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May 22, 2010

The Honorable Max Baucus,
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The Honorable Charles E. Grassley
Ranking Minority Member
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The Honorable Sander E. Levin,
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US House of Representatives
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The Honorable Dave Camp
Ranking Minority Member
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US House of Representatives
Washington, DC 20515

Re: Comments on the Proposed Denial of Treaty Benefits for Certain Related-Party Deductible Payments[*]

Dear Sirs:

We write to convey our substantial and serious reservations about section 301 of the Promoting American Jobs and Closing Tax Loopholes Act, H.R. 4849 (the "Jobs Bill"), passed by the House of Representatives on March 24, 2010.[1]

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[*] The Letter may be cited as New York State Bar Association Tax Section, *Comments on the Proposed Denial of Treaty Benefits for Certain Related-Party Deductible Payments* (Report No. 1213, May 22, 2010). The principal drafters of this letter were Richard L. Reinhold and Ansgar A. Simon, with help from Michael Hilkin and helpful comments from Kimberly Blanchard, Peter Blessing, Douglas Borisky, William Burke, Andrew Braiterman, Peter Canellos, Michael Schler and Willard Taylor.

Opinions expressed herein are those of the Tax Section of the New York State Bar Association and do not represent those of the New York State Bar Association unless and until they have been adopted by the Association's House of Delegates or its Executive Committee.

[1] The Bill, H.R. 4849, was previously referred to as the "Small Business and Infrastructure Jobs Tax Act of 2010." The same provision was adopted by the House of Representatives

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Section 301, if enacted, would add new section 894(d) (the "Treaty Override") to the Internal Revenue Code of 1986, as amended (the "Code"). The Treaty Override would deny any reduction of withholding tax on a payment made, directly or indirectly, by a US payor to a more-than-50% related foreign person that is otherwise eligible for reduced withholding under a US income tax treaty if (1) the payment is deductible by the US payor, (2) both payor and payee are members of a "foreign controlled group of entities" and (3) the foreign parent corporation would not be eligible for reduced withholding under a US income tax treaty if the payment were made directly to the foreign parent. A foreign controlled group of entities is, for this purpose, a controlled group whose common parent is a foreign corporation and whose members are connected to the common parent through one or more chains of entities connected through more than 50% direct stock ownership (by vote or value).[2]

A simple example will illustrate the inappropriateness of the Treaty Override. Consider a Mexican subsidiary with a substantial active business in Mexico and royalty income from its US subsidiary that is connected with that business. If a majority stake in the Mexican subsidiary were to be sold in an auction, the company could continue to avail itself of the US-Mexico tax treaty if acquired by a company resident in Venezuela (a treaty-country resident), but not if acquired by a company resident in Brazil (which does not have a tax treaty with the United States). A prospective Venezuelan acquiror might thus bid higher than a prospective Brazilian acquiror simply because its ownership would permit continued exemption of the royalty from U.S. withholding tax under the US–Mexico tax treaty whereas the Brazilian company's ownership would deny treaty relief to the Mexican company depite the Mexican company's strong nexus with Mexico based on its active business there.

The Treaty Override ostensibly aims at curbing treaty shopping. Generally, safeguards against treaty shopping are implemented in US income tax treaties through limitation on benefits ("LOB") provisions, which Treasury has developed to be the strictest of their

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in November 2009 as part of H.R. 3962 and has been previously included in the proposed Middle Class Tax Fairness Act of 2008, H.R. 6595 (110th Cong., 2nd Sess.), the proposed Alternative Minimum Tax Relief Act of 2008, H.R. 6275 (110th Cong., 2nd Sess.) and the proposed Tax Reduction and Reform Act of 2007, H.R. 3970 (110th Cong., 1st Sess.); it has been modified from a prior version included in The Farm, Nutrition and Bioenergy Act, H.R. 2419 (110th Cong., 1st Sess.), which the House approved in 2007 and which was initially introduced by Rep. Lloyd Doggett as H.R. 3160 (110th Cong., 1st Sess., 2007). The American Jobs and Closing Tax Loopholes Act of 2010 (H.R. 4213), introduced May 20, 2010, does not include the provision.

