . payments . . . made to an associated enterprise . . . that are subject to an aggregate rate of tax . . . in the hands of the recipient that is less than 50 percent of the rate that would be applicable had the payment been received in the State of residence of the payor." *Id.*

255. 1981 U.S. Model Treaty, *supra* note 3.

256. I.R.C. § 884(e)(4)(D) (1988).

257. The test, for example, is included in the U.S. treaty with Mexico, which requires the person claiming treaty benefits to be engaged in the active conduct of a trade or business and the income to be derived in connection with, or be incidental to, this trade or business. U.S.-Mexico Income Tax Treaty, *signed* Sept. 18, 1992, 2 Tax Treaties (WGL) ¶ 62,000.

258. Mary C. Bennett, *The U.S.-Netherlands Tax Treaty Negotiations: A U.S. Perspective*, 45 BIFD 3, 5 (1991).

transaction.[259] Considering the special situation of the Netherlands as an attractive country for headquarter companies, the quantum of activity meeting the active trade or business test had to be determined ex-ante rather than ex-post. Therefore, a headquarter test was included in the U.S.-Netherlands treaty.[260] This test provides that benefits can be obtained by a company that performs a substantial portion of the supervisory and administrative functions for a multinational corporate group doing business in at least five countries.[261] The headquarter test is important for Dutch holding companies because it provides them a safe harbor rule. The test was adopted exclusively in the U.S. treaty with the Netherlands.[262]

The U.S. model[263] and most recent U.S. treaties contain provisions that the OECD commentaries would approve as bona fide provisions, such as the motive test and derivative clauses.[264] The motive test[265] is found in the 1981 U.S. Model[266] as well as in recent U.S. treaties. For example, in the U.S.-Mexico treaty an entity not otherwise entitled to treaty benefits may nonetheless demonstrate its entitlement to such benefits.[267] While the motive test gives broad discretion to the tax administration, it generally gives entities that otherwise would not qualify for treaty benefits the opportunity to do so. In the United States, the taxpayer may obtain an ex-ante determination under the motive test in a private letter ruling from the Internal Revenue Service.[268]

---

259. U.S.-Netherlands Treaty, *signed* Dec. 18, 1992, 3 Tax Treaties (WGL) ¶ 6,030.

260. *Id.*

261. For the United States, the determination of business activity would probably be governed by Treas. Reg. §§ 1.884, 1.367(a)-2T(b)3, which require that "the officers and employees of the corporation carry out substantial managerial and operational activities." For the Netherlands, this issue has already been decided in connection with the participation exemption and for VAT purposes, namely when "a holding company has a controlling and administrative function with respect to the active companies in the corporate group."

262. U.S.-Netherlands Treaty, *signed* Dec. 18, 1992, 3 Tax Treaties (WGL) ¶ 6,030.

263. 1981 U.S. Model Treaty, *supra* note 3.

264. *1995 OECD Model Treaty*, *supra* note 1. See, e.g., the treaties with Mexico, 2 Tax Treaties (WGL) ¶ 62,000; Germany, 2 Tax Treaties (WGL) ¶ 39,000; and the Netherlands, 2 Tax Treaties (WGL) ¶ 66,000.

265. *See supra* notes 179-80 and accompanying text.

266. 1981 U.S. Model Treaty, *supra* note 3, art. 16(2).

267. U.S.-Mexico Income Tax Treaty, *signed* Sept. 18, 1992, art. 17(2), 2 Tax Treaties (WGL) ¶ 62,000.

268. Advance determination is not a requirement under this rule. A taxpayer could, conceivably, rely on its purity of motive to give itself comfort that it could persuade the competent authority to make a favorable determination after the fact or, if it failed, persuade a court that the competent authority abused its discretion. For a variety of reasons,

Largely representing a counter-reaction to its intense effort to eliminate, or at least restrain, treaty shopping, the United States is the first country to make use of derivative clauses.[269] These clauses establish that benefits pursuant to a tax treaty between two countries can be obtained by entities owned by third-country residents.[270] Such clauses materialized in the recent U.S. treaties with the Netherlands and Mexico.[271] Under these treaties, entities owned by a narrowly defined class of third-country residents are able to qualify for treaty benefits.[272] In the U.S.-Netherlands treaty for example, European Community (E.C.) members, whose treaty rate is as low as that claimed under the U.S.-Netherlands treaty can claim treaty benefits under the U.S.-Netherlands treaty if they operate a Netherlands corporation in order to invest in the United States.[273] The same principle is applied in the U.S.-Mexico treaty with respect to North American Free Trade Agreement (NAFTA) countries.[274]

The appearance of derivative benefits in U.S. tax treaty policy represents a principal achievement in the recognition of the European Community and NAFTA as economic confederations.[275]

> however, at least where the United States is the source State, only the boldest of taxpayers will rely on this provision without obtaining the advance blessing of the IRS.

Mary C. Bennett et al., *A Commentary to the United States-Netherlands Tax Convention*, 4-5 INTERTAX 165, 195 (1993).

269. The 1995 OECD Model does not contain any reference to multinational economic groups. *1995 OECD Model Treaty*, *supra* note 1.

270. *Id.*

271. U.S.-Mexico Income Tax Treaty, *signed* Sept. 18, 1992, 2 Tax Treaties (WGL) ¶ 62,000; U.S.-Netherlands Income Tax Treaty, *signed* Dec. 18, 1992, 3 Tax Treaties (WGL) ¶ 66,030.

272. U.S.-Mexico Income Tax Treaty, *signed* Sept. 18, 1992, 2 Tax Treaties (WGL) ¶ 62,000; U.S.-Netherlands Income Tax Treaty, *signed* Dec. 18, 1992, 3 Tax Treaties (WGL) ¶ 66,030.

273. U.S.-Netherlands Income Tax Treaty, art. 26(4)(a)(i)-(ii), 2 Tax Treaties (CCH) ¶ 6103 ("[M]ore than 30 percent of the aggregate vote and value of all its shares . . . is owned, directly or indirectly, by qualified persons resident in the Netherlands; [and] more than 70 percent of all such shares is owned, directly or indirectly, by qualified persons and persons that are residents of member states of the European Communities. . . .").

274. The "ownership" test is fulfilled if more than 30% of the beneficial interest is owned, directly or indirectly, by a resident of a contracting state and more than 60% is owned, directly or indirectly, by a NAFTA member state. U.S.-Mexico Income Tax Treaty, *signed* Sept. 18, 1992, 2 Tax Treaties (WGL) ¶ 62,000. In addition, in order to qualify for treaty benefits, the treaty-country entity must satisfy the base-erosion test. Under the base-erosion test, less than 70% of the gross income may be used to directly or indirectly meet liabilities to persons not entitled to benefits under this treaty and less than 40% may be used to directly or indirectly meet liabilities to NAFTA members. *Id.*

275. Goossen, *supra* note 167, at 36.

The integration and harmonization process in Europe was mainly furthered by the Treaty of Rome,[276] which prohibits states from discriminating against residents of other E.C. countries.[277] Articles 52 and 58 of the Treaty of Rome provide that any company incorporated under the laws of any E.C. country has the right to establish itself in any other E.C. country under the same conditions as a domestic company.[278] Because a limitation-on-benefits provision in a bilateral treaty usually favors only the residents of one E.C. country, such a provision could conflict with the freedom of establishment under the Treaty of Rome and discriminate against other E.C. members. It is obvious that E.C. members have to comply with the nondiscrimination rule regarding treaties with each other. Controversy arises, however, over whether E.C. member states have the right to negotiate and conclude treaties with non-E.C. states that could indirectly result in discrimination against other E.C. members. This issue was discussed in the European Parliament after the conclusion of the 1989 U.S.-German tax treaty and has been analyzed by practitioners.[279] Even though there is no explicit rule with regard to treaties with non-member states, Article 5 of the Treaty of Rome urges E.C. members to take "all appropriate measures, whether general or particular, to ensure fulfillment of the obligations arising out of this treaty . . . and abstain from any measure which could jeopardize the attainment of the objectives of this treaty."[280]

On this basis, the Dutch, when negotiating the tax treaty with the United States, insisted on the first derivative clause ever imposed in a bilateral tax treaty related to the E.C.[281] In this regard, the Dutch were in a good bargaining position because they made so many concessions on most other treaty shopping provisions. Even so, the derivative provisions in the U.S.-Netherlands treaty do not go far enough for most Europeans.[282] The ownership requirements allow only a certain percentage of participation by European states other than the Netherlands.[283]

---

276. Treaty Establishing the European Economic Community, Mar. 25, 1957, 298 U.N.T.S. 11, *as amended by* Single European Act, 1987 O.J. (L 169) 1, 7 [hereinafter Treaty of Rome].

277. Dirk van Unnik & Maarten Boudesteijn, *The New U.S.-Dutch Tax Treaty and the Treaty of Rome*, 1993/2 EC TAX REV. 106, 108.

278. Treaty of Rome, *supra* note 276.

279. U.S.-German Income Tax Treaty, *signed* Aug. 29, 1989, 2 Tax Treaties (WGL) ¶ 39,000. Helmut Becker & Otmar Toemmes, *Treaty Shopping and EC Law*, EUR. TAX'N, June 1991, at 173.

280. Treaty of Rome, *supra* note 276.

281. U.S.-Dutch Tax Treaty, 2 Tax Treaties (CCH) ¶ 6103.

282. *Id.*

283. Goossen, *supra* note 167, at 36, 44-45.

The derivative benefits policy manifested in the U.S.-Netherlands treaty and the U.S.-Mexico treaty represents the beginning of a significant development that could set a pattern for future treaty negotiations. By recognizing economic and legal realities, the derivative benefits policy constitutes a breakthrough in the area of bilateral treaties.[284]

The 1977 and 1981 U.S. model treaties and recent treaty practice demonstrate the change in the U.S. treaty shopping position over the past eighteen years.[285] Since the radical turning point in the early 1980s,[286] there has been an increase in the sophistication and complexity of United States treaty shopping

284. For a critical analysis of the derivative benefits policy, see Rosenbloom, *supra* note 164.

285. Though none of the post-1981 treaties is identical to the U.S. model, some of them directly correspond to the U.S. model. For example, see U.S.-Cyprus Income Tax Treaty, *signed* Mar. 19, 1984, 1 Tax Treaties (WGL) ¶ 29,126; U.S.-Jamaica Income Tax Treaty, *signed* May 21, 1980, 2 Tax Treaties (WGL) ¶ 55,117. Most of the post-1981 treaties have slight alterations in the ownership threshold or base-erosion test. For example, see China Protocol, 1 Tax Treaties (CCH) ¶ 2136; U.S.-Finland Income Tax Treaty, *signed* Sept. 21, 1989, art. 16, 1 Tax Treaties (WGL) ¶ 37,020; U.S.-France Income Tax Treaty, *signed* Aug. 31, 1994, 2 Tax Treaties (WGL) ¶ 38,020; U.S.-India Income Tax Treaty, *signed* Sept. 12, 1989, art. 24, 2 Tax Treaties (WGL) ¶ 48,100; U.S.-Indonesia Income Tax Treaty, *signed* July 11, 1988, art. 28, 2 Tax Treaties (WGL) ¶ 49,100, at 49,128; Spain, *supra* note 213; U.S.-Tunisia Income Tax Treaty, *signed* June 17, 1985, 3 Tax Treaties (WGL) ¶ 85,550. The treaties, however, with Australia, *signed* Aug. 6, 1982, 1 Tax Treaties (WGL) ¶ 15,030; Italy, *signed* April 17, 1984, 2 Tax Treaties (WGL) ¶ 53,060; and New Zealand, *signed* July 23, 1982, 3 Tax Treaties (WGL) ¶ 67,046, do not contain any base-erosion test, with the result that an entity that satisfies the ownership test is entitled to treaty benefits. The U.S.-Barbados Income Tax Treaty, *signed* Dec. 31, 1984, 1 Tax Treaties (WGL) ¶ 20,100, provides a disjunctive rather than a conjunctive ownership and base-erosion test. *See also* 1977 U.S. Model Treaty, *supra* note 9; 1981 U.S. Model Treaty, *supra* note 3.

