REPORT #572

TAX SECTION

New York State Bar Association

Report on the override of U.S. Tax Treaty Provisions
By Amendments to the Internal Revenue Code

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Table of Contents

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This report by the Committees on U.S. Activities of Foreign Taxpayers and Foreign Activities of U.S. Taxpayers discusses the extent, if any, to which amendments to the Internal Revenue Code should override conflicting provisions of previously ratified U.S. income tax treaties with foreign countries.[*]

This report in particular addresses tax treaty override provisions contained in, or raised in connection with the technical Corrections Bill of 1987 (the "Bill") and the Tax Reform Act of 1986 (the "Act").[**] Section 112(y) of the Bill provides that in any case not specifically addressed in the Bill or in the Act, the provisions of the Act will apply notwithstanding the provisions of any existing treaty. Section 1810(a) of the Act provides that the amendments made by the Tax Reform Act of 1984 to what is now Section 904(g) of the Internal Revenue Code of 1986 (the "Code") are intended to supercede both prior treaties unless a subsequent treaty clearly expresses an intent to override these Code rules by specific reference to them; Section 1881 of the Act makes this change retroactive to the effective date of the corresponding provisions of the Tax Reform Act of 1984. Section 884(e) of the Code provides specific

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[*] This report was written by John A. Corry and William L. Burke with the assistance of Cynthia G. Beerbower and Brent C. Whitman. Helpful comments were received from Herbert L. Camp, Richard O. Loengard, Jr. and David Sachs.

[**] H.R. 2636 (introduced on June 10, 1987).

tax treaty override rules with respect to the branch profits tax and second level tax provisions.* Several additional instances where the Act will or will not override tax treaties are set forth in Section 112 (y)(2)(A) and (B) and in Section 112(y)(3) of the Bill, respectively.

This report first discusses the adoption of a policy of presumptive override of tax treaties without consideration of the particular case in the legislative process. The adoption of such a policy is strongly opposed for a number of reasons. The report then addresses specific treaty override issues raised by the Act and the Bill.

A. Override of Treaties Without Express Consideration of the Particular Case

1. Relationship of Treaties and Statutes

A treaty between the United States and a foreign country, like a federal statute, has the status of supreme law of

* Section 112(o) of the Bill changes the language of these provisions, but not their substance.

the land.[*] Tax conventions are within the meaning of "treaty" under the Constitution, and thus share the status of supreme law.[**] Therefore, acts of Congress and treaties stand on the same plane under the Constitution,[***] and when inconsistencies arise, the latter in time prevails. As a consequence, a treaty may override a prior act of Congress; similarly, a subsequent act of Congress may override a treaty.

While the Constitution thus permits the Federal government constitutionally to exercise its power in violation of existing treaty obligations, it is not correct to say that a subsequent statute can repeal a treaty. A more accurate statement is that the subsequent action compels the United States to go into default on the international obligations that it assumed in

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[*] U.S. Const. art. VI, cl. 2.

[**] Samman v. Comm'r, F.2d 461, 463 (4th Cir. 1963); American Trust Co. v. Smyth, 247 F.2d 149, 153 (9th cir. 1957).

[***] The Chinese Exclusion Case, 130 U.S. 581, 600 (1889); The Head Money Cases, 112 U.S. 580, 599 (1884). The Supremacy Clause of the Constitution, upon which these cases are grounded, provides that (1) the Constitution, (2) the laws of the United States and (3) treaties are the supreme law of the land. It does not follow that all these are of equal weight among themselves; and, clearly, the Constitution is superior to the other two. Thus, as a matter of first impression, the concept that the laws and treaties are necessarily equal is subject to substantial question. See, L. Henkin, Foreign Affairs and the Constitution, 163-64 (1972). However, in light of the old Supreme Court pronouncements to the contrary, we are accepting for purposes of this report the validity of the concept that as between laws and treaties the latter in time prevails in the event of a clear conflict.