We have previously discussed a predecessor proposal in New York State Bar Association Tax Section, *Report on International Provisions of H.R. 3970 and Effects of Reduction in Corporate Tax Rates*, (December 24, 2008), available at http://www.nysba.org/Content/ContentFolders20/TaxLawSection/-TaxReports/1173Report.pdf ("2008 NYSBA Report").

[2] The relevant entities are corporations includible in a controlled group as defined in Code section 1563(a), disregarding the exclusions under Code section 1563(b)(2), as well as insurance companies and, if controlled by members of the group, partnerships. Apparently, then, an entity that is classified as a foreign partnership for US tax purposes could be a member, but not a foreign parent corporation, of a foreign controlled group of entities.

kind of any country since they were first introduced in the early 1980s and refined in later years.[3]

We believe that the current approach to curbing treaty abuse–i.e., the (re-)negotiation of tax treaties by Treasury with increasingly more nuanced LOB provisions and their ratification by the Senate–has been successful and should be continued. The Treaty Override by contrast fails in our view to meaningfully advance tax treaty policy because:

1. the kind of tax treaty abuse cited in support of the Treaty Override does not reflect modern LOB provisions;

2. the measure would be both over-inclusive, by affecting not only foreign parent corporations resident in no-tax or low-tax jurisdictions, but at the same time might be considered under-inclusive, as discussed below;

3. the measure would deny treaty benefits principally in situations where treaty benefits are best justified under modern LOB provisions and therefore would be in conflict with US tax policy;

4. Treasury has a history of successfully renegotiating tax treaties to address tax treaty abuse through progressively more targeted LOB provisions; and

5. legislative overrides of tax treaties, as violations of international obligations of the United States, ultimately weaken the position of the United States with respect to tax treaty negotiations as well as the international standing of the United States in general, and they do so in particular where the provision lacks a clearly articulated rationale, cannot achieve its stated rationale, or is not precisely targeted.[4]

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[3] LOB provisions supplement the requirement that tax treaty benefits generally are available to a foreign corporation only if it is a "resident" of the other treaty country, i.e., generally only if it is a person that under the laws of the treaty country is "liable to tax therein by reason of [its] domicile, residence … place of management, place of incorporation, or any other criterion of a similar nature." Art. 4(1) of the United States Model Income Tax Convention of November 15, 2006 (hereafter, the "2006 US Model Treaty"). Current income tax treaties further limit the eligibility for the benefits of any US tax treaty under LOB provisions to entities that exhibit specified criteria for "connectedness" to or presence in the other treaty country, thereby functioning as a stopgap against potential "treaty shopping"– i.e., the structuring of investments in the United States by third-country residents through entities in the treaty country by which the third-country residents seek to obtain treaty benefits otherwise not available to them.

[4] We have in the past opposed measures that overrode existing tax treaties. *See* New York States Bar Tax Association, *Legislative Overrides of Tax Treaties*, reprinted in 37 TAX NOTES 931 (Nov. 30, 1987) (hereafter "1987 NYSBA Report"). The measures at issue in the 1987 NYSBA Report generally involved relatively narrow changes that would not have affected a large number of treaty beneficiaries or found reasonable support in sound tax policy. The Treaty Override by contrast would apply wholesale to entities that are owned by non-treaty parties, with no indication that those parties are necessarily "tax haven" entities or engaged in treaty shopping.

We therefore have strong reservations about the Treaty Override. Our arguments are addressed in more detail below.

1. The Treaty Override's Articulated Rationale Does Not Reflect Modern LOB Clauses

It is unclear from the House Committee Report accompanying the measure why Congress thinks the Treaty Override should deny otherwise available tax treaty benefits. According to the House Report, the measure aims at treaty shopping by foreign multinational taxpayers in non-treaty countries, singling out "tax havens" as one class of such countries. "Treaty shopping by foreign multinational companies may involve organizing, in jurisdictions that have income tax treaties with the United States that offer favorable US withholding rates on deductible payments, subsidiaries with no substantial business activities or other connection to those jurisdictions."[5]

Since LOB provisions specifically operate to undercut conduit-like arrangements employed by third-country residents to avail themselves of treaty benefits, they already do the work that the House Committee Report would like to assign to new section 894(d).[6]

The House Committee Report appears to be concerned with tax treaties with no LOB provision. It references the *Treasury Report to The Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* from 2007 (the "2007 Treasury Report"),[7] which observed that the most attractive treaty-shopping countries are those with a zero-percent withholding tax on interest and no LOB provision: the treaties with Poland (1974) as well as Hungary (1979) and Iceland (1975) then in effect.[8] Since publication of the 2007 Treasury Report, the United States has renegotiated and signed new tax treaties with Iceland (2007, ratified by the Senate in 2010) and Hungary (2010, awaiting Senate approval). Treasury is likewise in the process of negotiating a new treaty with Poland (although it did not appear to play a role as a treaty-abuse jurisdiction based on the 2004

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5 H.R. Report No. 111-447 at 36.