286. Following the development in the 1981 model, all subsequent income tax treaties contain full-blown anti-treaty-shopping clauses similar to those in the 1981 U.S. Model Treaty, *supra* note 3: U.S.-Australia Income Tax Treaty, *signed*, Aug. 6, 1982, art. 16, 1 Tax Treaties (WGL) ¶ 15,030; U.S.-China Income Tax Treaty, *signed* Apr. 30, 1994, Protocol art. 7(1), 3 Tax Treaties (WGL) ¶ 72,100; U.S.-Cyprus Income Tax Treaty, *signed* Mar. 19, 1984, art. 26, 1 Tax Treaties (WGL) ¶ 29,100, at 29,126; U.S.-Finland Income Tax Treaty, *signed* Sept. 21, 1989, art. 16, 1 Tax Treaties (WGL) ¶ 37,020, at 37,020-P; U.S-India Income Tax Treaty, *signed* Sept. 12, 1989, art. 24, 2 Tax Treaties (WGL) ¶ 48,100, at 48,124; U.S-Indonesia Income Tax Treaty, *signed* July 11, 1988, art. 28, 2 Tax Treaties (WGL) ¶ 49,100, at 49,128; U.S.-Italy Income Tax Treaty, *signed* Apr. 17, 1984, Protocol, art. 2, 2 Tax Treaties (WGL) ¶ 53,030, at 53,060; U.S.-Jamaica Income Tax Treaty, *signed* May 21, 1980, art. 17, 2 Tax Treaties (WGL) ¶ 55,100, at 55,117; U.S.-New Zealand Income Tax Treaty, *signed* July 23, 1982, art. 16, 3 Tax Treaties (WGL) ¶ 67,030, at 67,046; U.S.-Spain Income Tax Treaty, *signed* Feb. 22, 1990, art. 17, 3 Tax Treaties (WGL) ¶ 79,550, at 79,550.17.

provisions, culminating in the U.S.-Netherlands treaty.[287] The United States apparently realized that the economic importance of treaty shopping had grown tremendously and that urgent measures were needed.

3. Judicial Precedents

Long before treaty shopping was addressed on a large scale in U.S. treaty practice, the judiciary dealt with cases involving treaty shopping and developed precedents based on domestic abuse principles.[288] An evolution had taken place that had to be considered in light of changing investment positions, the growing number of claims for tax relief based on a few tax treaties, and the increasing sophistication of treaty shopping structures. Since most treaties at the time lacked detailed anti-treaty shopping provisions,[289] the courts applied general principles of domestic tax law to interpret the meaning and purpose of the treaties.

In U.S. tax law, there are two distinct approaches that can be applied to deny treaty benefits to conduit companies: (1) the sham doctrine and (2) the conduit concept. A sham corporation is a mere shell, lacking business activity or business purpose. To the extent that a corporation lacks business activity or purpose, it will not be considered a separate taxable entity. The result is that all profits and losses of the company are imputed to its shareholders.[290] Conduit companies, in contrast, are respected as distinct legal entities, functioning as agents with regard to a particular transaction or groups of transactions. Thus, the tax consequences do not have to be determined with respect to the treaty-protected entity, but the final recipient of the income. In both cases, it must be considered whether it would be appropriate

---

287. For example, the limitation-on-benefits article of the U.S.-Netherlands Income Tax Treaty, *signed* Dec. 18, 1992, art. 26, 3 Tax Treaties (WGL) ¶ 66,030, at 66,056, covers almost seven pages. Additionally, the Technical Explanation of the Protocol amending the treaty contains 38 pages explaining Article 26, compared to 66 pages explaining the rest of the treaty. This proportion shows that the limitation-on-benefits article was extremely important to the U.S. negotiators. It is estimated that the new limitation-on-benefits provision will be simpler than that in the Dutch treaty, which was "somewhat difficult to use in negotiations." *See Report Bulletins*, 1 Tax Treaties (WGL), Vol. 26, No. 5, at 5 (May 27, 1994). The new model will probably contain provisions similar to the German and Mexican treaties, whereas the Netherlands treaty will stand alone and not become a pattern for future standards. Because the complexity and sophistication of the limitation-on-benefits article has increased drastically, as a result of the changing U.S. tax policy, the need for a revised U.S. model treaty has also increased. *See supra* note 236.

288. *1987 Hearing*, *supra* note 6, at 360.

289. *See supra* Part IV.A.1.

290. WESTIN, *supra* note 87, at 554.

to give effect to the substance rather than the form of the transaction. Therefore, because a sham company will not be regarded as a separate entity for tax purposes, the characterization has been narrowly construed by U.S. courts.[291]

In early cases, when facing the problem of form versus substance, U.S. courts were reluctant to overlook the corporate form of an entity established for tax purposes if the entity had been formed for a substantial business purpose. The test did not depend on the personal objective of the taxpayers creating the corporations, but on whether the corporations were "mere skeletons."[292] If the court found "significant flesh on the bones,"[293] the foreign corporation would be considered a separate legal entity and therefore entitled to benefits under the applicable tax treaty. A minimal quantum of corporate activities was considered sufficient to qualify for recognition as a distinct entity. The alternative requirements of business purpose or business activity were restated in a long line of cases.[294]

a. *Bass v. Commissioner*

The first time the Internal Revenue Service (I.R.S. or Service) used the sham argument in an international tax case was in *Bass v. Commissioner.*[295] In *Bass*, a U.S. taxpayer had organized a Swiss corporation in which he owned 97.96 percent of the stock. He transferred working interests in certain oil and gas leases to this corporation, which then exercised those rights by signing work agreements, collecting royalties, and carrying out other activities.[296] This Swiss company then filed a U.S. income tax

---

291. Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943).

292. Gregory v. Helvering, 293 U.S. 465 (1935); Hay v. Commissioner, 2 T.C. 460 (1943); Commissioner v. Smith, 136 F. 2d 556 (2d Cir. 1943).

293. Bass v. Commissioner, 50 T.C. 595 (1968).

294. *See* Nat'l Carbide Corp. v. Commissioner, 336 U.S. 422, 429 (1949); Jackson v. Commissioner, 24 T.C. 1, 12 (1955), *aff'd*, 233 F.2d 289 (2d Cir. 1956); Aldon Homes, Inc. v. Commissioner, 33 T.C. 582, 597 (1959); Shaw Construction Co. v. Commissioner, 35 T.C. 1102, 1114 (1961), *aff'd*, 323 F.2d 316 (9th Cir. 1963); Nat Harrison Assocs. v. Commissioner, 42 T.C. 601, 618 (1964); Columbian Rope Co. v. Commissioner, 42 T.C. 800, 813 (1964); V.H. Monette & Co. v. Commissioner, 45 T.C. 15, 35 (1965), *aff'd*, 374 F.2d 116 (4th Cir. 1967); Bass v. Commissioner, 50 T.C 595, 600 (1968); Ross Glove Co. v. Commissioner, 60 T.C. 569, 588 (1973); Achiro v. Commissioner, 77 T.C. 881, 901 (1981).

295. *Bass*, 50 T.C. 595 (1968).

296. *Id.*

return claiming that it was not subject to federal income tax pursuant to the U.S.-Swiss Income Tax Convention.[297]

The *Bass* court had to decide whether to disregard the existence of the Swiss entity because the sole purpose for incorporation was to avoid U.S. taxes. In accordance with the definition of a sham company and the principle of substance versus form, the court did not focus on the taxpayer's intent to minimize taxes, but rather on whether the corporation was carrying out "substantive business functions"—whether the corporation was in fact a "viable business entity, . . . actually engaged in substantive business activity."[298] The administration of the oil rights required at least some business activity, which was distinct from the decision-making process carried out by the sole shareholder. Applying the narrow definition of a sham entity, the court found that the corporation was engaged in a substantive business activity,[299] and that the Swiss company's status as a separate entity would be respected.[300] Relying on prior cases,[301] the court held that a tax avoidance motive was insufficient to cause an entity to be disregarded for tax purposes if some business purpose or activity existed.[302]

b. *Johansson v. United States*

The sham test was also applied in *Johansson v. United States*.[303] In *Johansson*, a Swedish heavy-weight boxer, Ingemar Johansson, created a Swiss company that received the income from his boxing activities and paid him a salary as an employee.[304] When filing his U.S. tax return, Johansson claimed an exemption from income tax assessed under the Internal Revenue Code (I.R.C.) for the services performed in the United States on the basis of the U.S.-Swiss Income Tax Convention.[305]

---

297. U.S.-Swiss Income Tax Convention, *signed* May 24, 1951, 3 Tax Treaties (WGL) ¶ 82,101.

298. *Bass*, 50 T.C. at 600. *See also* National Carbide Corp. v. Commissioner, 336 U.S. 422, 433 (1949).

299. The court held that a taxpayer may adopt any desired form for the conduct of the business and the mere fact that this form results in tax savings does not require that the form be ignored for tax purposes. *Bass*, 50 T.C. at 600.

300. *Id.* at 602. It is important to note that the issue really concerned residence-based tax. Perry Bass was a U.S. resident who used foreign incorporation and a tax treaty to avoid residence-based tax. *Id.*

301. *See, e.g.*, Siegel v. Commissioner, 45 T.C. 566 (1966).

302. *Bass*, 50 T.C. at 600.

303. 336 F.2d 809 (5th Cir. 1964).

304. *Id.* at 813.

305. *Id.* at 812. *See also* U.S.-Swiss Income Tax Convention, *signed* May 24, 1951, 3 Tax Treaties (WGL) ¶ 82,101.

Using the conduit theory, the I.R.S. argued that treaty benefits could not be obtained by entities organized in a treaty jurisdiction solely to obtain treaty benefits that otherwise would not be available for the ultimate recipient of the treaty-protected income.[306] The court, however, applied the sham corporation doctrine and found that the corporation lacked any legitimate business purpose and that the primary motive for its creation was tax avoidance.[307]

What distinguishes *Johansson* from *Bass* is that the income from Johansson's activities as a boxer constituted the only source of income for the corporation. The *Johansson* corporation carried on no separate activity apart from his personal activities. The case was not decided on the fact that Johansson was motivated in his actions by considering the desire to minimize his tax burden,[308] but rather by considering the nature of the service contract.[309] Because the only activity of the corporation was performed by Johansson himself and the corporation did not have administrative functions, the court concluded that the entity completely lacked a business purpose.[310] Invocation of the conduit principle—treating the corporation as merely an agent that received Johansson's income on his behalf so as to escape U.S. taxation—may also have led to the Service's success in *Johansson*.

c. *Aiken Industries*

The *Bass* and *Johansson* cases show that, in the early years, U.S. courts focused primarily on the substance of the entity rather than the transaction. However, because treaty shopping structures often involved back-to-back transactions, a new test was needed that would focus on the beneficial owner of the income rather than the activity of the treaty-protected entity.[311] Since the Service would have had no chance to succeed in most

---

306. *Johansson*, 336 F.2d at 813.

307. *Id.* at 814. *See also* Noonan v. Commissioner, 52 T.C. 907 (1969).

308. *See also* Siegel v. Commissioner, 45 T.C. 566 (1966).

309. A similar issue arose in *Jones v. Commissioner*, 64 T.C. 1066 (1975), where an official court reporter reproduced and sold official transcripts of trials he was responsible for in the course of his official duties. Since an official court reporter is required by law to be an individual and not a corporation and the corporation did not have any other activities, its income was attributed and made taxable to the court reporter himself under I.R.C. §§ 61(a) & 482 (1988).

310. *Johansson*, 336 F.2d at 814.

311. *1987 Hearing*, *supra* note 6, at 364.

treaty shopping cases on the basis of a sham argument,[312] it had to find another legal principle upon which to rely. The conduit argument provides the needed focus on the true recipient of the income.

The court applied the conduit theory in the leading case of *Aiken Industries, Inc. v. Commissioner*,[313] which dealt with an incorporation obviously aimed at the receipt of treaty benefits. A wholly owned U.S. subsidiary borrowed money from its parent, a Bahamian corporation and in recognition of the debt, the U.S. subsidiary issued to its parent a four percent promissory note.[314] No income tax treaty existed between the United States and the Bahamas. At the time, however, an income tax convention was in force between the United States and Honduras.[315] The Bahamian parent assigned the four percent promissory note obtained from its U.S. subsidiary to its other wholly-owned subsidiary in Honduras.[316] As consideration, the Bahamian parent received notes of the Honduran corporation, bearing the same rate of interest and having exactly the same value.[317] Thus, the Honduran affiliate became the recipient of the interest payments from the U.S. company. Pursuant to the tax treaty between the United States and Honduras, the interest payable to the owner of the note would have been exempt from any U.S. withholding obligation.[318] If the Bahamian parent had received the payments from the U.S. affiliate, the U.S. affiliate would have been required to withhold at source a thirty percent tax on the interest payment.[319]

Even though the actions were taken to minimize the overall tax burden, the court held that a treaty benefit could not be denied to parties otherwise entitled to it under the terms of the treaty.[320] The court interpreted the words "received by" to mean

---

312. However, use of the sham argument to combat treaty shopping structures has not been abandoned. The Service relied again on this argument in 1983 when dealing with a case involving a tax haven. Hospital Corp. of America v. Commissioner, 81 T.C. 520 (1983). However, the Service was not successful because the Cayman Islands subsidiary was not held to be a sham company and was recognized as a separate legal entity for tax purposes. *Id.* at 586.