agreeing to the treaty.[*] Because the result is a default in international obligations, however effective as a matter of domestic law, Congress has rarely overridden tax treaties, and courts are reticent to construe treaties as inconsistent with statutes.[**] Indeed, unless there is a clear indication that a statute is meant to override a treaty, courts will favor the treaty.[***]

The Internal Revenue Code itself has clearly recognized this priority of treaties over domestic tax law for more than half a century. Internal Revenue Code Sections 894(a) and 7852(d) act as a legislative implementation of tax treaties. Section 894(a) provides that "Income of any kind, to the extent required by any treaty obligation of the United States, shall not be included in gross income ...," and Section 7852(d) provides that "No provision of this title shall apply in any case where its application would be contrary to any treaty obligation of the

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[*] See Restatement of Foreign Relations Law (Revised) §135(1)(b) (Tent. Draft No. 6, 1985). The violation of a treaty should be distinguished from its termination. Tax conventions typically include termination provisions. Thus, for example, the United States was able recently to terminate its tax treaty covering the Netherlands Antilles, since that treaty allowed for termination with six months notice. It should also be noted in this regard that the notice given by the United States has been modified to terminate the Netherlands Antilles treaty only in part, with exemptive provisions relating to interest (which benefit Netherlands Antilles residents and corporations) remaining in effect. See, Commerce Clearing House, Tax Treaties No. 426 (July 30, 1987) (filed in Vol. 3, Commerce Clearing House Tax Treaty Service).

[**] See, Whitney v. Robertson, 124 U.S. 190 (1887); Cook v. United States, 288 U.S. 102 (1933). Accord, Restatement of Foreign Relations Law (Revised) §135 (Tent. Draft No. 6, 1985).

[***] Menominee Tribe v. United States, 391 U.S. 404 (1968); Cook v. United States, 288 U.S. 102 (1922); Rev. Rul. 880-223, 1980-2 C.B. 221 at 222; Restatement of Foreign Relations Law (Revised) §135 Comment (Tent. Draft No. 6, 1985).

United States ....”* These sections, which Congress enacted in order to prevent the abrogation of treaties, demonstrate the longstanding general Congressional policy not to override tax treaties except in limited instances after careful consideration of the particular case.**

Other legal systems, such as that of France, give even greater weight to this preference for treaties, placing all treaties above legislation so that treaties may be abrogated only through diplomacy.*

2. Reasons for the Preference for Tax Treaties

There are several important reasons why, as a policy matter, tax treaty provisions are generally treated as superior to internal law. First, tax treaties are but one of many types of treaties which the United States enters into and agrees to abide by in its respect for and support of adherence to a broad concept of international law generally. Thus, a Congressional override of treaty provisions would place the United States in the position of having violated international law, and could legally expose it to highly disadvantageous retaliatory measures. We fail to see what makes a tax treaty so unique from treaties generally that they should be subjected to a special rule that allows them to be violated through inadvertence while a different, more respectful

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* As discussed herein, Section 112(y) of the Bill would amend Section 7852(d) so as to adopt the opposite rule in the case of provisions of the Act that conflict with treaties.

** Congress has, on one occasion, deviated from this otherwise well-established policy. The Revenue Act of 1962, in Section 31, overrode Section 7852 (d) for purposes of the Act, despite widespread criticism. The Treasury Department noted, however, that no conflicts existed between the 1962 Act and prior treaty provisions. See, H. Rep. No. 2508, 87th Cong., 2d Sess. 48 (1962).

rule applies to all other treaties (and, conversely, why the United States should put in question its willingness to adhere to its treaties generally by adopting such a policy of disregard as to any of its treaties).

Second, tax treaties involve the political and foreign policy objectives of the United States and therefore should be considered to be on a plane above local tax policy.

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* Beemer, Revenue Act of 1962 and United States Treaty Obligations, 20 Tax L. Rev. 125, 127 (1964).