6 We also note that LOB provisions are not the only provisions available under US tax law to attack conduit arrangements. Straight "funneling through" should not be possible as a result of the enactment of section 7701(l) of the Code and the issuance of Treas. Reg. § 1.881-3. *Compare also Del Commercial Properties Inc. v. Comm'r*, 251 F3d 230 (D.C. Cir. 2001) *aff'g* 78 TCM 1183 (1999), *cert. denied*, 1/14/2002 (denial of treaty benefits where treaty-country resident corporation did not serve any role other than avoiding US withholding tax, with a "sufficient business or economic purpose to overcome the conduit nature of the transaction," citing Rev. Rul. 84-153, 1984-2 CB 383, 384) *with Northern Indiana Public Services Co. v. Comm'r*, 105 TC 341 (1995) (use of treaty-country resident corporation motivated by business purpose of accessing the Eurobond market).

7 TaxAnalyst Document Service Doc. 2007-26269.

8 The 2007 Treasury Report showed that US source interest payments to Iceland and Hungary had grown from less than $1 million in 1996 to a combined amount of slightly more than $1.25 billion in 2004. This growth was obviously very much out of proportion with the growth in US source interest payments to other treaty (as well as certain non-treaty) countries.

figures).[9] Numerous other tax treaties have been successfully renegotiated, signed and ratified over the last decade and now contain modernized LOB provisions reflecting the standard of the 2006 US Model Treaty.[10]

If the concern is with the reduced – albeit non-zero – withholding rate on, e.g., interest under the few remaining tax treaties without an LOB provision,[11] the measure seems overbroad. Instead, Treasury should, and we assume that in due course it will, renegotiate and modernize the remaining pre-LOB tax treaties.

Earnings stripping through the use of affiliates eligible for the benefits of a US income tax treaty has also been an issue with respect to US corporations that, as a result of corporate inversion transactions before enactment of the anti-inversion rules of section 7874 of the Code, are owned by foreign parents in low-tax or no-tax jurisdictions.[12] We understand, however, that several publicly-traded multinational companies that had previously undergone inversion transactions have announced or completed relocations to, e.g., Ireland or Switzerland, and the group parent company is eligible for treaty benefits if publicly traded in the United States. The Treaty Override thus would fail to apply to such companies in any event. We understand the concern in respect of expatriated entities, and would suggest that more precisely targeted approaches, such as the tightened earnings stripping (Code section 163(j)) provisions aimed at expatriated entities that were proposed by the Administration and included in proposed legislation in recent years, be considered.

2. The Treaty Override Is Not Tailored to Its Articulated Target of Foreign Parent Corporations in Low-Tax or No-Tax Jurisdictions

Statements made in support of the measure also focus on treaty abuse by companies located in "tax haven" jurisdictions. The House Ways and Means Committee summarized the measure as aiming at "prevent[ing] foreign multinational corporations incorporated in tax haven countries from avoiding tax on income earned in the United States by routing their income through structures in which a United States subsidiary of the foreign multinational corporation makes a deductible payment to a country with

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9 *See* 39 TAX MGM'T INT'L J. 282 (May 14, 2010).

10 The 2006 US Model Treaty specifically aimed at tightening the required nexus between the resident company and the relevant treaty country in several areas where Treasury had identified the potential for treaty abuse. *See, generally*, 2007 Treasury Report.

11 I.e., the tax treaties with Greece (1953), Pakistan (1959), the Philippines (1982), Romania (1976) and some former Soviet republics under the income tax treaty with the former Soviet Union (1976). The 2007 Treasury Report did not indicate that transactions routed through these jurisdictions have created any cause for concern.