313. 56 T.C. 925 (1971).

314. *Id.* at 926.

315. *Id.* at 927.

316. *Id.* at 926.

317. *Id.*

318. *Id.* at 927. *See also* U.S.-Honduras Income Tax Treaty, 1 Tax Treaties (CCH) ¶ 257.

319. I.R.C. §§ 871(a) and 1441 subject foreign individuals, and I.R.C. §§ 881(a) and 1442 (1988) subject foreign corporations who are engaged in trade or business in the United States, to a withholding tax on specific items of income (dividends, interest, rent, etc.). *See also* I.R.C. § 864(c) (1988).

320. *Aiken Industries*, 56 T.C. at 933.

more than just the momentary, physical receipt of the obligation to transmit the funds.[321] Therefore, the court considered the Honduran company to be an agent that received the payments for the Bahamian parent without having actual rights to them.[322]

In the *Aiken Industries* case, the only argument the Service had to attack this obvious treaty shopping structure was that the Honduran company was merely a conduit with no actual beneficial interest in the payments received. Since the treaty explicitly accorded treaty benefits to entities incorporated under Honduran law and the entity had a business activity, it was not possible to deny benefits under a sham approach. In substance, the U.S. company was paying the interest to the Bahamian parent.

For the first time in treaty shopping cases, the court respected the existence of a conduit company, but treated the income received by such an entity as having been received by it as an agent for the ultimate foreign investor.[323] The United States took a flexible approach toward treaty interpretation allowing for examination of the context of the parties' intentions and general objectives.[324] Under international law, however, it is a controversial question whether the outcome of *Aiken Industries* is covered by the scope of the treaty.

4. Congressional Attitude

As opposed to the 1960s and the early 1970s, when it was still possible to deal with treaty shopping on a case-by-case basis, the late 1970s and 1980s witnessed a tremendous increase in treaty shopping. Treaty shopping became a common tool for international tax minimization due to the growing number of tax treaties, the increasing worldwide economic interaction, the technological advances in communications, the growing international banking network, the large number of investors seeking stable political and economic systems in which to invest their capital, and the increasing availability of tax advice for investors in the international community.[325] Only when treaty

---

321. The court reasoned that "the words 'received by' refer not merely to the obtaining of physical possession on a temporary basis of funds representing interest payments from a corporation of a contracting State, but contemplate complete dominion and control over the funds." *Id.*

322. *Id.* at 934.

323. *1987 Hearings*, *supra* note 6, at 364.

324. *See Aiken Industries*, 56 T.C. at 934.

325. Kenneth A. Grady, *Income Tax Treaty Shopping: An Overview of Prevention Techniques*, 5 J. INT'L BUS. 626, 627 (1983).

shopping attained widespread economic impact did it become a subject of congressional debate.[326]

a. Changing Attitude

The beginnings of the treaty shopping debate may be traced back to congressional hearings held in April 1979.[327] In light of the common tax planning strategies involving the Netherlands and the Netherlands Antilles, the U.S. Treasury Department announced its intention to investigate certain aspects of the treaty, noting that it had been subject to widespread abuse.[328] Until then, the United States had taken a pragmatic approach, convinced that it would be in its best interest to abstain from any significant action.[329] Previously, the United States had thought that even tax haven treaties were of substantial economic and financial benefit to the United States, outweighing the revenue loss.[330] This attitude was based on the U.S. goal to attract more foreign capital. When the United States switched from a capital exporting country to a major capital importing country, the net disadvantage grew to such proportions that urgent remedies became essential.[331] The hearings of 1979,[332] 1983,[333] and 1987,[334] as well as the Gordon Report,[335] provided enough material to suggest that treaty shopping was detrimental to the fiscal and economic well-being of the United States and that the United States should undertake effective measures to stop it.

b. Tax Equity and Fiscal Responsibility Act

The first legislative attack on treaty shopping was Section 342 of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA),[336] which increased the reporting requirements for foreign investors and therefore provided a basis for the I.R.S. to identify third-country users of U.S. tax treaties, as well as

326. Rosenbloom, *supra* note 7, at 763.
327. *Offshore Tax Havens, Hearings Before the Subcomm. on Oversight of the House Comm. on Ways and Means*, 96th Cong., 1st Sess. (1979) [hereinafter *Havens Hearings*].
328. Treas. Dept. News Release, B-1694 (June 29, 1979).
329. Kooiman, *supra* note 225, at 195-96.
330. *Havens Hearings*, *supra* note 327 (testimony of H. David Rosenbloom).
331. Kooiman, *supra* note 225, at 196.
332. *1979 Hearing*, *supra* note 9.
333. *1983 Hearing*, *supra* note 86.
334. *1987 Hearing*, *supra* note 6.
335. GORDON REPORT, *supra* note 57.
336. Pub. L. No. 97-248, 96 Stat. 324 (approved Sept. 3, 1982).

domestic investors abusing U.S. tax treaties.[337] Until then, the U.S. withholding agent, in the case of dividends, could rely on nothing more than the foreign address to identify the recipient as a qualified recipient of a tax treaty benefit. Under the new provisions, the person qualifying under the treaty must get a certificate of residence from the local tax authority, which is then submitted to the withholding agent.

c. Tax Reform Act of 1986

The U.S. Tax Reform Act of 1986[338] has had a significant impact on treaties and treaty shopping, resulting in an elaborate, unilateral override of bilateral tax treaties that would otherwise reduce or eliminate the branch profits tax and branch-level interest tax imposed under Sections 884(a) and (f) of the I.R.C.[339] Under Section 884, foreign corporations engaged in business in the United States are subject to a branch profits tax and a branch-level interest tax in addition to the regular tax on income effectively connected with the conduct of a trade or business in the United States (or, in the case of a foreign corporation entitled to treaty benefits, a permanent establishment in the United States).[340] The objective of the branch tax is to burden a foreign corporation's U.S. business profits with roughly the same taxes whether the business is done through a domestic subsidiary or an unincorporated branch in the United States.

Because the branch profits tax is a substitute for the tax on dividends that would be imposed under Section 881(a) of the I.R.C.,[341] if the U.S. branch were a separately incorporated domestic subsidiary, the statutory branch profits tax rate is the same as the rate of withholding. The base for the branch profits tax—the "dividend equivalent amount"—is designed to approximate the amount of a corporation's earnings available for distribution as dividends.[342] The branch-level interest tax in Section 884(f) of the I.R.C. also is intended to provide a similar parity for interest paid by a foreign corporation engaged in trade or business in the United States either through a branch or domestic subsidiary.[343]

---

337. Grady, *supra* note 325, at 630.
338. Pub. L. No. 99-514, 100 Stat. 2085 (approved Oct. 22, 1986).
339. I.R.C. § 884(a)(f) (1988).
340. *Id.*
341. I.R.C. § 881(a) (1988).
342. BITTKER & LOKKEN, *supra* note 34, at 66-92, ¶ 66.5.2.
343. Treas. Reg. § 1.884-2T (as amended in 1992).

The branch taxes can be reduced by an income tax treaty in the same way as the thirty percent withholding tax on dividends and interest payments from a domestic subsidiary.[344] The branch profits tax can also be barred by nondiscrimination provisions of treaties.[345] A nondiscrimination clause is violated when a U.S. corporation carrying on the same activities as a foreign corporation is not subject to the same tax.[346]

Without a statutory anti-treaty-shopping rule, an income tax treaty conflicting with the branch profits tax would usually prevail. Congress was concerned that foreign corporations would seek to make use of treaties that bar or reduce the branch profits tax in order to avoid the severe impact the tax created on foreign corporations operating branches in the United States.[347] Therefore, Congress sought to ensure that the benefits provided under those treaties would only be used by the intended beneficiaries. Accordingly, the chances for a treaty shopping corporation to obtain the benefits of an advantageous treaty are limited by statute. Under Section 884(e) of the I.R.C.,[348] a foreign corporation has no right to claim any treaty benefits if it is not a "qualified resident" of the treaty country.[349] Under Section 884(e)(4) of the I.R.C.,[350] a foreign corporation is a qualified

---

344. Treas. Reg. § 1.884-4T(b)(7).

345. I.R.S. Notice 87-56, 1987-35 C.B. 367, listed 28 tax treaties that prohibited the imposition of the branch profits tax and 9 treaties that permitted it.

346. *E.g.*, U.S.-U.K. Income Tax Treaty, *signed* Dec. 31, 1975, art. 24(2), 3 Tax Treaties (WGL) ¶ 89,030, at 89,054 ("The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities."). Even though Congress believes that the branch profits tax does not unfairly discriminate against foreign corporations because it treats foreign corporations and their shareholders together no worse than U.S. corporations and their shareholders, it is necessary to consider corporations and shareholders separately to determine whether discrimination exists. STAFF OF JOINT COMM. ON TAXATION, 99TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 1036-38 (Comm. Print 1987) [hereinafter 1986 Bluebook].

347. *See* 1986 Bluebook, *supra* note 346, at 1036-38.

348. "No treaty between the United States and a foreign country shall exempt any foreign corporation from the tax imposed by subsection (a) (or reduce the amount thereof unless (A) such treaty is an income tax treaty, and (B) such foreign corporation is a qualified resident of such foreign country." I.R.C. § 884(e)(1) (1994).

349. *Id.*

350. I.R.C. § 884(e)(4) (1994) provides that:

> For purposes of this subsection
>
> (A) IN GENERAL. Except as otherwise provided in this paragraph, the term "qualified resident" means, with respect to any foreign country, any foreign corporation which is a resident of such foreign country unless—

resident of a treaty country if the corporation meets at least one of three tests: (1) the ownership or base-erosion test, (2) the publicly traded test, or (3) the active business test.[351]

(i) 50 percent or more (by value) of the stock of such foreign corporation is owned (within the meaning of section 883(c)(4)) by individuals who are not residents of such foreign country and who are not United States citizens or resident aliens, or

(ii) 50 percent or more of its income is used (directly or indirectly) to meet liabilities to persons who are not residents of such foreign country or citizens or residents of the United States.

(B) SPECIAL RULE FOR PUBLICLY TRADED CORPORATIONS. A foreign corporation which is a resident of a foreign country shall be treated as a qualified resident of such foreign country if—

(i) the stock of such corporation is primarily and regularly traded on an established securities market in such foreign country, or

(ii) such corporation is wholly owned (either directly or indirectly) by another foreign corporation which is organized in such foreign country and the stock of which is so traded.

(C) CORPORATIONS OWNED BY PUBLICLY TRADED DOMESTIC CORPORATIONS. A foreign corporation which is a resident of a foreign country shall be treated as a qualified resident of such foreign country if—

(i) such corporation is wholly owned (directly or indirectly) by a domestic corporation, and

(ii) the stock of such domestic corporation is primarily and regularly traded on an established securities market in the United States.

(D) SECRETARIAL AUTHORITY. The Secretary may, in [the secretary's] sole discretion, treat a foreign corporation as being a qualified resident of a foreign country if such corporation establishes to the satisfaction of the Secretary that such corporation meets such requirements as the Secretary may establish to ensure that individuals who are not residents of such foreign country do not use the treaty between such foreign country and the United States in a manner inconsistent with the purposes of this subsection.

351. The ownership or base-erosion test is met if (1) more than 50% of the corporation's stock is held by individuals who are either residents of the treaty country, or citizens or residents of the United States and (2) less than 50% of the corporation's income is used directly or indirectly to meet liabilities to persons who are not residents of the treaty country or the United States. Under the public ownership test, a foreign corporation that is a resident of a treaty country is a qualified resident if the corporation's stock is primarily and regularly traded on a recognized securities market in the treaty country or in the United States. A corporation is considered to be a qualified resident if it meets the active business test, which requires that the corporation (1) be actively engaged in business in a treaty country, (2) have a substantial presence there, and (3) the income derived from activities within the United States be a part of the corporation's active business. *See id.*

Similar to § 884(e), the 1986 Act also made changes in the shipping and aircraft area with regard to the reciprocal exemption provisions of § 883 of the I.R.C. Under prior law, no U.S. income tax was levied on foreign ships and aircraft if the country of their registration granted an equivalent exemption to U.S.

The scope of the qualified resident definition considers both U.S. and treaty-country residents in determining the beneficial owner. Because the United States had experienced a flood of third-country investors claiming treaty benefits under treaties to which they were not a party, these provisions are directed solely against third-country residents to prevent them from taking advantage of treaties.[352]

Fearing that, during the slow process of renegotiating tax treaties, the United States tax base would be eroded, Congress clearly intended to override conflicting provisions in U.S. treaties.[353] The qualified residence provision therefore takes precedence over all existing U.S. tax treaties since most older tax treaties do not contain such a sophisticated and complex anti-treaty-shopping provision. The enactment of Section 884(e) of the I.R.C. considerably tightens the availability of treaty protection from the branch profits tax in many instances and therefore may abrogate treaty obligations under international law.