Tax treaties are intimately entangled with foreign policy concerns. Signatory nations commonly take account of cultural, geographical or economic factors that are not directly related to taxation.[*] Indeed, tax treaties may be signed primarily for economic and political purposes, rather than for tax purposes. Even if there is relatively little United States investment in the partner nation, or vice versa, a tax treaty may nonetheless be useful for the improvement of general diplomatic and political relations. A tax treaty often serves as demonstrable evidence of good relations between the United States and its foreign partner.

As tax treaties are regularly used for nontax economic and political purposes, the foreign policy concerns of the United States are at stake in any potential legislative override. Tax treaties, like other international agreements, make a statement about relations between the signatories, and abrogation of such a treaty would make a corresponding statement, with significant foreign policy implications that extend beyond the treaty's terms. For this reason, although the residual treaty override of section 112(y)(2)(C) has been made a part of the Technical Corrections Act, the repudiation of an international agreement cannot be viewed as a mere technical correction.

Third, because taxation touches so directly matters of the basic commercial structure through which international trade is conducted and because of the difficulty of revising such structures to adjust to changes without incurring what are in effect retroactive financial penalties in the form of tax liabilities related to what has already developed, there is, if anything, greater need for long-term stability and predictability in the case of international taxation than may be the case in

[*] Rosenbloom, Current Developments in Regard to Tax Treaties, 1982 N.Y.U. Fortieth Tax Annual Institute on Taxation 31-31 through 31-35.

other areas (such as areas involving "public" international law). If proof of this proposition is required, one need only consider the recent upheaval occasioned by the initial announcement of the complete termination of the tax treaty applicable to the Netherlands Antilles. In recognition of such concerns, on prior occasions where statutes have been adopted to overrule tax treaties Congress has been careful to consider the need for transition rules, providing, for example, a five-year deferral period before the provisions of the Foreign Investors Real Property Tax Act of 1980 took precedence over existing treaties.

The above reasons do not argue for an existing tax treaty being immune in all events from override by subsequent legislative enactments. We believe, however, that they argue compellingly for legislative overrides to be exercised with restraint and only after express and full consideration of the particular cases, including the appropriateness in the specific case of deferred effective dates or other transition relief that will permit the United States to give its treaty partners the opportunity to object with the kind of advance notice contemplated in tax treaty termination provisions.

B. Legislative Override of Subsequent Treaties

Section 1810(a)(4) of the Act provides that the amendments made by Section 904(g)* override any subsequent treaty, as well as any prior treaty, unless the subsequent treaty by specific reference to Section 904(g) of the Code clearly expresses the intention to override those statutory provisions. The effective date for this provision (Section 1886 of the Act) would retroactively negate, for this special source rule, the

* These amendments were made in the Tax Reform Act of 1984.

effect of tax treaties that came into force after the Tax Reform Act of 1984 and before the Act even for the interim period between the two enactments. This override would appear to have only a limited effect and we therefore question why Congress found it necessary to utilize Section 904(g) in providing, apparently for the first time, a subsequent legislative treaty override.*

Although it may be a small point in this instance, we believe that this treaty restriction may well be contrary to the spirit if not the letter of the Constitution. As a constitutional matter, while a statute can be changed by another statute only with the approval of both houses of Congress, treaties require the joint action of the executive branch and the Senate alone without the House of Representatives. A statute purporting to restrict the approval of subsequent treaties infringes upon the prerogatives of the Senate in this regard. Although a statute such as Section 1810(a)(4) of the Act, in order to be enacted, required approval of the Senate as well as the House of Representatives, and although it permits the treaty negotiators to specifically negate Code Section 904(g), by its very presence

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* Section 904(g) provides that under certain circumstances dividends paid by certain United States owned foreign corporations will be treated as U.S. source income notwithstanding the Code provisions that are generally applicable to such dividends. Section 904(g) can be read as conflicting with the provisions of certain older U.S. tax treaties, which provide that dividends paid by a corporation of one of the treaty parties will be treated as derived from sources within that country. See, e.g., the treaty with Austria, Article II(2)(a) and the treaty with Finland, Article 6.1. However, these provisions would have no effect on United States taxpayers since Article XV of the Austrian treaty and Article 1.3 of the Danish treaty permit the United States to tax its citizens and residents as though those treaties had not taken effect. Most treaties contain provisions of this sort, e.g., Article 23(1) of the Draft Model United States Income Tax Treaty of June 18, 1981, which commences with "in accordance with and subject to the limitations of the law of the united States (as it may be amended from time to time without changing the general principals thereof ..."; acc'd, Draft Model Income Tax Treaty of May 17, 1977, Art. 23(1).