12 *See* H.R. Report No. 111-447 at 36 ("The Committee believes that some instances of treaty shopping ... involve formerly U.S.-based companies that engaged in corporate inversion transactions"); Department of Treasury, Office of Tax Policy, *Corporate Inversion Transaction: Tax Policy Implications* (May 2002), reprinted at TaxAnalyst Document Service Doc. 2002-12218. *Cf.* 2007 Treasury Report at 4.

which the United States has a tax treaty before ultimately repatriating these earnings in the tax haven country."[13] Similarly, Rep. Lloyd Doggett stated on March 24, 2010 that the measure is directed against companies "headquartered in tax havens" and engaged in "funneling funds through a subsidiary in a tax treaty country … to avoid US taxes."[14]

The measure would apply, however, whenever an ultimate foreign parent is not resident in a treaty country regardless of whether the third country is a jurisdiction imposing low or no income taxes on corporate income. Yet, absence of a treaty is not indicative of the status of a country as a low-tax or no-tax jurisdiction.

The United States lacks tax treaties with significant trading partners in Latin America (Brazil, Argentina, Colombia) and Asia (Malaysia, Taiwan, Vietnam), and has no income tax treaties with African countries other than Egypt, Morocco, South Africa and Tunisia. This reflects neither their actual status nor to our knowledge Treasury's judgment about their tax system or their status as "tax havens." Rather, the US tax treaty network has developed largely for historic reasons, leaving gaps with countries, e.g., for reasons of US tax treaty policy or because few if any benefits would result for US taxpayers.[15] Thus, besides countries with low withholding tax rates,[16] the United States may not be interested in pursuing a tax treaty with a non-low tax jurisdiction that is not willing to reduce (high) withholding taxes. A tax treaty would then be absent precisely because of the robust tax system and a conflict with US treaty policy. But the Treaty Override would deny otherwise available tax treaty benefits to a treaty-resident foreign corporation owned by a foreign corporation resident in a jurisdiction with a robust tax system. We fail to see why this should be the case.

We also note that, if the concern underlying the Treaty Override is that tax base erosion may be facilitated by permitting a multinational group to shift income through related-party deductible payments without substantial economic consequences, the issue can arise regardless of whether the ultimate foreign parent corporation is in a treaty jurisdiction or a non-treaty jurisdiction. In particular, to the extent the concern is with expatriated entities, they are not necessarily charcterized by a non-treaty country rather

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[13] TaxAnalyst Document Service Doc. 2010-6229, at 5 (March 22, 2010). This repeats verbatim the summary of the Tax Reduction and Reform Act of 2007. *See* TaxAnalyst Document Service Doc. 2007-23866 (Oct. 25, 2007).

[14] TaxAnalyst Document Service Doc. 2007-6486 (March 24, 2010).

[15] In the case of Brazil, for example, negotiations appear to have paused because Brazil continues to insist on, *inter alia*, tax sparing. *See* D. Hora do Poco and H. Rosenbloom, "Thoughts on the Brazil-U.S. Tax Treaty Negotiations," 56 TAX NOTES INT'L 517 (Nov. 16, 2009). In another case, failure to confirm that the treaty partner would abide by the information-exchange provision lead to a delay in the ratification of a treaty signed in 1975 for almost twenty years. *See* R. Avi-Jonah, INTERNATIONAL TAX AS INTERNATIONAL LAW: AN ANALYSIS OF THE INTERNATIONAL TAX REGIME (2007), at 174.

[16] *See, e.g.*, R. Femia and L. Aksakal, "The Use of Tax Treaty Status in Legislation and the Impact on US Tax Treaty Policy", 58 TAX NOTES INT'L 341 (April 26, 2010). Alternatively, a jurisdiction may not attract significant US investments and not justify the use of Treasury resources to negotiate a treaty.

than treaty company parent company, as discussed above. Thus, to the extent expatriated companies are a target, the Treaty Override would be under-inclusive.

3. *The Treaty Override Would Principally Deny Treaty Benefits in Situations Where They Are Fully Justified*

There are effectively three ways in which a corporation resident in a treaty country that is more-than-50% owned by a non-treaty country foreign parent corporation could become entitled to tax treaty benefits under a modern LOB provision. First, the treaty country corporation could satisfy the active trade or business test.[17] Generally a corporation will be considered to carry on a trade or business only if the officers and employees of the corporation conduct substantial managerial and operational activities.

