# The U.S. Income Tax Treaty Program: A Possible Future

# By Rocco Femia[[1]](#footnote-1)\*

This paper is about the U.S. tax treaty program, and in particular its ongoing utility in addressing double taxation or excessive source-basis taxation of U.S. multinational enterprises (“MNEs”). The international tax framework applicable to U.S. MNEs has undergone tumultuous changes over the last 15 years. These changes were precipitated by economic globalization and financial and technological innovation that allowed MNEs more flexibility in raising capital, locating supply chains, and accessing markets. MNEs used this new flexibility to enhance their competitiveness in part by centralizing value-creating activities and asset ownership in regional hubs, thereby lowering costs (including tax costs). Tax policymakers around the world took notice, taking measures to expand taxation of income of foreign MNEs, while at the same time taking measures to expand domestic taxation of the worldwide income of resident MNEs.

For decades, the balance between source- and residence-basis taxation of U.S. MNEs has been mediated by bilateral tax treaties to which the United States is a party. By some measures, the U.S. tax treaty program has been successful in achieving U.S. policy objectives; it has reduced or eliminated traditional withholding taxes on U.S. residents and provided a framework for the resolution of transfer pricing and other tax disputes. As the U.S. tax treaty program enters its 10th decade, however, it is fair to ask whether time has passed it by. While political pressure built outside the United States for increased taxation of U.S. MNEs at source, the U.S. tax treaty network proved inadequate as a bulwark to stem the tide of novel (and not so novel) taxes. Moreover, the sclerotic U.S. process for ratifying protocols or new treaties hindered the utility of the U.S. tax treaty program to address new policy concerns through bilateral negotiation.

Where should the U.S. tax treaty program go from here? In its present state, the U.S. tax treaty program retains some utility. But the action – in terms of extraterritorial taxes outside the reach of U.S. tax treaties, as well as minimum taxes – is elsewhere. Could tax treaties be reconceptualized to provide real and durable protections to U.S. MNEs against excessive source-basis taxation? Would (or should) the United States be willing to make the concessions necessary to bring this about? And are there changes to the process for effectuating changes in law in this area that would permit policymakers to respond to new developments more effectively?

Part I provides a brief history of the U.S. tax treaty program, and an overview of its purpose. Part II describes the current challenges to the program. Part III addresses several areas ripe for reconsideration or reform, including the allocation of primary taxing rights, relief of double taxation, limitation on benefits, and the tax treaty ratification process.

# U.S. Tax Treaties – Purpose and History

The principal purpose of U.S. tax treaties typically is stated in neutral terms: to eliminate tax barriers to cross-border trade and investment between the two contracting states.[[2]](#endnote-1) Tax treaties eliminate tax barriers to cross-border trade and investment by categorizing income earned by the residents of one state from sources in the other state, and providing reciprocal limits and priority rules with respect to the taxation of such income by each state. Tax treaties assign taxpayers a single state of residence; allocate primary taxing rights between source and residence states; reduce excessive taxation at source by limiting or reducing the rate of gross-basis withholding taxes imposed by one state on the residents of the other state; provide relief from double taxation through common transfer pricing rules and, with respect to income taxed at source, through the application by the residence state of a credit or exemption method; and establish a framework for the resolution of income allocation or other tax disputes. Tax treaties do not permit certain discriminatory taxes. Tax treaties are intended to provide a measure of certainty and stability to the residents of one state that are considering investments in or expansions into the other state. Tax treaties also serve other important purposes; in particular, tax treaties authorize the exchange of information by the tax authorities of each contracting state to support the administration and enforcement of each state’s tax law.[[3]](#endnote-2)

The animating purpose of the U.S. tax treaty program, as distinct from the purpose of U.S. tax treaties, is to reduce taxes imposed by other states on U.S. residents. During the formative history of the U.S. tax treaty program – the 30 years following World War II – the United States was the dominant market economy in the world. It was eager to facilitate cross-border trade and investment by U.S. residents, opening markets for U.S. goods and services and increasing economic interdependence between the United States and its major trading partners in Western Europe and the Pacific Rim. Absent tax treaties, many states would impose burdensome and excessive taxation on U.S. residents, including gross basis taxation of outbound payments such as dividends and interest, net basis taxation of income that has limited connection to the source state, and discriminatory taxes. The United States viewed itself as having a national interest in limiting the taxes imposed by other states on U.S. residents. To the extent such taxes are excessive or discriminatory, they would limit investment opportunities of U.S. residents or impose significant costs on repatriation of funds back to the United States, harming those residents and frustrating U.S. international economic objectives. Tax treaties were a tool of international economic diplomacy, a mechanism by which the United States negotiated reduced levels of taxation for its residents in pursuit of its national interests.[[4]](#endnote-3) Further, the United States had a direct revenue interest in reducing foreign taxes on U.S. residents. Because the United States in general taxed the worldwide income of U.S. residents and permitted a foreign tax credit for foreign taxes paid, at the margin foreign taxes were borne by the U.S. fisc.

The earliest handful of U.S. tax treaties were negotiated between the First and Second World Wars, and were based on a model developed by the League of Nations that was designed to accommodate states like the United States that imposed tax on the worldwide income of its residents.[[5]](#endnote-4) In the 15 years following World War II, the United States entered into tax treaties with most of its industrialized trading partners in Western Europe and the Pacific Rim. The United States further extended and updated its treaty network in the 1960s and 1970s, aided by the development of the OECD Model Tax Convention (first issued in 1963). This first wave of U.S. tax treaties included most of the elements of modern U.S. tax treaties, including limitations on gross-basis taxation at source of dividends, interest, and royalties; limitation of net-basis taxation at source to cases where the foreign resident had a permanent establishment in the source state; a prohibition on certain discriminatory taxes; and a framework for the resolution of tax disputes.