it is likely to inhibit their negotiating freedom. Because this impinges upon the exclusive role of both the executive branch and the Senate in the treaty making process, we believe that it may be unconstitutional and establishes an undesirable treaty override precedent.

C. Comments on Specific Treaty Override Issues

We have the following comments on specific treaty override issues presented by the Act and the Bill.

1. Branch and Second Level Withholding Taxes

Section 884(e)(1) generally provides that either the new branch profits tax or second level withholding taxes will apply, notwithstanding any treaty, unless the taxpayer that would otherwise be entitled to invoke such provisions is a “qualified resident” of the relevant treaty country, i.e., the taxpayer claiming the treaty benefit is not “treaty shopping.” The relevant treaty provisions are those that prevent a United States permanent establishment of a foreign corporation from being more onerously taxed than a U.S. corporation that is otherwise

similarly situated.[*] Similarly, Section 884(e)(3)(B) provides that only a qualified treaty resident payor of dividends may claim the benefits of an exemption from second level withholding under a treaty between the United States and the payor's country of residence; it also provides that a recipient of otherwise taxable dividends paid by a foreign corporation may claim a reduced rate of tax under a treaty between the United States and he country of which the recipient is a qualified resident.[**] Further, by cross reference to Section 884(e)(3)(B), Section 884(f)(1) would subject interest paid by a U.S. branch of a foreign corporation to tax notwithstanding a treaty unless the payor was a qualified resident of the country having the treaty, and would also make inapplicable any exemption in a treaty between a nonqualified resident payee's country of residence and the United States. Finally, the same cross reference would subject the payor to the tax imposed by Section 884(f)(1)(B) on excess interest notwithstanding a treaty provision unless the

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[*] See, the Tax Section's Report on the Proposed Foreign Corporation Branch Level Tax dated May 23, 1986 (pp. 15-19).

[**] This situation could arise where a treaty exempts a foreign payor of dividends from the branch tax but not from the second level withholding tax.

payor was a qualified resident of the treaty country.*

These provisions discriminate between foreign corporations that do business in the United States directly or through foreign subsidiaries and other foreign corporations that carry on United States business through United States subsidiaries. This is because, in the latter case, the dividend and interest provisions of a treaty that contains no anti-treaty shopping rules are applicable to any resident of the treaty country.** Neither the Act nor the Bill changes that result. This has the following anomalous consequences:

(a) Branch Tax. Under the Act, in the case of a dividend, if a foreign corporation that carries on business in the United States is not a qualified resident of a country that has a U.S. tax treaty with a reduced withholding tax on dividends, the branch tax will be imposed at the full 30%

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* These conclusions with respect to interest are clarified in the discussion in the General Explanation of the Tax Reform Act of 1986 (the "General Explanation") at pages 1044-1045 and in the Description of the Bill at page 218. See also, Notice 87-56, I.R.B. 1987-35, 9. One of the additional technical amendments to the Act approved by the Ways and Means Committee and Finance Committee on October 15, 1987 would apparently incorporate this conclusion into the Code.

** Treaties that contain no anti-treaty shopping rules include those between the United States and Japan and the United States and the Netherlands.

statutory rate. However, if instead such business is carried on by a U.S. subsidiary, dividends paid to the foreign corporation from the subsidiary would be eligible for the reduced treaty withholding taxes because the statutory “anti-treaty shopping” rule only applies to dividends paid by a foreign corporation.