From the U.S. perspective, a unilateral treaty override, Section 884(e) of the I.R.C., does not constitute a violation of international law. Under Article VI, Clause 2 of the U.S. Constitution, domestic law and U.S. treaties have equal status as the "supreme law of the land." Since both a statute and a treaty are in parity, the law later-in-time prevails in the case of conflicting provisions. The Restatement Third of the Foreign Relations Law of the United States provides that "if the purpose of [an] act to supersede [an] earlier [treaty] . . . provision is clear or [the two] cannot be fairly reconciled" the domestic act will prevail.[354] A strong congressional intent to override an existing treaty with a later-in-time domestic statute, however, is required under U.S. law.[355] To comply with this requirement, Sections 884(a) and 7852(d)(1) of the I.R.C. were amended in 1988[356] to codify the equal status of statute and treaty for purposes of tax

---

residents or domestic corporations. The new provision in the 1986 Act still retains the reciprocal exemption, but it makes it dependent on the taxpayer's residency under a similar approach as in § 884(e).

352. *See* discussion *supra* Part IV.A.2.

353. 1986 Bluebook, *supra* note 346, at 1038.

354. RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 115(1)(a) (1987).

355. *Id.*

356. Section 7852(d)(1) codifies the co-equal status and later-in-time rule by providing that "[for] purposes of determining the relationship between a provision of a treaty and any law of the United States affecting revenue, neither the treaty nor the law shall have a preferential status by reason of its being a treaty or law." I.R.C. § 7852(d)(1) (1988).

law and to explicitly express the intent to permit treaty override.[357]

The parts of the Tax Reform Act of 1986 dealing with treaty shopping, which probably had the most massive impact on U.S. domestic and international tax law, and the termination of the Netherlands Antilles treaty in 1987 demonstrated that the United States had declared war on treaty shopping in the mid-1980s.

Until recently, anti-treaty-shopping measures continued to be discussed in Congress[358] and will likely continue to be an issue in the future. The United States has heavily influenced several OECD members, including Germany, to share U.S. views in this regard. None of these countries, however, has attained the fiscal perfectionism of the United States in the field of anti-abuse provisions in treaty practice and domestic law.

B. *Germany*

Although Germany has long-standing concerns about treaty shopping, neither the depth of its concern nor the scope of its reaction has been nearly as great as that of the United States.[359] While Germany has not systematized its tax treaty policy in a model treaty, the problem of treaty shopping is not unknown to it. Consequently, Germany has adopted several approaches in tax treaties and domestic law to deal with the issue.

---

357. The Foreign Income Tax Rationalization and Simplification Bill of 1992, H.R. 5270, 102d Cong., 2d Sess., proposed in the House, was intended to extend the scope of § 884(e), which is confined to the branch profits tax, to all treaty benefits. The bill specifically directed that its provisions should take precedence over all existing and future U.S. double taxation agreements. However, due to substantial opposition, particularly on the international level, this further domestic limitation-on-benefits provision was dropped. *Hearings on H.R. 5270, The Foreign Income Tax Rationalization and Simplification Act of 1992 before the Comm. on Ways and Means of the U.S. House of Representatives*, 102d Cong., 2d Sess., *reprinted in* 11 INTERTAX 637 (1992).

358. The attempt by Congress to tighten the 1986 anti-treaty-shopping legislation and extend it to all benefits available under a treaty instead of branch profit tax relief peaked in the 1992 Foreign Income Tax Rationalization and Simplification Bill, H.R. 5270, 102d Cong., 2d Sess., which was not enacted into law.

359. Helmut Becker, *Report from Germany*, *in* TREATY SHOPPING, *supra* note 45, at 138.

1. Anti-Treaty-Shopping Measures in Tax Treaties

Germany has adopted several concepts in its treaties to prevent abuse. The abstinence approach is maintained with respect to well-known tax havens (*e.g.*, Liechtenstein, the Channel Islands, Monaco, Netherlands Antilles, and Panama). Specific treaty provisions, however, are limited to the fiscal situation with each treaty partner. A rather rudimentary approach is to exclude from treaty benefits companies that by their nature are used as vehicles for tax avoidance. For example, Luxembourg holding companies were excluded from the application of the German-Luxembourg treaty in 1958,[360] one of the first measures against the improper use of a tax treaty. Similarly, the German-Canadian tax treaty of 1984[361] excludes tax-favored Canadian nonresident-owned investment corporations.[362]

The treaty with Switzerland[363] contains more detailed provisions, including the subject-to-tax approach, the channel approach, and a provision following the Swiss decree[364] providing that entities substantially owned by non-residents of Switzerland cannot claim treaty benefits unless they are fully subject to cantonal tax under the law of the canton in which they are incorporated.[365] These provisions, however, were more likely designed to prevent Germans from avoiding residence taxation than to prevent third-country users from avoiding source based tax.

After almost ten years of hard negotiations for a new tax treaty, the United States and Germany signed the convention in 1989.[366] The result is one of Germany's most complex limitation-on-benefit provisions, which is directly attributable to the strong U.S. negotiating position. The treaty frequently has been criticized for creating uncertainty as a result of the broad discretion it gives to tax authorities,[367] causing compliance difficulties that could affect German investors and, arguably,

---

360. 1959 Bundesgesetzblatt, Teil II [BGBl.II] 1270 (F.R.G.).

361. 1982 BGBl.II 801; 1983 BGBl.II 652.

362. Income Tax Act, R.S.C., ch.1 § 133 (1985) (Can.).

363. 1972 BGBl.II 1021; 1990 BGBl.II 1698.

364. *See supra* notes 106 and 183.

365. Art. 23(2) of the Swiss-German Double Taxation Convention, 1972 BGBl.II at 1022, 197 BStBl.I 519, *as amended by* 1980 BGBl.II 750, 1980 BStBl.I 399; BGBl.II 766, BStBl.I 409.

366. 1991 BGBl.II 355.

367. Klaus Vogel & Rainer Prokisch, *General Report*, *in* DOUBLE TAXATION CONVENTIONS, *supra* note 77, at 102; Reinhard Poellath, *German National Report*, *in* DOUBLE TAXATION CONVENTIONS, *supra* note 45, at n.115.

violating the anti-discrimination requirement against E.C. members.[368]

Though Germany's treaty practice has not generally shown great concern about third-country treaty shoppers, its recent treaties with Kuwait and the United Arab Emirates (U.A.E.) are evidence of increasing concern. The 1989 tax treaty with Kuwait[369] and the 1995 treaty with the U.A.E.[370] both contain unique anti-treaty-shopping provisions that are designed to seriously curtail treaty shopping. According to Article 23 of each treaty, relief may be obtained with regard to all items of income[371] only if at least seventy-five percent of the entity claiming German tax benefits is owned by the state (Kuwait or the U.A.E.) or one of its government institutions. In addition, the corporation has to provide sufficient proof that the remaining share is owned by individuals residing in the contracting state in question.[372] Benefits with regard to dividends, interest, and royalties can also be invoked if a company gives substantial evidence that it is controlled by individuals of the respective treaty partner and proves that the German company was not established for the principle purpose of obtaining treaty benefits to the advantage of nonresident persons. It is interesting to note that this limitation-on-benefits clause is a one-way provision applicable only to treaty partners who seek German source tax relief; the provision does not impose similar limitations on German corporations operating in Kuwait or the U.A.E. This kind of anti-treaty-shopping provision is wholly dependent on the specific circumstances of the treaty party and may suggest a new pattern of tax interaction between Germany and Persian Gulf States.

2. Interpretation of Tax Treaties

In the absence of specific treaty provisions, preventing treaty shopping is highly controversial. It is generally acknowledged that a bilateral tax convention cannot be interpreted against its

368. Poellath, *supra* note 367, at 344.

369. 1989 BGBl.II 354; 1989 BGBl.II 637.

370. The treaty with the United Arab Emirates was signed in July 1995, but has not yet entered into force.

371. For example, residents of the United Arab Emirates may invoke treaty benefits with regard to business profits, income from shipping and air transport, dividends, interest, royalties, capital gains, independent personal services, dependent personal services, and other income not specifically specified. *Id.*

372. Abkommen zur Vermeidung der Doppelbesteuerung [Agreement for the Avoidance of Double Taxation], F.R.G.-Kuwait, 11 VERHANDLUNGEN DES DEUTSCHEN BUNDESTAGES 50 (1988) (F.R.G.) (Bundestagsdrucksach 11/2553 at 30).

explicit wording, even if the result would be unsatisfactory or contrary to the prevailing administrative practice.[373] If a treaty explicitly defines the persons entitled to treaty benefits, and if those provisions apply to all residents of the contracting states including the legal entities formed under the laws of those states, then it will be difficult to ignore the express terms of the treaty on the ground that the shareholders are nonresidents.[374] Judicial precedents appear to adopt the view that when results are achieved through long-term negotiations and finally laid down in a binding agreement, they must be respected in their full scope and cannot be disregarded, either by unilateral actions within the national tax law or by a one-sided interpretation of a contracting party.[375]

Even when the meaning of terms may seem unambiguous, the wording of a provision regularly requires some kind of interpretation. Generally, interpretation is confined to the "natural view"[376] or the "common usage"[377] of the terms.[378] If the wording allows different interpretations, a court may consider the "objective and purpose" of the treaty.[379] In this context, it is not the "one-sided subjective conception" that is decisive but the "common perception" reached during the negotiations.[380] The focus, however, is on the meaning of the words, not on the purpose of the treaty. The German Tax Court requires a stricter application of the wording in tax treaty matters than in domestic law.[381] Therefore, unless the agreement contains an explicit anti-abuse provision, it is almost impossible to deny treaty benefits on the basis of treaty interpretation, despite the fact that strict application of the terms often produces results that were not intended by the parties.[382]

---

373. Germany follows the OECD view, which expressly states: "Existing conventions may have clauses with safeguards against the improper use of their provisions. Where no such provisions exist, treaty benefits will have to be granted under the principle pacta sunt servanda even if considered improper." 1987 OECD Report, *supra* note 42, at 101.

374. TREATY SHOPPING, *supra* note 45, at 8.

375. Poellath, *supra* note 367, at 332. In past cases, the courts followed the exact wording of the treaty not only with respect to the principle of state sovereignty but also to the protection of the taxpayer. *See* Judgment of Feb. 5, 1965, BFH, 1965 BStBl.II, 258, 259 (Germany-Switzerland); Judgment of Sept. 13, 1972, BFH, 1973 BStBl.II 57, 59 (Germany-Netherlands).

376. Judgment of June 18, 1969, BFH, 1969 BStBl.II 579, 581.

377. Judgment of Sept. 13, 1972, BFH, 1973 BStBl.II 57, 58.

378. Poellath, *supra* note 367, at 333.

379. *Id.* at 334.

380. *Id.* at 334-35.

381. Judgment of Jan. 27, 1988, BFH 1988 BStBl.II 574.

382. Becker, *supra* note 17, at 196.

3. Application of Domestic Anti-Avoidance Regulations

When it appears that an abusive result may occur, a domestic anti-abuse statute, which usually covers situations that cannot be dealt with by mere interpretation, may offer a mechanism for denying treaty benefits contrary to the parties' intent.

a. Application of the General Avoidance Rule

Until recently, there was controversy over whether Section 42 Abgabenordnung (AO), the German general anti-abuse statute, could be a legal basis for the denial of treaty benefits. Section 42 AO provides that "the tax law may not be by-passed through the misuse of structural possibilities provided by the law."[383] If an abuse occurs, "the tax liability equals the amount that would have been due in case a reasonable legal structure corresponding with the economic necessities of the transaction would have been chosen."[384]

i. Application by the Courts

The Bundesfinanzhof (Federal Tax Court) ruled that Section 42 AO was generally applicable in the context of tax treaties.[385] However, abuse is deemed to occur only if the avoidance structure directly affects internal German law, rather than the tax treaty per se.[386] This means that in practice, the courts distinguish between resident and nonresident taxpayers. The Federal Tax Court has regularly considered foreign-based companies to be abusive when no economic or other non-tax reason for their establishment existed, or when a foreign-based company did not have any independent business activity.[387] Those rulings, however, were based on facts relating to a resident taxpayer "subject to unlimited taxation")[388] who, in order to take advantage of a treaty, had set up a corporation in a low tax country, usually Switzerland, to avoid the higher German residence-based tax.

---

383. AO § 42 (Steuergesetze, Textsammlung, C.H. Beck).

384. *Id.*

385. Judgment of Mar. 5, 1986, BFH, 1986 BStBl.II 496 (referring to Judgments of May 21, 1971, BFH, 1971 BStBl.II 721 and July 17, 1968, BFH, 1968 BStBl.II 695).