Importantly, the first wave of U.S. tax treaties also provided that tax treaties generally did not limit the application by the United States of its domestic tax rules to its residents (and citizens), the so-called “saving clause”.[[6]](#endnote-5) This policy has been consistently applied by the United States, and has had several notable repercussions. First, as a practical matter this policy limited the early expansion of U.S. tax treaties with developing states. Developing state treaties in the 1950s-1970s with states that taxed their residents on a worldwide basis often featured tax sparing rules intended to preserve the benefits of local tax concessions granted by the source state to increase foreign investment. Such provisions required the residence state to provide a credit for taxes that had been spared, or not paid, under the incentive regime of the source state. The United States refused to accede to tax sparing credits in its treaties.[[7]](#endnote-6) Second, this policy of ensuring that tax treaties did not limit U.S. tax on U.S. residents drove the view of the United States that the imposition of U.S. tax on U.S. persons with respect to the unrepatriated earnings of U.S. controlled foreign corporations (“CFCs”) was not limited by U.S. tax treaties.[[8]](#endnote-7) Thus, the United States preserved its right to tax U.S. shareholders of U.S. CFCs without regard to the terms of U.S. tax treaties that generally limited the right of the United States to tax the unrepatriated earnings of foreign corporations resident in the other contracting state.

Bilateral tax treaties, of course, are reciprocal in nature. But the reductions in U.S. taxation on residents of other contracting states in the first wave of U.S. tax treaties appear to have been the price the United States was willing to pay to achieve reductions in foreign tax on U.S. residents, and not an independent objective of the U.S. tax treaty program. The United States may benefit from reducing U.S. taxes on residents of other states. The United States has a national interest in attracting foreign investment, which improves the wellbeing of U.S. residents through economic growth and increased employment and wages. To the extent U.S. taxation of nonresidents is a barrier to such investment, reducing such taxes could increase investment. But the United States does not need tax treaties to reduce U.S. taxes on nonresidents – it can do so unilaterally as a matter of domestic law. If the United States concludes that a U.S. tax on nonresidents is harming the U.S. national interest or otherwise raising economic policy issues, it could change its law. Indeed, the United States has done this from time to time, in particular with respect to foreign portfolio investment. The United States enacted safe harbors from its U.S. trade or business rules for trading in securities or commodities in 1966, and eliminated its withholding tax on interest from U.S. portfolio debt in 1984. A stated purpose of these legislative changes was to attract foreign portfolio investment into the United States.[[9]](#endnote-8)

A major element of modern U.S. tax treaties was introduced at the end of the 1970s: anti-treaty shopping rules, including most prominently limitation on benefits (“LOB”) rules. The U.S. tax treaties negotiated in the post-World War II period did not include anti-treaty shopping rules. Further, several U.S. tax treaties, in particular favorable treaties with the Netherlands and the United Kingdom, extended benefits to resident entities located in territories of these states that did not impose income tax. As a result, these treaties permitted persons that were not resident in a state with a U.S. tax treaty to “shop” into a U.S. tax treaty without incurring any local tax cost by establishing an entity resident in a territory. Treaty shopping undermined the main purpose of the U.S. tax treaty program – to negotiate the reduction of taxes imposed by other states on U.S. residents – by undercutting U.S. negotiating leverage. If residents of states without a tax treaty with the United States, or with an unfavorable treaty, could nevertheless obtain full U.S. tax treaty benefits by shopping into the U.S.-Netherlands or U.S.-U.K. treaty, then it would be difficult for the United States to negotiate decreases to the taxes imposed by that state on U.S. residents.[[10]](#endnote-9)

Following the introduction of LOB rules, a major objective of the U.S. tax treaty program was the renegotiation of existing tax treaties to incorporate LOB rules.[[11]](#endnote-10) In general, these rules provide objective tests that residents of a state must satisfy in order to claim treaty benefits. The objective tests are directed at determining whether the person claiming treaty benefits has a sufficient non-tax nexus to its state of residence. In addition to the objective tests, most treaties provide that the competent authority of the source state can provide treaty benefits even in cases where the objective tests are not met. Over the course of the 1980s and 1990s, the LOB rules in U.S. tax treaties became significantly more complex. In addition, beginning with treaties signed in the early 2000s, the LOB rules have been repurposed to address issues beyond their original purpose of addressing treaty shopping by including limitations on benefits to foreign residents with significant U.S. ownership or other U.S. nexus, and limitations on benefits in cases where the foreign resident is not subject to sufficient levels of taxation.[[12]](#endnote-11)

Over the 1980s, 1990s, and 2000s the U.S. tax treaty program was successful in expanding the treaty network to large emerging economies such as China, India, Mexico, South Africa, and Turkey, as well as to former Soviet states and other Eastern European countries. Some of these treaties, notably the treaty with India, provided significant concessions, including relatively high withholding tax rates on interest, royalties, and (exceptionally) technical service fees. At the same time, the United States negotiated reductions to withholding taxes on royalties and interest from existing treaty partners,[[13]](#endnote-12) and for the first time agreed to eliminate withholding taxes on certain direct dividends.[[14]](#endnote-13)

# Challenges in Current U.S. Tax Treaty Program

The U.S. tax treaty program has faced major challenges over the last 15 years. Changes to the operations of MNEs spurred by economic globalization and technological innovation provided flexibility to MNEs in reorganizing business operations, leading to reduction in or avoidance of source-basis taxation. Policymakers reacted by adopting measures to expand taxation of MNEs at source and also on a residence basis. The limited breath of the U.S. tax treaty network, together with the sclerotic U.S. process for approving protocols or new treaties, hindered the utility of the U.S. tax treaty program to address these policy developments through bilateral negotiation.