(b) Second Level Tax. Similarly, a treaty shopping foreign corporation, i.e., a corporation that is not a “qualified resident”, that receives a dividend from a foreign corporation with a U.S. branch would not be entitled to claim relief from any second level withholding tax rate imposed in the absence of a treaty between the United States and the country of which the recipient corporation is a resident. However, on a dividend from a United States corporation, the same recipient foreign corporation would be still eligible for the reduced treaty rate.

(c) Interest. Interest paid to a foreign corporation by a U.S. branch of another foreign corporation would qualify for withholding tax reduction or exemption under a treaty only if the payee is a qualified resident of that country. However, the same interest received by the same payee from a U.S. corporation would be eligible for treaty protection even if the payee is treaty shopping.

The effect of these provisions in the Act is to impose harsher tax treatment on payments of dividends and interest by a foreign corporation that does business in the United States than on similar payments by a United States corporation. This seems

highly illogical since, if anything, payments of dividends and interest by a foreign corporation should be more favorably treated than dividends and interest paid by a U.S. corporation.*

This inconsistency results from the fact that the Act does not address broader treaty override question arising in a treaty shopping context as an overall policy matter. Instead, it covers only branch tax issues and related withholding tax questions. The Bill also does not consider override issues that are not raised by provisions of the Act.

Last year, the Treasury Department urged Congress not to adopt these particular treaty overrides so as to give Treasury an opportunity to renegotiate existing treaties that do not contain

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* Under section 861(a)(2)(A)(B), dividends paid by a U. S. corporation (other than a section 936 corporation) are entirely treated as U.S. source income without regard to the source of the payor's own income, whereas dividends paid by foreign corporations are treated as U.S. income only if 25% or more of its gross income is effectively connected with a U.S. trade or business and only then in the proportion that its total gross income is thus effectively connected.

effective treaty shopping prohibitions.* In the branch tax and withholding tax areas, Congress rejected that advice. The U.S. Government's recent action in terminating the Netherlands Antilles Tax Treaty may provide support for the willingness of the Treasury to take forceful steps in this regard.

In our report on the proposed branch profits tax dated May 23, 1986,** we questioned whether the relatively small amount of additional tax revenues anticipated from that tax justified the overriding of treaty provisions that potentially carries implications extending well beyond the Federal tax laws. We further suggested that at the very least the effective date of the treaty override provision should be deferred until after a suitable grace period of, say, three years. Particularly in view of the even broader treaty override provisions of the Bill and as part of the broader recommendations herein, we again suggest that Congress reconsider these branch tax treaty override provisions that it enacted last year.

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* Letter from Treasury Secretary Baker to then Senate Finance Committee Chairman Packwood dated April 7, 1986. Such a provision is contained in Article 16 of the 1981 Model U.S. Income Tax Treaty.

** pp. 1-6.

2. Foreign Tax credit Limitation Provisions

Section 112(y)(2) of the Bill provides that the new foreign tax credit limitation provisions of the Act and the 10% disallowance of foreign tax credits against a taxpayer's minimum tax liability will apply notwithstanding any contrary treaty provision. It is not entirely clear why this poses a significant treaty issue, since many United States tax treaties retain for the United States the right to tax its own citizens, residents and corporations as though the treaty had not come into effect.* Indeed, this would probably have been the case even where treaties that provide for foreign tax credits do not contain such language. In any event, the limitations imposed by the Act on a taxpayer's ability to utilize foreign tax credits almost exclusively affect United States persons rather than foreign persons. While we agree with the statement by then Deputy Assistant Treasury Secretary Chapoton before a Senate Finance Taxation Subcommittee on July 22, 1987 that the 90% limitation that the Act imposes on the alternative minimum tax foreign tax credit is bad policy because it results in double taxation, we believe that from the standpoint of treaty override concerns it is much less significant than the other issues that are raised by the Act and the Bill.

3. Other Areas of Conflict

Section 112(y)(2)(C) of the Bill provides that in any unspecified situation not otherwise covered by legislation, the provisions of the Act (as amended by the Bill) will override any treaty provision that is inconsistent therewith. If enacted,

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* See, e.g., Article 1.3 of the 1981 Draft Model U.S. Income Tax Treaty and the treaties between the United States and France (Article 22(4)(a)) and Switzerland (Article XV(a)).