The active business test obviously has very strong tax policy underpinnings,[18] and based on the number of private rulings issued under active business provisions, a large number of taxpayers have relied on this provision.[19] A treaty-resident subsidiary satisfying the active trade or business test could hardly funnel related-party deductible payments to its non-treaty country parent in a tax-avoidance arrangement, because the active trade or business would have to be substantial and the item of income for which treaty benefits are claimed would have to be *connected with or incidental to* it. We are not aware of a tax policy justification for disallowing treaty benefits for such an item of income.

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[17] The active trade or business provision has been incorporated, with some slight variations, in all post-1988 US income tax treaties. Examples from the last decade are Hungary (2010), Chile (2010 Italy (2009), France (2009), Malta (2008), New Zealand (2008), Bulgaria (2007), Canada (2007), Iceland (2007), Belgium (2006), Finland (2006), Denmark (2006), Sweden (2005), Germany (2006), Netherlands (2004), Bangladesh (2004), Barbados (2004), Japan (2003), Australia (2001), United Kingdom (2001). The business of making or managing investments for the resident's own account is not an active trade or business unless conducted by a bank, insurance company or registered securities dealer.

Under this LOB test, a treaty-country resident entity may qualify with respect to certain items of income derived from US sources if (1) the treaty-country resident conducts an active trade or business in the residence state, (2) the items are connected with or incidental to that active trade or business and (3) if an item of income is derived from a related person in the United States, the active trade or business in the residence country is "substantial" in relation to the trade or business activity of the related person in the United States. Art. 22(3) of the 2006 US Model Treaty. The trade or business activity of a 50% or greater connected person generally counts towards the substantiality test.

[18] *See also* P. Morrison, "Overriding Income Tax Treaties in Codifying the New LOB", 38 TAX MGM'T INT'L J. 637 (October 2009).

[19] *See, e.g.*, PLR 2006-20-017 (Feb. 9, 2006); PLR 2004-09-025 (Nov. 20, 2003); PLR 2003-01-039 (Oct. 1, 2002). *See also* Memorandum of Understanding Regarding the Scope of the Limitation on Benefits Article to the U.S.-German income tax treaty (Aug. 29, 1989).

Some recent treaties also contain an LOB test for a headquarters company of a multinational group.[20] To qualify for treaty benefits under this test, the headquarters company must satisfy strict additional requirements designed to ensure sufficient nexus with the country of residence.[21] The headquarters test is therefore also not conducive to arrangements aimed at funneling deductible payments from the United States to a non-treaty country foreign parent corporation.

Third, a resident of a treaty country is also eligible for the benefits of the tax treaty if its principal class of shares (and any disproportionate class of shares) is regularly traded on one or more recognized stock exchanges. Recognized stock exchanges are generally any stock exchange registered with the SEC as a national stock exchange, the NASDAQ System, the stock exchange in the treaty country and certain other stock exchanges that are either specified in the treaty or to be agreed upon by the competent authorities. A treaty-country resident that is majority owned by a non-treaty country foreign parent corporation could thus meet this LOB test if the remaining, less-than-50% of its shares were publicly traded in the treaty country or the United States.

Although originally the publicly-traded test appears to have relied on the view that if shares are publicly traded in the country of residence then they would be largely held by other residents (and ultimately individuals) of the treaty country,[22] this is unlikely to comport with contemporary markets, where the shares may be traded in the local jurisdiction but mostly on a larger foreign market. Inverted formerly-domestic companies in particular might be traded in the United States, where they historically traded, rather than on a local stock market.[23] To strengthen the publicly traded test, Treasury added in the 2006 US Model Treaty the requirement that either (1) the principal class of shares is primarily traded on one or more stock exchanges in the residence country (or, for EU member states, generally stock markets in certain EU member states)

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[20] The test first appeared in the 1992 Netherlands-U.S. treaty and has since appeared in the treaties with Austria (1996), Switzerland (1996), Belgium (2006) and most recently Chile (2010) and Hungary (2010).