## Impact of Globalization and Innovation on International Tax Policy Context

The basic contours of tax treaties were developed in the post-World War II period to address issues of the day. As relevant to U.S. MNEs, those issues often related to two-sided business models with the United States at the center. A common paradigm was a U.S. parent group of a U.S. MNE with vertically integrated business operations in the United States that sells goods or services into a foreign market and, as the market grows, that establishes direct branch or subsidiary operations in that market to distribute goods or services and ultimately to manufacturer or provide services locally. Another common paradigm was a U.S. parent group of a U.S. MNE with vertically integrated business operations in the United States that acquires natural resources or other inputs from a foreign state for sale or further processing in the United States, and establishes direct branch or subsidiary operations to do so. The issues raised by such two-sided paradigms involve the allocation of taxing rights between the source state and the United States over the income of the U.S. parent group and its local subsidiaries. Early U.S. tax treaties were intended to prevent the imposition of net-basis tax on U.S. residents in these contexts unless the U.S. resident had a local permanent establishment, to ensure that local permanent establishments and subsidiaries were not subject to discriminatory taxes, and to limit or eliminate withholding taxes on payments from local subsidiaries back to the U.S. resident.

Over time, the reality of business models employed by U.S. MNEs moved further and further away from these two-sided paradigms with U.S. residents at the hub of bilateral flows with affiliates or other counterparties in foreign states. That movement has accelerated in recent decades with the increase of economic globalization.[[15]](#endnote-14) Technological innovations in transportation, communications, and information technology provided flexibility to MNEs in reorganizing and optimizing their supply chains, permitting MNEs to centralize manufacturing and other operations in regional hubs to enhance their competitiveness by reducing costs. The liberalization of international trade rules, together with the entry into the global trading system of China and former Soviet states, opened new markets and new manufacturing hubs to U.S. and other MNEs. And financial reforms and innovation allowed MNEs more flexibility in raising capital, providing MNEs with the ability raise capital from investors and capital markets in different states and contributing to combinations of large MNEs based in different regions or states.

MNEs used the new flexibility afforded by economic globalization and innovation to centralize value-creating activities and asset ownership in regional hubs. This often had the effect of reducing corporate income taxes as a result of differences or gaps in domestic tax rules in applicable states and incentives provided by regional hubs to attract mobile investment. MNEs in some industries adopted business models that allowed them to access markets without establishing a physical presence, thereby avoiding taxation in the destination state. And MNEs adopted increasingly sophisticated legal entity and financing structures, which minimized the possibility that income or gain would be subject to tax in multiple states, but sometimes permitted income to escape taxation altogether.[[16]](#endnote-15) Tax policymakers around the world took notice of these developments, expressing increasing alarm at perceived harmful tax practices,[[17]](#endnote-16) base erosion and profit shifting that permitted MNEs to operate without paying “their fair share” of income tax.[[18]](#endnote-17)

## International Tax Policy Responses

Policymakers have pursued a variety of unilateral and multilateral responses aimed at preserving or enhancing taxation of income of MNEs, in particular U.S. MNEs. Unilateral measures included a reassertion of source-basis taxation, for example traditional gross-basis withholding taxes on outbound payments, as well as novel measures such as gross-basis taxes on income from digital services. These gross-basis taxes often are applied to items of gross income that likely required significant expenses to produce. Another set of unilateral measures were indirect stock transfer rules imposed on gain from the sale of companies that are resident outside the state imposing the tax in cases where the target owned companies resident, or assets located, in that taxing state. The European Commission instituted a series of state aid cases to investigate the extent to which EU member states had provided tax benefits to (mostly) U.S. MNEs in violation of EU law. A multinational initiative, the OECD/G20 Base Erosion and Profit Shifting (“OECD BEPS”) Project, produced a raft of recommended measures adopted by many states, including the United States, to expand taxation at source, including rules limiting deductions for payments of interest or hybrid payments. The United States adopted new Code Sec. 59A, a minimum tax on certain outbound payments to related parties. Finally, states adopted anti-abuse rules to prevent perceived abuses of tax treaties, such as general anti-abuse rules and diverted profits taxes. It is noteworthy that these and other expansions of source-basis taxation occurred notwithstanding the limits on source-basis taxation provided by U.S. (and other) tax treaties.

At the same time, policymakers have pursued a variety of unilateral and multilateral measures, including minimum taxes, to expand the current domestic taxation of the worldwide income of resident MNEs. The United States was an advocate throughout the OECD BEPS process for enhanced CFC rules as an alternative to additional taxation at source. This policy ultimately was adopted in the form of global minimum taxes, first in the United States and then abroad. As part of the reform of the U.S. international tax rules in 2017,[[19]](#endnote-18) the United States enacted Code Sec. 951A (the “GILTI” rules). While the United States had long had CFC rules targeted at passive or mobile income (the “subpart F” rules, the GILTI rules expanded the reach of U.S. CFC rules to substantially all business income of US CFCs above a normal return on tangible assets. This income is included in the income of U.S. shareholders when earned by the CFC, and subject to U.S. tax at a lower rate comparable to the rate applicable to the foreign derived intangible income of U.S. corporations. As part of the OECD/G20 Pillar Two[[20]](#endnote-19) global minimum tax initiative, many states have committed to enact comprehensive CFC rules, so called Income Inclusion Rules (“IIRs”), applicable to large MNEs. Under these rules, in general, CFC income subject to local tax of less than 15% is topped up to 15% by the residence state of the corporate parent of the MNE. The adoption of IIRs has been encouraged by the threat of the UTPR, a backstop under which third states in which an MNE operates could impose top-up tax on low-tax constituent entities of an MNE to the extent no IIR is imposed. Further, as part of the Pillar Two initiative, many traditionally low tax states are considering, or have enacted, Qualified Minimum Top-up Taxes (“QDMTTs”). Under these rules, the tax rate on local subsidiaries would be topped up to 15%, thereby avoiding the imposition of top-up tax by the shareholder state (under an IIR) or a third state (under a UTPR).

Taken together, these tax policy responses to the perception of base erosion and profit shifting by MNEs have and will result in increased foreign taxes on U.S. MNEs. If the purpose of the U.S. tax treaty program is to prevent such increases, it has failed in that objective in recent years. There are many reasons for this, including the inadequacy of the current U.S. tax treaty network, the inapplicability of existing U.S. tax treaties to taxes aimed at U.S. CFCs, and the near paralysis in the U.S. process for approving protocols or new treaties.