386. *Id.*

387. Judgment of Jan. 29, 1975, BFH, 1975 BStBl.II 553; Judgment of Jan. 16, 1976, BFH, 1976 BStBl.II 401; Ruling of July 29, 1976, BFH, 1977 BStBl.II 263.

388. Ruling of Oct. 29, 1981, BFH, 1982 BStBl.II 150.

The Federal Tax Court explicitly stated that the same reasoning cannot implicitly be applied in cases involving third-country residents (taxpayers "subject to limited taxation").[389] The formation of a foreign-based company in a treaty country by a third-country resident as such, even if it derives income from German sources,[390] does not provide enough of a nexus with German tax law to subject the foreign-based company to German anti-abuse law. However, when the foreign-based corporation is legally connected with a domestic company that is controlled by a third-country resident, there may be a sufficient nexus to apply the domestic anti-abuse statute.[391]

This approach is well reflected in the *Monaco* case,[392] which involved a typical treaty shopping situation. In *Monaco*, a resident of Monaco (which has no tax treaty with Germany) organized a corporation under Swiss law to which he transferred his participation in a German company.[393] As a result, the dividend income of the German company was only subject to fifteen percent taxation under Article 6(3) of the German-Swiss treaty, rather than the regular German withholding tax rate of twenty-five percent.[394] Despite the fact that an economically meaningless dummy corporation had been created to avoid the otherwise applicable tax rate, the Federal Tax Court held that the structure was not abusive because "the establishment of a corporation in a foreign country by a foreigner is a procedure not affecting the internal tax law and withdraws itself, as a matter of principle from being considered as an abuse of forms and concepts of the law."[395] The court noted that the result is the same when the corporation has some business activity and when it is merely a letter-box company.[396]

In the *Quintet* rulings,[397] the Federal Tax Court dealt with the application of Section 42 AO to cases in which taxpayers sought to rely on a treaty. These cases arose under the law applicable

---

389. *Id.*

390. *See Monaco, infra* text accompanying notes 392-96.

391. *See Niederlaendische-Brueder Fall, infra* text accompanying notes 404-07.

392. Ruling of Oct. 29, 1981, BFH, 1982 BStBl.II 150.

393. *Id.*

394. *Id.*

395. *Id.*

396. *Id.*

397. Detlev J. Piltz, *Doppelbesteuerungsabkommen und Steuerumgehung unter besonderer Beruecksichtigung des Treaty Shopping*, DER BETRIEB 1987, Beilage 14, at 3 (citing Ruling of Sept. 13, 1972, 13.9 BFH, 1972-G.R. 130/70, 1973 BStBl.II 57; Ruling of Feb. 19, 1975, 19.2, BFH, 1975-GR 26/73, 1975 BStBl.II 584; Ruling of Feb. 9, 1982, 9.2, Finanzgericht Köln, 1982-VI 452/77 KE).

before 1977.[398] The tax treaties in effect at that time contained "suspension clauses," which denied treaty relief for foreign corporations that owned more than twenty-five percent of a German entity.[399] To avoid the resulting tax disadvantage, the foreign parent corporation split up its holdings in the German company and created several new foreign corporations, giving each less than twenty-five percent ownership of the German company.[400] While the tax authorities argued that the parent foreign corporation actually owned one hundred percent of the German company and thus was not eligible for treaty benefits, the Federal Tax Court interpreted the wording "owned by" to mean only direct participation, and not two-tier or three-tier structures.[401] Although it was obvious that the intermediary entities were established for the purpose of taking advantage of the treaty and that Section 42 AO was generally applicable to tax treaty situations, the court did not see any abuse under Section 42 AO.[402] Thus, foreigners were free to structure their businesses in any way they considered appropriate from a tax point of view. Even the predominant intent of achieving tax benefits was not regarded as sufficient to constitute an abuse under Section 42 AO.[403]

In the third major decision, *Niederlaendische-Brueder-Fall*,[404] two Dutch partners of a German general partnership (Offene Handelsgesellschaft or OHG) owned a Swiss corporation, which in turn held a silent participation in the German partnership.[405] Under the Swiss-German tax convention, income from a silent

---

398. *Id.*

399. *See, e.g.*, *Denmark* 1963 Bundesgesetzblatt, Teil II [BGBl.II] 1311; *France* 1961 BGBl.I, 398; 1961 BStBl.II 343, *as amended*, BGBl.II at 770, 1990 BStB1.II 413.

400. *See supra* note 397.

401. *Id.* The court interpreted the meaning according to German private law because the treaty gave no indication about the extent of the term. According to similar cases under German law, indirect holdings are not viewed as sufficient to be covered by the term "gehoeren" (owned by). Therefore, it was irrelevant whether the foreign recipient of the income was considered a "fiscal unit" or a "controlling parent of a group" under its national law. All that counted was the direct participation of the nonresident company itself. *Id.*

402. 1975 BStBl. II 584, 586 (with reference to 1974 BStBl.II 645, 646 and 1975 BStBl.II 553, 554).

403. KRAFT, *supra* note 112, at 64.

404. Judgment of Nov. 10, 1983, BFH, 1984 BStBl.II 605 (BFH Nov. 10, 1983).

405. *Id.*

partnership was not subject to German tax.[406] Had the two Dutch residents directly participated in OHG as silent partners, the income therefrom would have been subject to German withholding tax. The court held that this triangular structure involving Switzerland, Germany, and the Netherlands constituted an abuse under Section 42 AO.[407]

Even though this ruling seems contradictory to the rulings of *Quintet* and *Monaco*, the facts of this case can be distinguished. The avoidance scheme was structured not merely to make improper use of a tax treaty but to take advantage of German domestic law as a whole.[408] The silent partners improperly used domestic law by pretending that their silent participation was a typical one, meaning a purely passive investment. In reality, they were involved in management functions, which under German law would lead to an atypical silent participation. The Dutch partners simply wanted to profit from the preferential tax treatment granted to truly silent partners by interposing an entity. Clearly, a person cannot be both a co-owner of a business, charged with all kinds of business activities, and a passive investor, completely excluded from any business decisions in the same company. Because the Dutch partners tried to circumvent the passive partner prerequisite by creating a separate entity, the case arguably involved "corporation shopping" rather than treaty shopping.[409]

While the courts held Section 42 AO to be generally applicable in the context of tax treaties, the interpretation of the term "abusive" was confined to situations that directly affect internal German tax law.[410] Thus, the fact that a non-German established a corporation in a foreign country with the sole purpose of obtaining treaty benefits was held to be nonabusive. It

---

406. *Id. See also* Swiss-German Tax Convention, 1972 BGBl.II 1022, 1972 BStBl.I 519, *as amended by* 1980 BGBl.II 750, 1980 BStBl.I 399; BGBl.II 766, BSBl.I 409.

407. *Niederlaendische-Brueder-Fall*, 1984 BSt.Bl.II 605.

408. German law recognizes silent participation as a form of hybrid shareholder financing. The silent partner contributes a certain sum to a business entity in exchange for sharing in the profits or losses. German commercial law recognizes two types of such arrangements, "typical" and "atypical" participation. The typical form requires pure passive investment, whereas in the atypical form the silent participant has a status similar to that of a co-owner in entrepreneurial activities. Under commercial law, the co-owner is then subject to full business risk and, for income tax purposes, is treated as a partner. Thus, once a silent partner participates in business decisions, preferential tax treatment is lost. FG Niedersachsen (Lower Saxony), Nov. 8, 1990, VI 174/89, 28 R.I.W. 79 (1992). *See* R. Prokisch & M. Rodi, *German Finance Tribunal Finds Foreign "Atypical" Silent Participant Liable for German Tax*, 4 TAX NOTES INT'L 418 (1992).

409. Becker, *supra* note 17, at 193.

410. *Niederlaendische-Brueder-Fall*, 1984 BStBL.II 605.

is questionable whether this legalistic distinction is logically comprehensible.[411] Abuse should be determined with regard to the corporation's structure and the individual's motive—it should not merely be a matter of the taxpayer's residence.

ii. Attitude of Tax Scholars

Many scholars believe that treaty law and domestic law are two entirely separable areas of law and, therefore, that domestic law cannot be used to deny benefits to anyone governed by a treaty, regardless of taxpayer residence status. For purposes of treaty shopping by third-country residents, the controversy between the courts and tax scholars is largely theoretical, differing more in approach than result. Moessner, for example, considers the application of the general anti-avoidance rule to be inappropriate in connection with income tax conventions.[412]

Vogel contends that Section 42 AO is not a proper legal basis for denying treaty benefits in cases involving treaty-protected entities.[413] He asserts that denial can only be justified by the general international anti-avoidance concept.[414] Vogel argues that an unwritten, independent rule on abuse exists, which is derived from corresponding national abuse conceptions.[415] The fact that both contracting states have incorporated a general abuse provision into their national laws implies that they would have wanted to extend their application to income tax treaties. According to Vogel's view, however, this general unwritten anti-abuse concept is only applicable in striking, intolerable abuse situations.[416]

Piltz, in contrast, rejects the idea that international law provides an unwritten or implied anti-abuse rule and maintains that governmental action to the detriment of the taxpayer requires explicit legislative regulation.[417] Piltz deems it adequate to apply Section 42 AO in situations within the scope of the treaty.[418] He realizes, however, that provisions of a treaty containing more specific regulations in a certain situation will overrule the general

---

411. Franz Wassermeyer, *Die Mißbrauchsvorschriften des deutschen Gesetzgebers auf dem Gebiet des Internationalen Steuerrechts*, 4 STEUER UND WIRTSCHAFT INT'L 143 (1995).

412. Mössner, *supra* note 190, at 213.

413. Vogel, *supra* note 184, at 378.

414. *Id.*

415. *Id.*

416. *Id.*

417. Piltz, *supra* note 398, at 6.

418. *Id.*

statute, with the effect that Section 42 AO is not applicable.[419] The majority of other German experts agree with Piltz's analysis of the applicability of Section 42 AO to the denial of treaty benefits.[420]

b. Recent Anti-Treaty-Shopping Legislation: Section 50(d)(a) EStG

The enactment of the new German anti-treaty-shopping statute may have stilled the controversy between tax scholars and the courts. On December 10, 1993, the German Bundestag passed the Anti-Abuse and Technical Correction Act (StMBG),[421] which became effective in January 1994.[422] The new legislation applies to all benefits otherwise available under an income tax convention,[423] and also applies to the reduced dividend withholding rate that is applicable to distributions made by German subsidiaries of qualified E.C. parent companies.[424] The StMBG denies treaty relief to foreign companies to the

> extent that persons have interests in the foreign company who would not be entitled to tax relief if such persons received the income directly, and there do not exist any economic or other adequate reason for the interposition of the foreign company and the foreign company does not conduct its own business activity.[425]

This provision, however, is rather vague and will lead to a number of interpretative problems. The phrase "to the extent" does not

---

419. *Id.*

420. Helmut Debatin, *Rechtsmissbrauch im internationalen Steuerrecht im Lichte deutscher Rechtsprechung*, 1979 DER BETRIEB 211, 232; HANS FLICK ET AL., DOPPELBESTEUERUNGSABKOMMEN DEUTSCHLAND-SCHWEIZ: STEUERN VOM EINKOMMEN UND VERMÖGEN NACHLASS- UND ERBSCHAFTSTEUERN, 20 1981/1988; BERNHARD GROSSFELD, BASISGESELLSCHAFTEN IM INTERNATIONALEN STEUERRECHT 99, 192 (1974); Volker Kluge, *Basisgesellschaften und Doppelbesteuerungsabkommen*, 21 RIW 525, 525 (1975).

421. Missbrauchsbekaempfungs- und Steuerbereinigungsgesetz (StMBG-Bundesratsdrucksache 788/93m, as amended by Drucksache 12/6123. The preamble to the draft of the StMBG (Bundestagsdrucksache 12/5630, Sept. 7, 1993) explains that the goal of the legislation is "the elimination of unjustified tax advantages and undesirable structures for tax purposes."

422. Richard D. Minor, *Germany*, 8 TAX NOTES INT'L 76 (1993); Richard D. Minor, *Tax Legislation*, 7 TAX NOTES INT'L 1539, 1540 (1993) (giving an overview of the new German anti-abuse and technical corrections act, StMBG, *supra* note 421).

423. The new legislation adds to § 50(d)1(a). EStG § 50(d) includes special rules for German withholding taxes in connection with reduced income treaty rates.

424. EStG § 44(d) (providing a general reduction of the dividend withholding tax to 5% with respect to distributions by a German subsidiary of a qualified E.U. parent).