Section 112(y)(2)(C) would reverse the long-standing legislative policy discussed above that, except where Congress specifically has otherwise directed, a treaty will override any subsequently enacted tax legislation with which it conflicts.

For the reasons discussed above, we believe that the policy that Section 112(y)(2)(C) reflects is wrong, and that Section 112(y)(2)(C) should not be enacted. Our objection to Section 112(y)(2)(C) is heightened by the statement at page 234 of the Description of the Technical Corrections Act of 1987 prepared by the Staff of the Joint Committee on Taxation ("the Description") that except for cases "that have been identified in the bill or in the Act, no cases are known where harmonious reading of the bill and U.S. treaties is not possible." In fact, two of the cases discussed in the Description as being consistent with U.S. treaty obligations appear to conflict with treaty provisions that are beneficial to our foreign treaty partners.

(i) The Tax on Excess Interest. The first situation involves the tax imposed by section 884(f)(1)(B) on the payor of interest to the extent that the payor's deduction for such interest under section 882 exceeds the interest paid by its United States trade or business. Our discussion above with respect to this excess interest tax in the context of the branch tax considers the treaty override question in cases of treaty shopping. However, if the statement in the Description is correct that there is no inconsistency between this tax and the treaty provisions, then the excess interest tax would be imposed even where the payor is a qualified resident of a treaty resident.

In our report on certain issues to be addressed in the branch profits tax regulations dated July 27, 1987, we noted that the tax on excess interest would appear to take away from a

permanent establishment of a foreign corporation a significant portion of the benefit of the indirect deduction for interest provided under the Internal Revenue Code. We concluded that for this reason, the tax would conflict with tax treaty provisions that permit the United States to tax only “income” or “profits” that are effectively connected with the foreign corporation's United States permanent establishment. We noted that article 7 of the 1981 Model U.S. Income Tax Treaty provides that in determining the business profits of a permanent establishment that are subject to tax “there shall be allowed as deductions expenses which are incurred for the purpose of the permanent establishment, including ... interest... whether incurred in the state in which the permanent establishment is situated or elsewhere.” The excess tax on interest in our opinion conflicts with such provisions.

This conflict is not addressed in the Description. The only question that the Description considers is whether the tax on excess interest is “discriminatory.” The Description concludes that it is not because it involves a “mere collection of this tax” from the foreign corporation payor of the interest rather than as a withholding tax, and thus does not create discrimination.[*] This statement is incorrect in

[*] Our July 27, 1987 report concluded that the excess interest tax probably does not violate anti-discrimination treaty provisions since, if the foreign corporation, branch had been incorporated as a U.S. corporation, it would not be a payor of the interest and would not be entitled to deduct it. It should be noted, however, that for certain foreign taxpayers, the loss of a deduction could be less serious than a tax on excess interest. That would occur where the foreign taxpayer's U.S. business is incurring losses so that a U.S. corporation conducting the business would pay no income tax even if the excess interest deduction were unavailable. In addition, it is possible that the excess interest tax may not be eligible for foreign tax credits in a foreign country of which the branch is a resident because it is not a tax on income.

treating the payor of interest as the alter ego of the payee. To the contrary, the payor and the payee, who may or may not be entirely unrelated parties, represent different taxpayers, so that a tax imposed on one often is very different from a tax imposed on the other. Further, except where the lender is reimbursed for withholding taxes by the borrower, the economic burdens of the excess interest tax and a withholding tax also fall on separate persons.