## Inadequacy of Current U.S. Tax Treaty Network

The starting point for any discussion of the limitations of U.S. tax treaty program is the limited scope of the U.S. tax treaty network itself. The United States has approximately 58 comprehensive tax treaties covering approximately 66 states. That network is smaller and less regionally diverse than that of other large, developed states, such as the United Kingdom. It excludes significant trading partners of the United States, notably emerging economies such as Brazil, Colombia, and other Latin American states, that historically have been unwilling to make concessions on source-based taxation required by U.S. negotiators. It also excludes Taiwan, a significant and strategic trading partner of the United States. U.S. tax treaties obviously do not provide any constraint on the ability of these states to subject U.S. residents or their subsidiaries to high levels of taxation or discriminatory taxes.[[21]](#endnote-20)

It is noteworthy that the U.S. tax treaty network also excludes significant trading partners, such as Singapore, Hong Kong, and Malaysia, that historically have maintained territorial systems and relatively low effective tax rates that, in the view of U.S. tax treaty negotiators, do not present significant risk of double taxation of U.S. residents. While the United States long ago terminated its tax treaties covering zero-tax jurisdictions, the U.S. tax treaty network has long included trading partners that have relatively small domestic economies and as a practical matter would not appear to present a significant risk of double taxation of U.S. residents, for example Cyprus, Malta, and Luxembourg. These treaties, together with other treaties with European “investment hubs,” have drawn a disproportionate amount of attention from the U.S. tax treaty program as they raise significant risks related to treaty shopping and other treaty abuse.[[22]](#endnote-21) These treaty relationships have put significant pressure on the U.S. treaty program to craft and negotiate ever more complex anti-treaty shopping rules. That said, a state’s tax and economic policies may change over time, and on balance it seems beneficial to have tax treaties in place with significant trading partners even when there is little present double taxation to eliminate so as to provide a baseline level of stability in the tax system and to facilitate other tax treaty objectives, including information exchange and the resolution of transfer pricing disputes. Further, while the domestic economies of investment hubs are relatively small, there are genuine residents and economic activities that tax place in these states that merit tax treaty benefits.

## U.S. Tax Treaty Network and Income Earned Through U.S. CFCs

Most of the unilateral measures to reassert source-basis taxation described in Part II.B. were adopted by tax treaty partners of the United States. In many cases, U.S. tax treaties provided little protection against these measures because the measures were imposed on the income or revenue of U.S. CFCs, and not on U.S. resident corporations eligible for benefits under U.S. tax treaties. Thus, for example, a diverted profits tax or a digital services tax[[23]](#endnote-22) could be imposed on the income or revenue of a U.S. CFC resident in Ireland, rather than on the income of a U.S. resident. U.S. tax treaties historically have provided benefits only to residents of the contracting states, and not to third-state subsidiaries of such residents. The same flexibility that allowed U.S. MNEs to structure their operations on a regional basis reduced the relevance of U.S. tax treaties as a tool for curtailing source-basis taxes on U.S. MNEs.

## Breakdown in Tax Treaty Approval Process

A possible U.S. response to the growing pressure around the world to expand source-based taxation would have been to open treaty negotiations with its treaty partners to reconsider the balance of benefits of existing agreements and work out a new deal that reflected current concerns. Whatever the merits of such a process, it was not possible because of the stasis in the U.S. tax treaty approval process since 2010, which severely limited the utility of tax treaty negotiations as a tool to address policy developments. This left unilateral or multilateral measures as the only way for states to assert additional source-basis taxing rights.

U.S. tax treaties traditionally have been implemented into U.S. law as treaties under the U.S. Constitution. The Treaty Clause of the U.S. Constitution provides that the President shall have the power, by and with the advice and consent of the Senate, to make treaties with other states, so long as two-thirds of the Senate concurs.[[24]](#endnote-23) For many decades prior to 2010, the process of approving tax treaties operated relatively smoothly. New treaties and protocols were negotiated and signed on a regular basis, and hearings regarding pending tax treaties were held by the Senate Foreign Relations Committee every two or three years. U.S. tax treaty policy was relatively stable, and tax treaties had overwhelming bipartisan support. In the 15 years from 1996 through 2010, 25 U.S. income tax treaties, and 14 protocols, were approved by the Senate, typically under expedited unanimous consent procedures, and ratified by the United States.

In the 14 years since 2010, only one U.S. income tax treaty (with Chile), and only four protocols, were approved and ratified.[[25]](#endnote-24) These five instruments were approved overwhelmingly by the Senate,[[26]](#endnote-25) indicating that the U.S. tax treaty program continued to have broad bipartisan support. Several protocols and treaties have been pending for many years, including a new tax treaty signed in 2015 with Vietnam, a large U.S. trading partner. The proximate cause of the slowdown appears to be concerns by one or two Senators with U.S. tax treaty policy related to the exchange of tax information with respect to U.S. individuals living abroad. Under the arcane rules of the Senate, the treaty approval process is vulnerable to delay caused by the concerted action of an individual Senator.

# Potential Reforms

## Allocation of Primary Taxing Rights

### Introduction

Historically, the United States has sought in tax treaties to reduce or eliminate excessive taxation at source. This policy has been justified as an extension of a policy preference for taxes on net income as opposed to taxes on revenues. The residence state has visibility into the expenses of its residents associated with generating gross income, and therefore can tax the income of residents on a net basis. Absent a local permanent establishment that itself incurs expenses or to which expenses can be reliably allocated, the source state may only have visibility into gross income flows. Accordingly, at the margin residence-based taxation is superior to source-based taxation because it is more likely to reach net income and therefore result in a level of taxation that is commensurate with net income. This is particularly the case for categories of gross income, such as interest to financial institutions, royalties, rents, and payments for technical services, that are likely to carry significant expenses.[[27]](#endnote-26)

This policy achieved significant successes. International norms in favor of reducing or eliminating source-based withholding taxes gained acceptance at the OECD. The OECD Model Tax Convention has long provided for an elimination of source-basis tax of royalties and income other than interest or dividends, such as service fees, except to the extent such income is attributable to a permanent establishment in the source state. While the OECD Model Tax Convention has provided for a positive rate of withholding tax on interest, beginning in 2005 the Commentaries have articulated an exception from this principle when the recipient is likely to incur significant costs such as financing costs, as would be the case for interest received by third-party financial institutions.[[28]](#endnote-27) Over time U.S. negotiators were able to achieve significant reductions or elimination of withholding tax on dividends, interest, royalties and other payments. The limitation or eliminating of withholding taxes on dividends and royalties was particularly beneficial to U.S. MNEs, which exported capital and valuable intangible property from the United States to affiliates operating throughout the world.