425. EStG § 50(d)(1)(a).

specify any participation percentage that would trigger the anti-avoidance rule, or whether treaty benefits should simply be denied only with regard to the participation of nonqualifying persons.[426] Similarly, the term "economic or other adequate reason" is undefined in the tax code. A more serious problem is that the wording of Section 50(d)(1)(a) EStG, "interests in a foreign company," could be interpreted to cover only direct participation, making it possible to circumvent the law by establishing a two-tier structure in the treaty country.[427]

Although the statute contains a number of uncertainties, it provides a basis for combating current treaty abuses because it explicitly covers treaty shopping by third-country residents. Moreover, German courts will not be able to refuse to implement the law on the ground that this domestic provision is not applicable with regard to third-country residents. However, the question of whether the application of the new statute is compatible with treaty obligations will remain a controversial issue among scholars. In the courts, the issue was resolved in a recent Federal Tax Court ruling,[428] that legitimated a possible treaty override arising from the application of Section 50(d) EStG. Although not formally binding, this decision will likely be followed by the courts. Yet, only the future will show the extent to which the new legislation can clarify the controversial understanding of the abusive character of treaty shopping structures. The judiciary definitely has a new basis for the interpretation of abuse structures. The new provision as *lex specialis* will at least put an end to the discussion about Section 42 AO.

Although the recent anti-treaty-shopping rule indicates a new awareness of the problems of treaty shopping, German concerns still lag far behind those in the United States. The new statute emerged out of a concern that the general avoidance provision was not enough to combat current treaty abuses.[429] Still, its general language and vague terms indicate a certain ambiguity toward the necessity of harsh anti-avoidance measures. It also may embody a certain fear that overly complex and strict rules may discourage investment. It seems that Germany prefers to deal with treaty shopping on a case-by-case basis rather than on

---

426. Minor, *Tax Legislation*, *supra* note 422, at 1540.

427. For example, a Japanese company (J) could qualify for a reduced withholding tax under the Dutch-German tax treaty if that company (J) owned all the stock of a Netherlands company (N), which in turn owned all the stock of another Netherlands company (N2), which in turn held interests in a German company (G). Wassermeyer, *supra* note 411.

428. Judgment of July 13, 1994, BFH, 1995 BGBl.II 130 (F.R.G.).

429. *Id.*

the basis of objective but complex rules such as those involved in the definition of a "qualified resident" in Section 884(e) of the U.S. Code.[430]

C. *The United Kingdom*

1. Anti-Treaty-Shopping Provisions in Tax Treaties

The United Kingdom does not use general anti-avoidance provisions in its domestic tax law, nor does it include any comprehensive anti-treaty-shopping provisions in any of its treaties.[431] Instead, U.K. domestic law contains anti-abuse clauses that are aimed at some particular perceived abuses. For example, the United Kingdom has negotiated treaty provisions dealing with the refund of the imputation tax credit on dividends,[432] or with financing and holding companies in certain countries.[433] The United Kingdom is one of few countries granting a tax credit refund under its imputation system to foreign corporate shareholders with substantial interest in U.K. companies.[434] This tax credit is granted in eleven separate treaties.[435] A number of countries, including the Netherlands, Switzerland, and Luxembourg, are often home to corporations that seek to exploit these treaties. For a time, the common practice was to set up a Netherlands Antilles company that wholly owned a Netherlands company, that in turn held shares in a U.K. company.[436] Because at one time there was no withholding tax on dividends paid by a Netherlands company to an Antilles company, and a Netherlands corporation qualified for a tax credit

430. I.R.C. § 884(e).

431. Leonard Beighton, the Deputy Chairman of the United Kingdom Inland Revenue, indicated that the United Kingdom will fight treaty shopping, but is not in favor of general anti-treaty-shopping clauses. He stated that the United Kingdom prefers narrowly targeted responses to perceived problems. Jonathan Schwarz, *Survey of World Taxation*, FIN. TIMES, May 20, 1994, *available on* LEXIS, News Library, Fortune File. *See* also John Avery Jones, *Anti-Treaty Shopping Articles—A United Kingdom View*, 8-9 INTERTAX 331 (1989).

432. Jones, *supra* note 431, at 331.

433. *Id.*

434. Eric Tomsett, *Treaty Shopping and Debt/Equity Ratios in the United Kingdom*, 44 BIFD 107 (1990).

435. Belgium, Canada, Denmark, Finland, Luxembourg, the Netherlands, Norway, Sweden, Switzerland, and, in a limited fashion, the United States. For example, the United States-United Kingdom Income Tax Treaty, *signed* Dec. 31, 1975, 3 Tax Treaties (WGL) ¶ 89,030, grants such an imputation credit refund to a U.S. corporate shareholder with an interest of 10% or more in a U.K. company.

436. Tomsett, *supra* note 434, at 108.

refund under the U.K.-Netherlands treaty,[437] the foreign investor's refund could be channeled through the Antilles at almost no tax cost.

As a consequence, the United Kingdom quickly inserted an anti-abuse clause into the U.K.-Netherlands treaty that completely denies a tax credit refund to holding companies involved in this specific structure.[438] The anti-avoidance provisions of other U.K. treaties, however, do not follow the scheme of the U.K.-Netherlands treaty. Instead, they take a qualitative approach, denying the tax credit refund to the foreign corporate shareholder only if the structure is chosen to take advantage of the tax credit.[439] Thus, the taxpayer corporation bears the burden of proving that it has not structured itself for an impermissible purpose.[440]

The absence of any general, consistent treaty language indicates that the United Kingdom is largely unconcerned about being a potential target for treaty shopping corporations. This has to do with the fact that the United Kingdom, as a net capital exporting country, is primarily interested in unrestricted investment flow.

2. Application of Domestic Precedents in the Treaty Context

The U.K. tax authorities have never issued rulings similar to those of the U.S. Internal Revenue Service. The U.K. Inland Revenue, however, has indicated that it regards the *Ramsay* case[441] as a precedent for further international proceedings, even though *Ramsay* occurred within the domestic context. In *Ramsay*, the court held that artificial avoidance structures can be ignored for tax purposes when they involve a series of transactions that are ultimately self-canceling.[442] The case of *Craven v. White*,[443] however, restricts the *Ramsay* holding to circumstances in which there are (1) a "preordained series of

---

437. 10 INTERNATIONAL TAX TREATIES OF ALL NATIONS 349 (1981).

438. Tomsett, *supra* note 434, at 108.

439. *Id.*

440. It specifically says that "unless the recipient of a dividend shows, if required to do so . . . , that the shareholding in respect of which the dividend was paid was acquired by the recipient for bona fide commercial reasons or in the ordinary course of making or managing investments and it was not the main object nor one of the main objects of that acquisition to obtain entitlement to the tax credit . . . ." *Id.* (quoting the U.K.-Switzerland double taxation treaty).

441. 1981 S.T.C. 174.

442. John Avery Jones, *U.K. National Report*, *in* DOUBLE TAXATION CONVENTIONS, *supra* note 77, at 597.

443. 1988 S.T.C. 476.

transactions" or "one single composite transaction" and (2) steps are inserted purely to avoid tax.[444] Whether these precedents could really be applied in a treaty context remains doubtful. In the United Kingdom, a judge is strictly bound by the literal wording of the statute or treaty provision, and this is particularly true in tax law.[445] Although, a court would probably be reluctant to find treaty abuse unless the specific anti-avoidance clauses clearly apply,[446] the U.K. courts have not yet addressed this issue.

There are only fourteen cases in which tax treaty interpretation has ever been relevant.[447] In addition, *CIR v. Commerzbank*[448] is the only case in which a court seriously discussed the method of interpreting tax treaties and applying Article 31 of the Vienna Convention.[449] Under the old U.S.-U.K. income tax treaty,[450] the court advocated a literal approach, using the ordinary meaning of words.[451] Inland Revenue argued that because the provision was applicable only to residents of contracting states, the U.S.-U.K. treaty should not be read to exempt from tax the U.S. dividends and interest income of a third-country resident entity.[452] Nonetheless, the court held the exemption applicable to the permanent establishment, in this case a German bank, because the treaty[453] did not contain any limitation to residents of one of the contracting states.[454] Even though the result might be considered improper or unreasonable, the court gave preference to the literal meaning of the provisions, because there was nothing in the purpose or context of the treaty that could alter the words' ordinary meaning.[455]

Clearly, the United Kingdom seems unwilling to make a serious issue out of treaty shopping either in its treaty interpretation or treaty practice. The most obvious and damaging treaty shopping structures are handled by inserting highly specific

---

444. *Id.*
445. Jones, *supra* note 442, at 597.
446. *Id.* at 597.
447. For a list of the fourteen cases, see *id.* at 597.
448. 1990 S.T.C. 285.
449. *Id. See also* Vienna Convention, *supra* note 176, art. 31.
450. 3 Tax Treaties (CCH) ¶ 13,001.
451. Commerzbank, 1990 S.T.C. at 285.
452. *Id.*
453. The former U.S.-U.K. treaty (1945), 3 Tax Treaties (CCH) ¶ 13,001, provided in Art. XV that "[d]ividends and interest paid by a [U.S. corporation] shall be exempt from tax by the [United Kingdom] except where the recipient is a citizen, resident, or corporation of the [United Kingdom]." *See* Jones, *supra* note 442, at 599.
454. Provisions of this sort are contained in *1995 OECD Model Treaty*, *supra* note 1, art. 1.
455. *Id.*

clauses. Otherwise, the United Kingdom's main interest is to maintain a free and unrestricted exchange of goods and capital, without burdening investors with complex compliance rules.

D. *Summary*

Analysis of the general attitude of the United States, Germany, and the United Kingdom toward treaty shopping suggests that European states regard specific anti-avoidance rules as valuable in preventing certain particularly abusive situations. However, this flexible, case-by-case approach to treaty abuse means that, under a strict constructionist view, treaty benefits cannot be denied unless a specific provision is included in a treaty. This flexible approach is controversial. An important counterargument is that the flexible approach creates two legal uncertainties that may have an impact on the planning decisions of international taxpayers. First, the courts in most countries have not yet developed regarding the treatment of third-country residents who take advantage of a treaty.[456] Second, the application of domestic law to treaty law interpretation is so controversial that many decisions based on such rules are based on a fragile legal foundation.[457]

Despite these problems, many OECD countries view a complex anti-abuse clause, such as the U.S. Model Convention's Article 16, as inappropriate to their specific economic situations.[458] In contrast, the United States claims that an efficient and necessarily complex anti-treaty-shopping clause is inevitable for the economic well-being of the country. Part V will explore the circumstances that influence a country as it shapes its own anti-treaty-shopping rules.

V. POLICY CONSIDERATIONS FROM A GLOBAL PERSPECTIVE

The preceding Part shows that the problem of treaty shopping and the means of its resolution can be looked at from many different perspectives. No one remedy is globally acceptable and applicable. Therefore, it is important to evaluate treaty shopping

---

456. KRAFT, *supra* note 112, at 117.

457. *Id.*

458. As to the United Kingdom, see Hugh Rowland et al., *British Multinationals Braced for a Double Dutch Tax Threat*, THE TIMES, Feb. 25, 1993, *available on* LEXIS, World Lib., Txtln File. As to France, see Jean-Pierre Le Gall & Sonia Reeb, *Treaty Shopping: The French Policy*, 8-9 INTERTAX 364 (1989). *See also* 1981 U.S. Model Treaty, *supra* note 3, art. 16.

and anti-avoidance measures in light of historical and economic developments. Only when all forces and counterforces are weighed objectively does it become possible to analyze each solution's advantages and disadvantages.

A. *Economic Considerations*

1. Competing Interests in Anti-Treaty-Shopping Policy Decisions

The economic situation of a country and its role in the international community play a decisive role in the country's approach to anti-treaty-shopping measures. A state, when crafting a limitation-on-benefits provision, faces a conflict of interest. When attempting to remedy the treaty shopping practice, a state must ensure that it does not create a cure worse than the illness. Thus, the drafting of counteracting measures requires a delicate balancing of economic and political interests with regard to a country's role both as a source and residence state.[459]

a. Varying Objectives of Source and Residence Countries

As a residence country, a state seeks to provide an environment in which it is as easy as possible for its own investors to do business abroad. The state has a legitimate interest in minimizing foreign taxes imposed on its corporations.[460] Therefore, the residence state must consider whether its interests would be best served if a stringent anti-treaty-shopping policy were universally applied.[461] The state must address whether the measures would burden its own investors and give the other contracting party more power to actually deny benefits to them. For the source country, however, the primary concern is to maximize taxation on inbound investment,[462] which means that it seeks to capture all revenue and particularly seeks to avoid giving tax relief granted to unintended beneficiaries.