(ii) Section 367(e)(2). The second situation in which the premise in the Description is incorrect involves Section 367(e)(2). That Section extends the repeal of General Utilities rule to the liquidation of a United States corporation that is 80% or more owned by a foreign corporate shareholder. Although new Section 337 generally continues the General Utilities exemption where a corporation is liquidated under Section 332, Section 367(e)(2) provides that the liquidation nevertheless is taxable to the distributing corporation if the distributee is a foreign corporation unless regulations are adopted that provide otherwise. In Notice 87-5, I.R.B. 1987-3, 7, the Internal Revenue Service stated that the regulations will provide that Section 367(e)(2) will not apply (and the liquidation therefore would be tax-free to the distributing corporation to the same extent as the general rule in new Section 337) where Section 367(e)(2) would violate a treaty non-discrimination clause based on capital ownership similar to Article 24(5) of the 1981 Draft Model Income Tax convention. That paragraph provides that if the capital of an enterprise of one contracting state is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other state, the enterprise will not be subjected by the first state to more burdensome taxation than the taxation to which similar enterprises of the first state -- presumably owned

by United States residents -- are subjected.[*] The apparent concern of the Internal Revenue Service in Notice 87-5 was that, since United States subsidiaries of United States corporations would not be subject to tax on liquidation, imposition of such a tax on a United States subsidiary of a treaty country resident would violate such a treaty provision.[**]

In Notice 87-66, I.R.B. 1987-39, 17, the Internal Revenue service withdrew Notice 87-5 on the basis that United States subsidiaries of foreign corporations are not similarly situated to United States subsidiaries of United States corporations since, in the latter case, the liquidating distributions may completely exempt appreciated assets of the United States subsidiary from United States tax whereas in the former case, tax on the appreciation is merely deferred until the United States parent disposes of the asset. This is similar to the statement in the Description (p. 235) that there is no conflict between Section 367(e)(2) and these treaty provisions because a foreign shareholder, unlike a U.S. shareholder, “will not bear U.S. corporate level tax on the income generated by those asset.” This statement makes the same fundamental error as the Description's statement regarding the tax on excess interest in failing to distinguish between two completely separate corporate entities. The Description further does not take into account the fact that, although the foreign corporate distributee

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[*] See, e.g., French Tax Treaty, Article 24(1) and Italian Treaty, Article 24 (3).

[**] Notice 87-5 states that the Treasury Department will seek to negotiate tax treaties which contain such a provision to assure that they contain “an adequate limitation of benefits provision” and add that if this is not successful, “it will reconsider the U.S. tax on liquidation of domestic subsidiaries of foreign corporations in treaty shopping situations.”

may pay no U.S. tax when it disposes of the distributed assets, it may well pay foreign income tax on the distribution or on the subsequent asset sale. It appears to ignore the fact that the possibility that a foreign shareholder and domestic shareholder of a liquidating U.S. corporation will be differently taxed by the United States is inherent in Article 24(5) of the 1981 Draft Model Income Tax convention. It thus conflicts with treaties that incorporate Article 24(5) type language.

Entirely apart from the foregoing, the position taken in the Bill and in Notice 87-66 seems to violate these anti-discrimination provisions because it results in the payment of tax on appreciated property distributed to a controlling foreign stockholder before the equivalent tax would be paid on appreciated property distributed to a controlling United States stockholder. In the case of an appreciated asset that the foreign stockholder uses after the liquidation in a United States trade or business carried on by it, this appreciation will ultimately be taxable in any event, and hence the supposed justification for the position that treaty non-discrimination provisions do not apply does not exist. As the current legislative recognition in other areas of the importance of the time value of money indicates, this timing difference can be a material one. Thus, even if the asserted justification for the Section 367 tax were valid, there is no reason why the tax should be paid prior to the disposition of the asset if the tax were ultimately payable on the disposition of the asset under rules similar to those contained in Section 864(c)(7). Under that provision, which was added to the Code by Section 1242 of the Act, any income or gain attributable to a sale or exchange of property that ceases to be used or held by a foreign taxpayer in connection with the conduct of a United States trade or business that occurs within ten years after the cessation of that business will be treated as

effectively connected with the conduct of a United States trade or business. We believe that a similar rule should appropriately be applied to liquidations of United States subsidiaries of foreign corporations, so long as the controlling foreign stockholder enters into a closing agreement with the Internal Revenue Service to the effect that it will report and pay taxes on such gains under principles similar to those contained in Section 864(c)(7).