Ultimately, however, the policy in favor of ever-increasing reductions in source-basis taxation has appeared to run its course. Emerging economies in Latin America and Asia have been reluctant to agree to reduce or eliminate withholding taxes, resulting in some cases in unfavorable treaties (e.g., India), and in many other cases in no treaty at all. More troublingly, even where treaties are in place, as discussed in Part II.B states considered and enacted unilateral workarounds to claw back source-basis taxing rights that had been given away (in spirit if not in law) in tax treaty negotiations. The U.S. tax treaty network has not served as an adequate bulwark to such taxes for a variety of reasons, included the practical fact that these taxes often are imposed on the income or revenues of U.S. CFCs that historically have not been entitled to benefits under U.S. tax treaties. This development has put the U.S. tax treaty program at a crossroads: it has become increasingly ineffective in reducing source-basis taxation on U.S. MNEs because U.S. trading partners have become increasingly adamant in exercising source-basis taxation of U.S. MNEs, and because U.S. MNEs have organized themselves in ways that make U.S. tax treaties less and less relevant. A potential path forward may be available by addressing both sides of this issue together.

### Extending Reach of U.S. Tax Treaties to U.S. CFCs

The provision of tax treaty benefits to U.S. resident corporations and their foreign branches, and not to CFCs of such corporations, had a strong policy basis prior to the changes in U.S. international tax law in 2017. Prior to 2017, the current taxation of U.S. shareholders on CFC income was exceptional, limited generally to passive and mobile income under the U.S. subpart F rules. In general, a state agrees to limit its right to tax the income of residents of the other contracting state when that income is subject to tax by that other contracting state. Prior to 2017, amounts paid to a third-state U.S. CFC were unlikely to be taxed by the United States when earned because the subpart F rules were limited. The 2017 Act turned this system on its head; after 2017, the business income of U.S. CFCs generally was subject to tax by the United States when earned under the GILTI rules, bringing the U.S. tax treatment of U.S. CFCs closer to that of foreign branches of U.S. corporations. Put another way, after the 2017 Act, in general U.S. MNEs are subject to U.S. taxation on their worldwide income on a current basis. This raises the question of whether the United States should reconsider the policy of negotiating tax treaty benefits only for U.S. resident corporations and their foreign branches, and consider extending such benefits to U.S. CFCs as well. Extending some or all of the benefits of U.S. tax treaties to U.S. CFCs whose income is included currently in the income of a U.S. resident would dramatically increase the utility of U.S. tax treaties to U.S. MNE groups because it would limit source-basis taxation of all constituent members of U.S. MNE groups that are not resident in the other contracting state.[[29]](#endnote-28)

Expanding the definition of U.S. resident to include third-state CFCs of U.S. resident corporations would be unprecedented. It also would raise numerous technical issues. GILTI income is subject to U.S. tax at a reduced rate;[[30]](#endnote-29) although this rate generally consistent with the rates applicable to the taxation of foreign derived intangible income earned directly by U.S. corporations, the preferential rate raises questions regarding the extent to which such income should be eligible for treaty benefits. Some business income earned by U.S. CFCs, for example certain oil and gas income and returns on tangible property, are exempt from U.S. tax under the GILTI rules, raising questions regarding whether such income should be eligible for treaty benefits. U.S. CFCs may have multiple owners, including shareholders that are not U.S. residents, again raising questions regarding the appropriate extension of tax treaty benefits. Further, if the U.S. CFC is a resident of a third state that itself has a treaty with the source state, there is the potential that two tax treaties might apply, raising complexities.

There are models in existing U.S. tax treaty policy for beginning to address these technical issues. Many U.S. tax treaties have triangular rules to address low-tax income arising in one of the contracting states that is earned by a third-state permanent establishment of a company resident in the other contracting state. Under such rules, if the third-state permanent establishment is subject to a low overall effective rate of tax, tax treaty benefits are reduced or denied unless an active business is conducted in the permanent establishment state.[[31]](#endnote-30) Similar rules could be applied to U.S. CFCs whose income is subject to tax under the GILTI rules. Further, the tax treaty principles applicable to hybrid entities and partnerships could be applied in the U.S. CFC context in the case of multiple owners or in the case where treaty benefits under more than one treaty may be available.[[32]](#endnote-31)

Of course tax treaties are reciprocal, and so any changes to the definition of resident for tax treaty purposes would have to be considered by the United States as a source state as well. Many U.S. tax treaty partners have adopted IIRs pursuant to the OECD’s Pillar Two initiative. Under IIRs, the income of third-state CFCs (and third-state permanent establishments) of large MNEs is subject to top-up tax at the level of resident shareholders on a current basis. There are substance-based exceptions for a return on tangible property and payroll in the CFC’s state of residence, and the top-up tax is set at 15 percent, which might be lower than the generally applicable rate of corporate tax in the shareholder’s state of residence. Would the United States be willing to extend U.S. treaty benefits with respect to U.S. source income or payments earned by third-state CFCs of corporate residents of the other contracting state so long as the contracting state maintains an IIR or similar rules? Even if the U.S. were willing to do so, there would be numerous technical issues to consider, similar to the technical issues that would arise if tax treaty benefits were extended to third-state CFCs of U.S. resident corporations.