---

459. A.L.I., *supra* note 5, at 163.

460. VOGEL ET AL., *supra* note 8, at 30.

461. A.L.I., *supra* note 5, at 162.

462. For background and issues relating to the taxation of foreign investment in the United States see STAFF OF JOINT COMM. ON TAX'N, 101ST CONG., 2D SESS., BACKGROUND AND ISSUES RELATING TO THE TAXATION OF FOREIGN INVESTMENT IN THE UNITED STATES 64 (Comm. Print 1990) [hereinafter BACKGROUND AND ISSUES].

Whether a country is more concerned about its needs as a source or as a residence country largely depends on whether the country is a net capital exporter or a net capital importer. A net capital exporting country will seek to avoid rules that operate to the disadvantage of its resident investors or its fisc, in case it has a tax credit, when it is the country of residency.[463] A net capital exporting country will thus consider the ability of its own investors to take advantage of treaties to which it is not a party.[464] In other words, a net capital exporting country sees treaty shopping as less of a problem when it is conducted by its own investors. Treaty shopping benefits the residence country's economy by reducing the tax burden for its domestic companies operating abroad and benefits the residence country's fisc by reducing the amount of creditable tax. The more oriented a country is toward external investment the stronger these concerns will be.

Most of the countries this Article discusses have far more outbound than inbound investment.[465] A general complex avoidance clause would give the contracting state the power to deny treaty benefits to its investors on a larger scale than would be in the interest of the capital exporting country.[466] Because the source country's focus is on maximizing source taxation on foreign investment, it will happily accept measures making it more difficult for its treaty partner's investors to qualify for treaty benefits.

b. The Position of the United States

The United States interest in implementing hard restrictions on treaty benefits both in treaties and domestic tax law became significant when it shifted from being the world's largest capital exporting country and its largest net international creditor, to being the world's largest debtor nation.[467] In this respect, the United States occupies a unique political and economic status and has experienced an extraordinary economic development in

---

463. Rosenbloom, *supra* note 7, at 775-76.

464. A.L.I., *supra* note 5, at 162.

465. In 1993, Germany had a trade balance surplus of DM 61 billion. However, in the years 1986 to 1990, the annual balance of trade surplus was over DM 100 billion. Beat Gygi, *Revision der Deutsche Aussenhandelszahlen*, NEUE ZUERCHER ZEITUNG, Aug. 2, 1994, at 17. France had a trade balance surplus of FFR 92,49 billion in 1993. *Weiterhin aktive Handelsbilanz Frankreichs*, NEUE ZUERCHER ZEITUNG, June 20, 1994, at 10.

466. Jones, *supra* note 431, at 331.

467. RAGLAND, *supra* note 208, E-3.

the last four decades. No other country has undergone such a significant change. This trend has had an enormous impact on U.S. tax policy regarding inbound investment. The U.S. role as a net international creditor shaped U.S. tax policy toward international investment for many years.[468] Now that the U.S. role has been reversed, one may question the usefulness of the former system. Arguably, the general orientation of U.S. tax policy should respond to the changed conditions, especially because the overall situation of the United States is unlikely to change in the foreseeable future.[469] With these considerations in mind, the United States allows its own residents to treaty shop by including U.S. residents in the ownership and base-erosion thresholds. On the other hand, the United States position as a source country requires the United States to prevent its tax treaties from being abused.

2. Impact of Stringent Anti-Treaty-Shopping Measures on Inbound Investment

a. Generally

When negotiating an anti-treaty-shopping provision, a country also must consider the impact of drastic measures on the inbound investment flow. In the present situation of international tax competition, a country must weigh carefully the possibility that stringent anti-avoidance measures might make it less attractive to foreign investment and that the economic loss caused by reduced foreign investment may far exceed the revenue lost from tax treaty abuse. Overly stringent avoidance rules may cause the treaty partner to conclude that the burden of qualifying for treaty benefits will outweigh the potential profits.[470] Largely net capital exporting countries cannot afford to discourage inbound investment without the possibility of creating investment imbalances. Countries in need of capital will be very sensitive to the fact that compliance complexity, or the fear of not qualifying for treaty benefits may deter incoming investment.[471] Therefore,

---

468. BACKGROUND AND ISSUES, *supra* note 462, at 151

469. Some adoptions have already been made. The abundant volume of foreign investment flooding its markets led the United States to sudden and often harsh course corrections, starting with the Foreign Investment in Real Property Tax Act, § 897, 94 Stat. 2682 (1980) [hereinafter FIRPTA], followed by the branch profits tax in 1986 (II-646; 1986 U.S.C.C. & A.N. 4084) and the 1989 earning-stripping rules, Budget Reconciliation Act 1240; 1989 U.S.C. C. & A.N. 2637.

470. A.L.I., *supra* note 5, at 163.

471. Rosenbloom, *supra* note 7, at 775.

those countries must weigh tax policy changes very carefully against their possible economic impact.[472]

b. The Status of the United States

The United States seems to be less vulnerable than other countries when implementing its strict tax on inbound investment.[473] The reason for this is that the United States is unique in its status as an invaluable investment place. The United States has a large, stable economy that is desirable to foreign investors.[474] Its huge market, with tremendous potential, attracts direct investment, while its preferential treatment of portfolio investment[475] lures needed capital. Under federal commercial laws and most U.S. states' liberal business laws, there is more flexibility than in many other countries and the United States still imposes some of the lowest corporate tax rates in the world. This is especially true if one takes into account the overall corporate tax burden. All of these facts indicate that, far from refraining from investment in the United States, even extremely strict measures against treaty shopping may result in the reorganization of existing structures or outright acceptance of a thirty percent withholding tax.[476] Moreover, the United States, as a capital importing country, with its main desire to collect as much tax as possible, will not have to fear that the restrictions, if reciprocally applied, would reduce the overall revenue income.

---

472. When Germany introduced its 10% withholding tax on interest payments in 1989, large amounts of foreign investment were withdrawn immediately. Two years later the withholding requirement was dropped as a result of investment losses. Forced by a decision of the constitutional court, legislation had to be enacted imposing a withholding tax on interest earnings. Due to the prior experience, however, foreign investors have the opportunity to obtain a waiver while being guaranteed full protection under the German bank secrecy law. § 43 Abs. 1 Nr. 7 Einkommenssteuergesetz, Steuergesetze, C.H. Beck, 1993 BGBl I 2310.

473. FIRPTA, *supra* note 469, in 1980, was followed by the branch profits tax in 1986 and the 1989 earning-stripping rules. Even though the Tax Reform Act of 1986, II-646; 1986 U.S.C.C. & A.N. 4084, was clearly unfavorable to U.S. based foreign companies, it has by no means affected the influx of foreign investment. *See* Ross, *supra* note 14, at 331.

474. BACKGROUND AND ISSUES, *supra* note 462.

475. *See* I.R.C §§ 871(h), 881(c) (1988) (exempting "portfolio interest" from U.S. gross withholding tax).

476. *U.S.-Netherlands Accord Seen Causing Business Reorganizations*, BNA INT'L BUS. & FIN. DAILY, Dec. 9, 1993, *available on* LEXIS, News Lib., BNAIBF File.

3. Influence of Revenue Considerations on the Shape of Limitation-on-Benefits Provisions

The stringency of anti-treaty-shopping measures will be heavily influenced by revenue considerations. Although a country has an interest in adopting more stringent anti-abuse clauses designed to prevent the erosion of its source tax base,[477] if it is not a likely target for treaty abuse, there is no need for harsh countermeasures. The abuse can simply be handled on a case-by-case basis or ignored because the foregone revenue is negligible.

Treaty shopping by third-country in the United States was so widespread that it caused erosion of the U.S. tax base.[478] Although it appears that no accurate estimates of the revenue loss due to treaty shopping exist, it is clear from U.S. policy that the U.S. Treasury Department believed the revenue loss was substantial. Developments in the late 1970s and mid-1980s show excessive erosion of source-based taxation caused by worldwide investment flows structured through the Netherlands Antilles.[479] Once again, the United States position was unique. No other country had to deal with tax avoidance of this magnitude.[480] Whereas other countries could adopt a laissez-faire attitude without fear of an excessive revenue loss, the United States was flooded by treaty benefit claims of unintended beneficiaries. Consequently, there is no real question about the need for efficient anti-abuse provisions.

B. *The Effect of the Treaty Network on Treaty Shopping*

1. The Importance of an Extensive Treaty Network

Treaty shoppers are not attracted to a country solely because it is a popular place to invest; they also assess the reach of the targets country's treaty network.[481] Countries with extensive tax treaty relations do not need to include specific anti-avoidance provisions in their treaties because most foreign investors can take advantage of a treaty in their home country. These investors would be more likely to shop for a favorable treaty if they were subject to full tax rates in the absence of a treaty.

---

477. A.L.I., *supra* note 5, at 163.
478. *See* discussion, *supra* Part IV.A.
479. *Id.*
480. *1983 Hearing*, *supra* note 86, at 7.
481. Schwarz, *supra* note 4, at 3.

The likelihood of treaty shopping diminishes with an increasing network of tax treaties.[482] While there is some tax planning opportunity when certain treaties provide more advantages for a person than an investor's nation's treaty, individuals from countries that do not have any treaty with the target country are much more likely to structure their business through third countries. Therefore, treaty shopping is less of a threat when the targeted country has tax treaties with the most important countries of the world, the most advantageous of which would result in a "one-way treaty with the world."[483]

2. The U.S. Treaty Relationship with Other Countries

It is noteworthy that the United States, with the largest economy in the world, has just fifty-five tax treaties in force.[484] In comparison, the United Kingdom maintains some eighty comprehensive tax treaties,[485] Germany about seventy, Italy about seventy, Canada about fifty-six, the Netherlands around fifty, Norway around fifty-three, Sweden about fifty-three, and even Finland has forty-six tax treaties with other countries.[486] Countries that maintain extensive treaty networks that include most of their trading partners do not need a strict anti-avoidance rule as urgently as do those with weak treaty networks. Unfortunately, the United States is more likely to be a potential target for treaty shopping constructions than many other states. On one hand, the United States is the world's largest economic power and most attractive country for foreign investment; on the other hand, it has a treaty network comparable to that of Sweden. This discrepancy certainly leads to frequent use of one especially favorable treaty, which then becomes, in effect, a "one-way treaty with the world."[487]

3. The Influence of Anti-Treaty-Shopping Provisions on the Expansion of the Treaty Network

In order to become less vulnerable to treaty abuse, the United States should establish a long-term policy objective to drastically

---

482. Jones, *supra* note 431, at 332.

483. Kooiman, *supra* note 225, at 196 (statement by Lesly Schreyer, Deputy International Counsel, during the 1st Treasury Hearing in 1982).

484. 1-3 Tax Treaties (WGL).

485. Jones, *supra* note 431, at 332.

486. The numbers are provided in the national reports of the countries. *See* DOUBLE TAXATION CONVENTIONS, *supra* note 77.

487. Kooimam, *supra* note 225, at 196.

expand its treaty network, and at the same time make the accorded treaty benefits more homogeneous. Foreign investors can obtain treaty benefits through a one-way treaty with the United States, foreign countries have no incentive to negotiate or renegotiate tax treaties with the United States. For example, there is no reason why Saudi Arabia should be willing to make concessions on its own source tax on a reciprocal basis if its residents can obtain full benefits in the United States through the use of the U.K. treaty. The probable result is that the United States will be unable to expand its treaty network, forcing it to remain a treaty shopping target.[488] Thus, an effective anti-treaty-shopping provision is inevitably necessary to force other countries to come to the bargaining table.[489]

4. A Pattern of Treaty Overrides

The existence of one-way treaties with the world is not the only reason countries may be reluctant to negotiate tax treaties with the United States. Countries are unlikely to be willing to make reciprocal concessions in a tax treaty if they fear that the treaty will soon be valid for only one party. This fear is grounded in the United States pattern of unilateral treaty overrides.[490] Foreign countries' confidence in the reliability of bilateral agreements is certainly shattered, and this fact does much to obstruct the United States long-term policy goal of extending its treaty network.

---

488. *1987 Hearing*, *supra* note 6, at 349.

489. This argument also might be true with respect to beneficial owners from countries that have no income tax treaty with the United States. But what happens if, for example, Japanese, Canadian, and German residents form a corporation under German law to invest in the United States? If the corporation is not engaged in an active trade or business it could be denied treaty benefits despite the fact that all three countries maintain comprehensive income tax treaties with the United States. *See* A.L.I., *supra* note 5, at 166, 167. Under these circumstances, the argument that anti-treaty-shopping provisions induce treaty negotiations is worthless. In this case, the limitation-on-benefits provision would adversely affect the freedom of decision-making, specifically, to choose the structure of doing business under pure economic considerations.