[21] Qualification under this test generally requires (1) that the resident provide a substantial portion of the overall supervision and administration of the group, and has and exercises independent discretionary authority to carry out these functions; (2) that the corporate group consist of corporations resident and engaged in an active business in at least five countries; (3) that the business activities carried on in each of the five countries generate at least 10% but not more than 50% of the gross income of the group; (4) that no more than 25% of the gross income on average is derived from the United States; (5) that the resident is subject to tax in the treaty jurisdiction; and (6) that the income derived in the United States is derived in connection with or is incidental to the active business of the multinational group.

[22] *See* R. Reinhold, "What is Tax Treaty Abuse? (Is Treaty Shopping an Outdated Concept?)," 53 TAX LAW. 663, 694 (Spring 2000).

[23] The fact that an inverted corporation would qualify under the LOB provision of the old tax treaty with Barbados (1984) if its shares continued to be traded in the United States prompted the 2004 protocol to that tax treaty, which provides for a comprehensive modern LOB provision. *See* "Remarks by Treasury Secretary John W. Snow at the Signing Ceremony for the U.S.-Barbados Income Tax Protocol," July 14, 2004, available at TaxAnalyst Document Service Doc. 2004-14476.

or (2) the company's primary place of management and control is in the residence country.[24]

Treasury's renegotiation of treaties with the Netherlands, Barbados, and various other countries have incorporated these modifications to the publicly traded test; there is no reason to doubt that in due course Treasury will succeed in conforming other tax treaties to this standard. The legislative history of the Treaty Override cited above does not indicate whether the publicly-traded test in the 2006 US Model Treaty was found to have policy shortcomings. The burden of arranging for public trading in shares, when the other conditions are satisfied, certainly does not fit into a picture of entities formed for the purpose of passing US related-party deductible payments on to a third-country parent corporation.[25] In any case, the Treaty Override is much too blunt and broad an instrument to address a potential abuse here.

In addition, tax treaties generally allow treaty benefits to a treaty-country resident that otherwise does not satisfy any of the LOB tests if the competent authority of the United States grants the treaty benefits (in general or with respect to a specific item). But this will be the case only if the US competent authority "determines that the establishment, acquisition or maintenance of such person and the conduct of its operations did not have as one of its principal purposes the obtaining of" treaty benefits.[26] There is obviously no policy reason for the Treaty Override here.

We do not deny that the other tests may in certain narrow circumstances leave gaps, but they generally require at least 50% ownership of the shares of the resident by other residents qualifying under an LOB test or, in treaties with EU member states, "equivalent beneficiaries" (generally for withholding tax purposes in respect of interest, dividends and royalty income only). But this does in our view in no way justify the Treaty Override, as it principally would override well-established LOB tests with solid policy justification that pose no discernible risk for tax treaty abuse.

4. The Treaty Negotiation Process has been Successful and Should Be Continued in Addressing Treaty Loopholes and Treaty Abuses

Not all comprehensive US income tax treaties have LOB provisions that reflect the LOB standard of the 2006 US Model Treaty (plus perhaps some additional tests like the headquarters test). To the extent that deficiencies in LOB provisions form the basis for a policy concern that has given rise to the Treaty Override, those deficiencies should be

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24 Art. 22(2)(c)(i) of the 2006 US Model Treaty.

25 Article 22(1)(f)(ii) of the recent tax treaty with Malta (2008) strengthened this test by adding a base erosion provisions. *See* Opening Statement of Manal Corwin, Treasury International Tax Counsel, to Senate Foreign Committee on Foreign Relations (Nov. 10, 2009), available to TaxAnalyst Document Service Doc. 2009-24862. Malta's prior tax treaty in 1995 (effective as of January 1, 1997) because it was considered to allow treaty benefits to third-country residents. *See* Treasury News Release, "United States Terminates Tax Treaty with Malta" (Now 20, 1995), 95 TAX NOTES TODAY 227-55.

26 Art. 22(4) of the 2006 US Model Treaty.

addressed through the treaty negotiation process. This process implements standards for anti-treaty shopping provisions, which evolve in tandem with changing conditions in the global markets.