### Accommodating Increased Taxation at Source

It is axiomatic that the U.S. tax treaty program can meet its primary objective only to the extent U.S. tax treaties cover and limit source-basis income taxes on U.S. residents. Taxes imposed by U.S. tax treaty partners that are designed to end-run tax treaty limitations should be discouraged. To the extent domestic political or tax policy pressure has built up in these states for greater source-basis income taxes than what current tax treaties permit, it is better for the United States to consider the legitimate tax policy goals of its major treaty partners in negotiations than to countenance the alternatives, which include implicit or explicit treaty overrides.

The first principle of U.S. tax treaty policy for many decades has been the negotiation of the greatest reduction in source-basis taxation possible. This principle clearly was in the interest of the United States when the first modern U.S. tax treaties were negotiated in the post-World War II period. It has not been so clearly the case in the decades since. The United States remains a large and wealthy state. It is home to a disproportionate share of the world’s largest and most profitable MNEs.[[33]](#endnote-32) U.S. MNEs maintain vast amounts of foreign direct investment, and develop intellectual property that is exploited throughout the world. That said, the position of the United States as the world’s dominant market economy has eroded since the residence-basis bias of U.S. tax treaty policy was developed. The United States has become a net importer of goods and capital. Europe and Japan rebuilt in the decades following World War II, and emerging economies such as China and India have grown in the decades since. Permitting some increased taxation at source may alleviate tax policy problems that have been difficult to address effectively through the OECD’s base erosion initiatives and obviate the need for complex LOB rules. It may be time for U.S. policymakers to reconsider U.S. interests in this regard.[[34]](#endnote-33)

The United States has defended its stance in favor of reductions in source-basis taxation on the principled basis that gross basis taxation at source invariably results in excessive taxation where the income being taxed is associated with expenses. This is the case for income such as interest paid to financial institutions, which is likely associated with interest expense paid by such institutions. It is also the case for royalties, which are likely associated with prior period and current period research and development or marketing expenses, and service fees, which are likely associated with current period costs of providing the services. Finally, it is also the case for revenues from digital goods and services, which are likely associated with prior period and current period expenses related to software development, building and maintaining networks, developing or acquiring content, and other items. U.S. tax treaties should limit the gross-basis taxation of such income flows to very low rates, or eliminate gross-basis taxation of such income flows altogether, to prevent excessive taxation at source.

As an alternative, U.S. tax treaties could permit the imposition of gross-basis taxation on such income or revenue at relatively high rates, but provide taxpayers with an election to be taxed at source on a net basis.[[35]](#endnote-34) A net income election is consistent with the U.S. tax treaty rules (and domestic tax rules) related to income from U.S. real property.[[36]](#endnote-35) There is no conceptual reason for preferring residence-basis taxation of net income to source-basis taxation of net income, so long as net income is measured appropriately[[37]](#endnote-36) and the residence state provides relief from double taxation for income taxed at source. The allocation of source-basis and residence-basis taxing rights over net income should be treated as a matter of negotiation, and not a matter of principle.

Finally, U.S. tax treaties should not permit taxation of U.S. residents where there is no meaningful relationship between the income being taxed and the state asserting the tax. In other words, U.S. tax treaties should clearly address and prohibit UTPRs. This position should be non-negotiable as a matter of political expediency,[[38]](#endnote-37) but also as a matter of principle. UTPRs should not be applied to the U.S. income of a U.S. MNE for several reasons. First, the objective of Pillar Two is to ensure a minimum level of tax on foreign income earned by MNEs so as to address cross-border base erosion and profit shifting issues. For U.S. MNEs, the United States is invariably the center of that MNE’s economic interests and the place of ultimate management of the MNE. As a result, the United States is more appropriately considered to be the natural location of the residual profits arising from the operation of the business, rather than a place to which profits are shifted to minimize tax. Second, and relatedly, while all states have a sovereign right to determine their own tax systems, that right is especially pronounced with regard to the system for taxing resident MNEs (as recognized implicitly by the design of the IIR, which permits the home state of an MNE to impose a top-up tax on low-taxed foreign subsidiaries). The United States should have the right to determine the appropriate manner of taxing the domestic income of its MNEs, balancing revenue concerns with tax incentives to encourage positive economic activity within the United States. Applying a UTPR to the U.S. income of U.S. MNEs inappropriately encroaches on the right of the United States to balance these domestic policy interests.

### A New Bargain?

Would the United States consider a rebalancing of taxing rights toward source-basis taxation in exchange for prohibiting UTPRs and extending limits on source-basis taxation and other tax treaty benefits to U.S. CFCs of MNEs? Such a bargain could bring new relevance to the U.S. tax treaty program. It would allow the United States to return to the business of negotiating limits on source-basis taxation on a bilateral basis with its largest trading partners, and ensuring that such limits apply in a meaningful way to income earned by U.S. MNEs as a whole rather than by the U.S. resident corporations that are part of U.S. MNE groups. In exchange for granting somewhat greater rights at source to tax royalties, inbound services, and revenues from digital goods and services, the United States could insist that taxpayers be permitted to elect to be taxed on net income instead of gross income or revenues, and could insist that those limits be extended to U.S. CFCs. This would represent a significant departure from traditional U.S. tax treaty policy on all fronts. But the pressure on policymakers around the world to expand taxation of MNEs at source, coupled with the enactment of worldwide current inclusion taxation systems represented by GILTI and IIRs, represent paradigm shifts that should be considered in evaluating U.S. tax treaty policy.

An observer of international tax developments may note that this new bargain is consistent in spirit with the pending negotiations at the OECD/G20 Inclusive Framework involving a Multilateral Convention on Amount A of Pillar One (the MLC). Under the MLC, a share of residual profits of the largest and most profitable MNE groups would be allocated on a destination basis to the states where the goods and services produced by the MNE are consumed (and from states where the profits are booked, based on a complex waterfall), in exchange for a prohibition on DSTs and similar measures. As of this writing, the prospects for the MLC are dim; it has proven exceedingly difficult to re-write the rules of road of international taxation in one fell swoop with many dozens of states with divergent interests at the table. Perhaps it would be preferable to set more incremental objectives through a reimagined U.S. tax treaty program.