490. The 1986 Tax Reform was an effort at undercutting the reciprocal nature of tax treaties (II-646; 1986 U.S.C.C. A.N. 4084). Fortunately the Foreign Income Tax Rationalization and Simplification Act of 1992, H.R. 5270, 102d Cong., 2d Sess., was never enacted into law.

C. *Simplicity Considerations*

1. Complexity of the U.S. Anti-Treaty-Shopping Provisions

One of the main problems of a complex and detailed anti-treaty-shopping provision is administrative feasibility. Many countries doubt that it is possible to draft a general anti-avoidance provision in a way that finds a workable balance between administrative feasibility and efficiency. The Deputy Chairman of Inland Revenue expressed the United Kingdom's view that general anti-treaty-shopping articles are costly to administer and may not actually prevent abuse.[491] Overly complex provisions are regarded as inefficient because a taxpayer has to put time, money, and effort into compliance activities when those resources could otherwise be used to make investments. Complex provisions cost governments money as well, because they must operate a large agency to interpret such rules and ensure compliance through regular auditing measures.[492] This argument has been used to critique the United States latest efforts to construct a loop-hole-proof anti-avoidance rule.[493] The very complexity of the benefits article creates tremendous difficulties in its administration and, at the same time, imposes a severe administrative burden on the taxpayer who has to provide "sufficient proof" for its tax relief eligibility.[494]

2. Balancing a Provision's Complexity and Effectiveness

The level of complexity and detail in a law is largely influenced by the provision's purpose and the government's desire to achieve the highest possible standard of compliance. When the final goal is to combat treaty shopping, a general abuse rule may be more costly and labor-intensive than à precise ex-ante determination of which entities are eligible for treaty benefits.

Promulgation of precise rules is more expensive than general provisions because precise rules involve advance determination of the law's content. In contrast, general avoidance provisions involve more costs for legal advice to predict or to enforce the law because the law's content is determined later.[495] Thus, in view of

491. Schwarz, *supra* note 431.
492. *Id.*
493. A.L.I., *supra* note 5, at 170.
494. *Id.*
495. *See* Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L. J. 557, 562 (1992). For example, if a third-country user is confronted

the promulgation costs of a complex rule and the legal costs for enforcement of an overly general anti-avoidance provision, the decisive factor in determining the degree of complexity is largely the frequency of violation of a law.[496]

If treaty shopping occurred randomly, it would not be appropriate to burden other taxpayers with high compliance costs and the increased administration costs associated with increased auditing measures; it would be enough to leave the final determination of an alleged violation to the courts on a case-by-case basis. However, if treaty shopping occurred regularly and the abuse features could be more or less determined, it is more efficient and less costly to precisely define what constitutes treaty abuse. The tax authorities could specifically direct their auditing measures to perceived abuse structures and deny benefits on the basis of the provision, without incurring the danger of constant litigation on the basis of a general standard. The deterrence function of a complex rule would be significant and this, in turn, would facilitate tax administration.

The effectiveness of the complexity and inclusiveness of anti-treaty-shopping provisions can be seen in the corporate restructuring that occurred after conclusion of the U.S.-Netherlands treaty.[497] An optimally complex rule is certainly hard to achieve and lawmakers will always run the risk of creating a treaty that is either overinclusive or underinclusive.[498]

3. Effect of Deterrence

The United States has been criticized for inserting severe anti-treaty-shopping provisions into its treaties just in case they are needed.[499] In view of the provisions' complexity, it is uncertain whether they are genuinely enforceable, because it is questionable whether all of the necessary facts can be verified. In the United States, which has years of experience with the limitation-on-benefits articles, not a single reported case has invoked one of these provisions in the last fifteen years.[500] The value of a severe treaty shopping provision is certainly open to

---

with a specific anti-avoidance provision. If faced with a general avoidance rule, the third-country user might take the risk. Then the courts would have to decide the user's eligibility for treaty benefits. *Id.*

496. *Id.* at 563.

497. *U.S. Netherlands Accord Seen Causing Business Reorganizations*, *supra* note 476. *See also* U.S.-Netherlands Treaty, 2 Tax Treaties (CCH) ¶ 6258.

498. Louis Kaplow, *A Model of the Optimal Complexity of Rules*, HARVARD PROGRAM IN LAW AND ECONOMICS, Discussion Paper No. 97 (1991).

499. Jones, *supra* note 431, at 331.

500. Rosenbloom, *supra* note 13, at 92.

question if its deterrent effect is accomplished by means of complexity rather than efficient administration. If this is indeed the United States strategy, it is overly broad. The complexity of the system equally affects bona fide and abusive investments, whereas efficient administration specifically aims at abuse structures. However, it appears that the United States complexity strategy has actually caused many foreign companies to restructure their businesses that were established for the purpose of treaty shopping.[501] Thus, it can be argued that complexity actually serves the goal of efficiency, because complexity provisions actually were designed to have a preventive function, in particular with regard to multinationals of a certain size and importance. As opposed to foreign corporations with minor U.S. inbound investment, which will always, to some extent, be able to slip through the net of auditing measures, large multinationals cannot risk routine noncompliance with limitation-on-benefits provisions because multinational corporations are certain to be audited on a regular basis. Thus, the preventive effect facilitates the administrative feasibility of countermeasures. The strict anti-avoidance measures are not a farce, but actually do prevent treaties from being abused.

D. *Impact of Overly Strict Anti-Avoidance Measures on Economic Efficiency*

Rules that seem both necessary and appropriate in tax haven jurisdictions, seem less urgent and intrusive on international economical relationships when they are applied to industrialized countries that have comprehensive tax systems and substantial amounts of trade.[502] Because the insertion of anti-treaty-shopping provisions in tax treaties is a very recent phenomenon, no empirical data exists on the effect of those provisions upon trade and investments.

Even in the absence of statistics, it is obvious that an overly strict avoidance policy inevitably entails less-than-optimal resource allocation decisions.[503] Taxation is only one of a variety of costs that might play a role in an investment decision. For example, there are compliance and tax planning costs that are

---

501. *U.S.-Netherlands Accord Seen Causing Business Reorganizations*, *supra* note 476.

502. A.L.I., *supra* note 5, at 165.

503. BACKGROUND AND ISSUES, *supra* note 462.

normally very small in relation to other costs.[504] If a substantial tax burden or administrative burden is imposed, however, these smaller costs may be decisive in determining whether to proceed with a certain activity.[505] If businesses involved in true treaty shopping are forced to restructure or give up their activities, then the provision has worked. What about entities possessing sound business reasons for structuring their investments through a third country? Although U.S. policymakers fortunately thought about this situation and provided bona fide clauses, these clauses contribute to corporations' uncertainty because it is not clear how the bona fide clauses relate to the strict rules of a treaty. The United States resolved this problem by permitting businesses to obtain a private letter ruling from the I.R.S.[506] Depending, however, on how many letter rulings the I.R.S. can handle, the companies may not get the ruling at the right time and may incur the risk of not qualifying under the treaty. Other companies with widely dispersed ownership of a substantial investment in the United States might be forced to list their company on recognized stock exchanges in order to qualify under the tax treaty, regardless of the general economic desirability of trading on the exchanges. Detailed compliance requirements give rise to high compliance costs and, therefore, indirectly inhibit the free flow of capital.

VI. CONCLUSION: DIRECTIONS FOR CHANGE

A. *Tax Harmonization*

Even though strict anti-treaty-shopping rules constitute a useful tool for eliminating treaty abuse, efforts should be made to level out the imbalance of the international tax system and neutralize the incentive to shift income and legal entities into other jurisdictions.[507] A country's long-term policy goal should not be the anxious protection of revenue sources but the growing liberalization of world trade and economic flows.

Unfortunately, the present international taxation system is a web of increasingly varied and complex tax agreements with

---

504. Michael Devereux, *The Impact of Taxation on International Business: Evidence from the Ruling Committee Survey*, 1992 EC TAX REV. 105, 113.

505. Alan Willensky, *Future Directions of U.S. International Tax Policy*, TAXES, Dec. 1992, at 1000.

506. *U.S.-Netherlands Accord Seen Causing Business Reorganizations*, *supra* note 476.

507. Merill & Patrick, *supra* note 221, at 142.

greatly disparate judicial and administrative interpretations. This situation raises the question of whether a balanced international tax system will ever be achieved.[508] Only international tax harmonization can effect the global neutrality that is required to ensure that an investor's choice of country is not influenced by international tax differentials. Tax harmonization would help to fight tax avoidance and treaty shopping more than any other existing anti-abuse measure. The United States could contribute greatly to tax harmonization by increasing its treaty network, but the complexity of its anti-treaty-shopping provisions must be restricted to an administrable extent. Because the United States is the world's most important economic power, the United States must extend its treaty relations at least to a level reached by other developed countries such as the United Kingdom and Germany. This would effectively reduce the need for complex anti-treaty-shopping structures.

B. *Multilateral Tax Conventions*

A multilateral treaty offers the prospect of even better results than a web of bilateral tax treaties.[509] For example, the OECD model treaty could be adopted, resulting in internationally shared terms and concepts and assuring that taxpayers are treated equally within member states.[510] The approach of multinational agreements is feasible[511] and already exists elsewhere in international legal diplomacy.[512] The advantage of a multilateral tax agreement addressing treaty shopping is that it requires states to find a homogenous way to treat entities incorporated in other treaty countries. This would benefit both the taxpayer and the fisc. Taxpayers could structure their businesses more flexibly (*e.g.*, by using capital from several countries' investors) without

---

508. WILLIAMS, *supra* note 24, at 166.

509. Rosenbloom, *supra* note 7, at 768.

510. *Id.*

511. NILS MATTSSON, GEHÖRT DEN MULTILATERALEN DOPPELBESTEUERUNGSABKOMMEN DIE ZUKUNFT? EINIGE BEMERKUNGEN IM HINBLICK AUF DIE ERFAHRUNGEN IN DEN NORDISCHEN STAATEN 13-16 (Institut für Ausländisches und Internationales Finanz- und Steuerwesen, University of Hamburg, 1985).

512. The multinational approach is found in an existing treaty adopted in 1984 by the Nordic countries: Sweden, Norway, Denmark, Finland, and Iceland. The treaty was revised in 1987 and 1989, and now includes the Faroes Islands. Other multilateral fiscal agreements have been concluded by the OCAM (Common African, Madagascan and Mauritanian Organization) in 1971 and the COMECON states. However, the multilateral tax agreement between the Nordic Countries is of much more importance because the agreement was concluded by OECD member states on the basis of the OECD model treaty.

the fear of not qualifying for treaty benefits. The tax authorities could more easily identify treaty shopping structures because of a common definition of abuse structures in the treaty, which would be binding on all members. A multilateral treaty would also provide better exchange of information.

Presently, it seems unlikely that a multilateral agreement will be achieved in the near future. Even though the advantages of reducing the possibility of treaty shopping are considerable, several obstacles remain. Concessions in the area of tax law would affect the core of state sovereignty, and reduce countries' willingness to enter into such agreements. The unrestricted sovereignty to assert tax jurisdiction and the attendant possibility of exploiting every revenue source in order to minimize growing budget deficits, is one of the most sensitive areas in public international law. Moreover, countries that need to increase their revenue generally tend to expect foreign investors to bear a larger share of the tax burden.[513] The reason for this trend is the fact that domestic measures affecting foreign investors can be implemented very easily—foreigners lack voting power and do not participate in influential interest groups.[514] Unfortunately, at present, multilateral tax treaties are seen as too inflexible to meet domestic revenue needs. As a consequence, the promise of a multilateral treaty in the foreseeable future is illusory,[515] even though it would definitely reduce the incentive for treaty shopping.

Thus, efficient and detailed anti-treaty-shopping provisions are necessary to prevent revenue losses on a large scale in the short-term perspective. Anti-treaty-shopping provisions might even be appropriate to achieve mid-term policy goals, because an increased harmonization in the international setting is not likely to be accomplished in the near future. Yet, the United States, as a major world economy, should not lose sight of long-term policies while focusing on today's revenue needs. The United States should seek to promote global economic growth in the international community, undistorted by tax differentials and tax competition and to contribute more stability, efficiency, and neutrality to the international tax environment. Accordingly, the United States ultimate goal should be a broader coordination and greater uniformity of tax policies, which, in the long run, will

---

513. For example, President Clinton's economic plan for 1993-96 presumes that foreign firms will contribute an extra $45 billion through new tax laws. *See* Bruce Lassman, *Clinton's $45 Billion Tax Crackdown*, THE TIMES, Nov. 12, 1992.

514. WILLIAMS, *supra* note 24, at 165.

515. ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, COMM. ON FISCAL AFFAIRS, MODEL TAX CONVENTION ON INCOME AND ON CAPITAL I-12 (1995).

result in greater efficiency that benefits the United States and the world economy.