We believe that this process has been successful, in particular through LOB provisions. In addition to the examples of Iceland, Hungary and Poland mentioned above, the Barbados tax treaty was successfully and efficiently renegotiated after it became clear that its LOB provision was deficient, among other reasons in light of corporate inversion transactions.[27]

If a country whose tax treaty with the United States allows for abusive treaty shopping was recalcitrant, there would always be the last resort of terminating the tax treaty, as the United States has previously done in the case of Aruba, the Netherlands Antilles and Malta. While a termination might elicit criticism (as it did in these cases), it would be limited to a specific country, tailored to articulated shortcomings of the tax treaty in question and consistent with the tax treaty, as tax treaties contain specific provisions for their termination.

5. Treaty Overrides Weaken the US Treaty Negotiating Position

Tax treaties, like other treaties, are carefully negotiated bilateral agreements of the United States with other nations. The Treaty Override would therefore cause the United States to breach agreements with other nations that are a part of international law. We have previously commented that for this reason treaty overrides should "be exercised with restraint and only after express and full consideration of the particular cases."[28] For the reasons stated above, we fail to see that this would be the case with the Treaty Override.

While we of course are aware that, under US law, tax (and other) treaties are on equal footing with other federal laws under the Constitution,[29] a subsequent statute can never "repeal" a treaty. Instead, treaty overrides violate US obligations under the relevant treaties and carry several risks.[30] First, treaty overrides risk weakening future negotiation

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27 See note 23 above. *Cf.* Notice 2003-69, 2003-2 CB 851.

28 1987 NYSBA Report. *See also* 2008 NYSBA Report at 40.

29 U.S. Const. art. VI, cl. 2; *The Chinese Exclusion Case*, 130 U.S. 581, 600 (1889); *The Head Money Cases* (*Edye v. Robertson*), 112 U.S. 580, 599 (1884); *American Trust Co. v. Smyth*, 247 F.2d 149, 153 (9th Cir. 1957); Code section 7852(d); Rev. Rul. 80-223, 1980-2 CB 217. However, this position may not be constitutionally unassailable. *See* A. Infanti, "Curtailing Tax Treaty Overrides: A Call To Action", 62 U. PITT. L. REV. 677 (2001) (arguing that Congress does not have the authority under the Constitution to override treaty obligations, because constitutional history shows that it was clearly intended that only the Senate be involved in treaty ratification and that it was specifically determined that it was not desirable to have the treaty approval process include bicameral review and because treaty overrides ought to be subject to the same procedural rules).

30 We note that these risks might be exacerbated, as compared to the late 1980s when several other treaty overrides were enacted, by the increased global economic interdependence and a changed position of the United States within the system of international trade and finance.

positions for Treasury because foreign counterparties have diminished expectations of US adherence to its international obligations.

Second, treaty overrides upset multinational trading patterns that have developed in response to, among other factors, multi-jurisdictional tax considerations, including tax treaties. This is especially troubling where, as here, a treaty override is not narrowly tailored to a specific abuse and where affected parties cannot adjust without significant costs.

Third, a unilateral abrogation of treaties is a violation of international law that permits, and may result in, retaliatory measures.[31] Congress should in our view consider with utmost care whether an overbroad Treaty Override justifies the risk of reprisals from countries with which the United States has a history of economic and diplomatic relations.

* * *

Because the rationale of the Treaty Override is insufficiently clear and because its reach goes far beyond the type of arrangements that could reasonably be singled out as abusive, we have strong reservations about the Treaty Override. We believe that any concerns about treaty shopping should be addressed through developing LOB standards, through the process of treaty negotiations and, if necessary, by termination of a treaty. We believe that Treasury's approach of developing the LOB standard in response to treaty abuse and of negotiating or renegotiating tax treaties to reflect the ever-evolving standard has been highly successful in curbing treaty abuse and is the appropriate course of action under international legal norms and should be continued.

We appreciate your consideration of our comments. Please let us know if you would like to discuss these matters or if we can assist you in any other way.

Respectfully submitted

Peter H. Blessing
Chair

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[31] *See, e.g., The Head Money Cases* 112 U.S. at 598 (infractions of treaties are not the subject of courts, but may lead to reprisal); *The Naulilaa Case*, 1928 (Portugal v. Germany) (reprisals permitted upon violation of international law, but requires prior notification and proportionality). *Cf.* Vienna Convention on the Law of Treaties (1969) Art. 60, which provides for limited reprisals. The United States signed this Vienna Convention on April 24, 1970, but the Senate has not ratified it.

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