## Double Tax Relief

### Introduction

Tax treaties typically provide that the residence state will relieve double taxation of its residents with respect to income that the treaty permits to be taxed by the source state. Historically, the United States has agreed under U.S. tax treaties to relieve double taxation on U.S. residents by providing a foreign tax credit. In the decades prior to 2017, these rules generally did not attract very much attention because they generally tracked analogous provisions of U.S. domestic law; indeed, they tended to attract attention only in cases where U.S. tax treaty negotiators attempted to depart from U.S. domestic law in fundamental ways. That lack of attention has changed in recent years because of significant changes in U.S. domestic law, and the reaction of U.S. tax treaty negotiators to those changes.

In recent decades, the relief from double taxation article of U.S. treaties, as relevant for U.S. MNEs, have included the following elements. First, a foreign tax credit is allowed for taxes paid to the other contracting state, in accordance with the provisions and subject to the limitations of U.S. law as that law may be amended from time to time, so long as the general principle of allowing a credit is retained. Second, an “indirect” foreign tax credit is allowed to U.S. resident corporate shareholders for taxes paid to the other contracting state by a foreign subsidiary resident in that state. And third, the treaty typically specifies which covered taxes imposed by the other contracting state are treated as creditable income taxes for purposes of the relief from double taxation article. The relief from double taxation article of U.S. tax treaties is an exception to the saving clause in that it modifies the U.S. tax rules applicable to U.S. residents.

The 2017 Act made significant changes to the U.S. international tax rules, including the rules governing the taxation of earnings of U.S. CFCs and the foreign tax credit. Under the pre-2017 rules, the earnings of a U.S. CFC were not subject to U.S. taxation until repatriated, subject to CFC rules that provided for the current taxation of certain passive or mobile income. Distributions were taxed, and an indirect foreign tax credit was provided under former law Code Sec. 902 for U.S. corporate shareholders to relieve double taxation on CFC earnings. The 2017 Act replaced this system with a current inclusion system, the GILTI rules, under which most categories of business income of U.S. CFCs are included when earned in the income of U.S. shareholders. U.S. tax on repatriation of CFC earnings was eliminated under Code Sec. 245A through a dividends received deduction (“DRD”), as was the prior-law indirect credit applicable to distributions. An indirect credit was provided under Code Sec. 960(d) with respect to inclusions under the GILTI rules, subject to special limitations that did not apply to other foreign source income.

Shortly thereafter, U.S. regulators embarked on an effort to revamp the U.S. foreign tax credit regulations to narrow the definition of creditable taxes. These regulations, most of which have since been suspended, were motivated by a desire to deny foreign tax credits for novel extraterritorial taxes. In general, the regulations provided new attribution requirements that limited the creditability of foreign taxes imposed on nonresidents to those taxes that were based on nexus rules similar to those under U.S. law, and they modified the longstanding regulatory net gain test by generally requiring closer conformity with U.S. tax law. The regulations also provided that a foreign tax that is treated as an income tax under the relief from double taxation article of a U.S. tax treaty is considered a creditable tax for purposes of U.S. law if paid by a U.S. resident that elects benefits under the treaty. This cast a new light on the precise terms of the relief from double taxation articles of U.S. tax treaties, which prior to the regulations had generally been viewed as coextensive with domestic law.

The recently ratified U.S.-Chile tax treaty, and the pending U.S.-Croatia tax treaty, illustrate the reaction of U.S. negotiators to these changes. With respect to the U.S.-Chile tax treaty, the Senate approved a reservation (requested by U.S. treaty negotiators) that replaced the indirect foreign tax credit rule with a DRD for distributions. The Senate Foreign Relations Committee report introducing the reservation also included a declaration providing that further work is required to fully evaluate the policy of the relief from double taxation article in light of the changes in the 2017 Act. The pending U.S.-Croatia treaty incorporates that change and makes another, more fundamental one, removing any independent obligation under the treaty to provide a foreign tax credit. These changes are not required by the 2017 changes to U.S. domestic law. As discussed below, the changes misconstrue the effect of the 2017 Act on the taxation of U.S. MNEs and the potential for double taxation. A different path is possible to maintain the historical role of U.S. tax treaties in ensuring relief from double taxation.

### Treaty Obligation to Provide Foreign Tax Credit for Covered Taxes

The primary purpose of the U.S. tax treaty program is to reduce taxes imposed by other states on U.S. residents. This policy advances U.S. interests by facilitating cross-border trade and investment by U.S. residents. To the extent U.S. tax treaties permit source-basis taxation, the United States as the residence state should take on the obligation to provide double tax relief for the same reason. The failure to provide double tax relief would burden cross-border trade and investment by U.S. residents, undermining the purpose of the U.S. tax treaty program. Denying double tax relief for source-basis taxes permitted by a treaty does not advance U.S. interests. From this perspective, the changes reflected in the pending U.S.-Croatia undermine the purpose of the U.S. tax treaty program and should be reconsidered.

The introductory language of Article 23(2) of the 2016 U.S. Model income tax treaty provided generally that, “[I]n accordance with the provisions 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 principle hereof)”, the United States “shall allow” a foreign tax credit for covered taxes paid. This language was included in the first U.S. Model treaty in 1977, and each subsequent U.S. Model treaty (1981, 1996, and 2006). This longstanding language reflected a careful balance between providing certainty to stakeholders that the United States as a general matter would provide relief from double taxation, while at the same time affording flexibility to Congress to modify limitations on the foreign tax credit to further its policy objectives so long as the general principle of the foreign tax credit – relief from double taxation – was preserved.

The pending U.S.-Croatia treaty modifies the introductory language of Article 23(2) to provide that the United States shall allow relief from double taxation “to the extent allowed under the law of the United States (as it may be amended from time to time).” This language would appear to remove any obligation of the United States to provide relief from double taxation under the treaty, departing from decades of precedent. The United States would be obligated to permit relief from double taxation only to the extent permitted under U.S. law (without regard to the treaty), including the law as modified or interpreted by Treasury regulations or other administrative guidance. This change would represent a significant departure from longstanding U.S. treaty practice,[[39]](#endnote-38) and would undermine the certainty that treaties are supposed to provide.