4. Areas Where No Conflict Exists.

We agree with the Description's conclusions as to three areas in which there is no conflict between the Act and treaty provisions. One of these concerns the new withholding tax imposed by Section 1446 on partnership distributions. We believe that the Description is correct in stating (p. 234) that, since this tax is refundable to the extent it exceeds a partner's U.S. tax liability, it constitutes a “reasonable collection mechanism” and hence does not violate any treaty non-discrimination provisions.

We also agree with the statement in the Description (pp. 234-235) that the amendment to Section 864(c)(6) that imposes tax on installment gains received after a foreign person ceases to conduct a U.S. trade or business is not inconsistent with treaty limitations that restrict the ability of the United States to tax a treaty resident's income that is attributable to that person's U.S. permanent establishment.

Finally, we agree with the Description (p. 235) that the consolidated tax return limitation on the utilization of deductions by a dual resident company (Section 1503(d)) is not inconsistent with anti-discrimination tax treaty provisions, especially since it does not distinguish between affiliated

groups that are owned by United States persons and affiliated groups that are owned by foreign persons.

D. Conclusions

1. We oppose enactment of 112(y)(2)(C) of the Bill. We believe that the long standing principle of overriding tax treaties only with restraint and only with express and full consideration continues to be sound. The United States enters into tax treaties because it believes that, on balance, they will benefit the United States economy and will further the collection of tax revenue through exchange of information procedures or provide other suitable benefits to the United States. Although a treaty provision may be viewed as excessively benefiting foreign nationals, it may often represent a quid pro quo for other provisions or benefits from which the United States stands to gain at least as much if not more than it has surrendered. Congress, through the Senate, has had an opportunity to review the treaty provisions when presented to it for ratification and, in certain instances, has refused to approve treaties unless provisions which the Senate deemed to be unacceptable were deleted.* For Congress to abrogate specific tax treaty provisions which offend it at a later date strikes at the very heart of the treaty negotiating and ratification process. Even if it does not lead countries with which we have concluded these treaties to terminate them unilaterally pursuant to their terms, it will make the task of U.S. treaty negotiators in the future much more difficult, since foreign countries will be less willing to enter into treaties with the United States if they can expect that certain provisions thereof can be overridden at any time on a

* Thus, in 1981, the Senate returned to the President without its approval proposed income tax treaties with the British Virgin Islands and Cyprus on the basis that they created unacceptable treaty shopping opportunities.

unilateral basis. We therefore oppose enactment of Section 112(y)(2)(C) of the Bill.

2. Wholly apart from whether or not it represents sound policy, we believe that the broad treaty override provision contained in Section 112(y)(2)(C) of the Bill should be a matter of general legislative consideration rather than part of a "technical corrections" proposal. Clearly, on its face, it represents much more than a "technical correction". To change long standing Congressional policy in the treaty override area is a matter that should be the subject of separate consideration, including hearings, at which the important issues involved can be thoroughly considered. It clearly represents much more than a "technical correction" to which only cursory consideration might be given.

3. With respect to specific cases of treaty overrides, we recognize policy considerations are involved in some cases that can be the subject of differing views in the course of the legislative process. Our comments are directed primarily to the technical substantive implementation of those policies and the manner of implementation. For example, the anti-treaty shopping provisions in the Act are a response to significant Congressional concerns that also are reflected in current U.S. tax treaty negotiating policy. However, particularly in view of the Administration's desire to resolve treaty shopping issues by treaty renegotiation and, if necessary as in the case of the Netherlands Antilles, by treaty termination, we believe that the executive branch of the government should be given the time to do so. This approach not only would be consistent with the general treaty override policy that we favor, but also would permit the issue to be considered in a careful way which would be less likely to produce such illogical results as those in the Act. We

would have no objection, however, if Congress imposed a reasonable “sunset” date after which Congress would be free to act in the case of treaties that had not yet been amended.