Article 23(3) of the pending U.S.-Croatia treaty identifies certain covered taxes imposed by Croatia as “income taxes” for purposes of applying Article 23(2). In light of Article 23(2), the extent to which Article 23(3) gives rise to a treaty obligation is unclear. One reading of the two provisions is that to the extent the United States provides a foreign tax credit under domestic law, it must treat as creditable income taxes the covered taxes identified as income taxes in Article 23(3). Another reading is that because Article 23(2) does not obligate the United States to provide a foreign tax credit except to the extent a credit is provided under U.S. domestic law (without regard to the treaty), then the United States could change its interpretation of U.S. domestic law to exclude from the foreign tax credit the covered taxes identified as income taxes in Article 23(3). Under this second reading, the Treasury Department or the IRS could determine, by regulation or sub-regulatory guidance, that a foreign income tax explicitly covered by the treaty is no longer a creditable income tax under a new interpretation of Code Sec. 901. Arguably this interpretation is consistent with the intent behind the change to Article 23(2), which may be related to the constraints imposed by existing U.S. tax treaties on the U.S. regulators that wished to narrow the scope of creditable foreign taxes. It would be advisable for U.S. tax treaty negotiators to clarify the appropriate interpretation of these provisions in the Treasury Technical Explanation. In terms of good tax treaty policy, the first reading is preferable to the second as it provides certainty to U.S. taxpayers. In general, foreign taxes are either creditable for all U.S. taxpayers, or creditable for none.[[40]](#endnote-39) During the recent reconsideration of the foreign tax credit regulations, the IRS stated that it did not have the resources to review the taxes of any particular state to determine whether those taxes are creditable, notwithstanding the benefits that such determinations might provide taxpayers. U.S. tax treaty negotiators, on the other hand, must review the taxes of the other contracting state in the context of tax treaty negotiations. The creditability of a foreign tax of a treaty partner should be determined as part of the process of negotiation and review of a tax treaty based on the standards at that time, and not open for administrative reconsideration after the fact.[[41]](#endnote-40)

An underlying issue that is raised by the suggestions in Part III.A is the extent to which U.S. tax treaty negotiators should hew to the U.S. domestic law standard for creditability when designating a covered tax as an income tax in a tax treaty. Part III.A.3 suggests that the United States consider tax treaties that would identify and permit a broader scope of source-basis taxes than has traditionally been the case, including potentially taxes on royalties, service fees, and revenue from digital goods and services in the absence of a permanent establishment. The historical approach of the U.S. tax treaty program has been to designate covered taxes as income taxes in cases where that would likely be the result under the then-current domestic law.[[42]](#endnote-41) This policy has been reinforced by the Senate, which in general has rejected efforts to expand by tax treaty the U.S. foreign tax credit to foreign taxes that clearly were not creditable under U.S. domestic law.[[43]](#endnote-42) To the extent the United States believes that the taxes of a treaty partner are excessive or discriminatory or unfair, the remedy that advances U.S. interests is to persuade the treaty partner to eliminate, reduce, or modify the tax by treaty (or otherwise), not to deny a foreign tax credit for the tax. Part III.A.3 suggests that to the extent the United States considers permitting source-basis taxes on gross income flows that are associated with significant expenses, the United States should also consider negotiating elections for taxpayers to be taxed on a net basis. Such elections would make it more likely that the tax imposed would be regarded as a creditable income tax under current domestic law standards.

### Deemed Paid Credits

For decades U.S. tax treaties provided for deemed paid foreign tax credits. This provision was removed from the U.S.-Chile treaty and replaced with a DRD in order to conform the treaty with U.S. domestic law following the 2017 Act. But U.S. domestic law following the 2017 Act subjects the income of CFCs to U.S. tax at the U.S. shareholder level, and relieves double taxation of these amounts through the indirect foreign tax credit provided by Code Sec. 960(d). The failure to provide double tax relief with respect to CFC income would burden cross-border trade and investment by U.S. residents. Accordingly, U.S. tax treaty policymakers should reinstate an indirect foreign tax credit that addresses inclusions of CFC income consistent with U.S. domestic law.

#### Covered Income Taxes Paid by Resident CFC

The 2016 U.S. Model treaty provided generally for an indirect foreign tax credit for covered taxes paid by a foreign subsidiary resident in the treaty state where dividends were paid by that subsidiary to a U.S. corporate shareholder out of the profits subject to foreign tax. This provision was included in the 1977 U.S. Model treaty and in each subsequent U.S. Model treaty. This provision mirrored the indirect foreign tax credit provided prior to 2017 by Code Sec. 902.

As noted above, a reservation to the U.S.-Chile treaty replaced the indirect foreign tax credit with a DRD for dividends. The pending U.S.-Croatia treaty is consistent with this approach. The provision of a DRD in U.S. tax treaties is appropriate given the 2017 changes to U.S. law – it is the case that the U.S. addresses the potential for double taxation of some CFC earnings at the time of repatriation by providing a DRD, which is comparable to an exemption. But U.S. tax treaties should also provide for an indirect foreign tax credit for covered taxes paid by U.S. CFCs resident in the treaty state with respect to income that is included in the income of U.S. corporate shareholders because the failure to do so would leave unaddressed the potential double taxation of material amounts of income. Following the 2017 Act, most categories of business income of U.S. CFCs are included when earned as income of U.S. corporate shareholders. To the extent the CFC is resident in a treaty state and the income is not connected with the United States, the treaty will provide primary taxing rights over the income to the treaty state. Because the income also is included in the income of a U.S. resident – the U.S. corporate shareholder – the income could be subject to double taxation without appropriate relief. The United States should obligate itself to provide relief from double taxation in its treaties through an indirect foreign tax credit. This is consistent with the relief provided under Code Sec. 960(d), and the relief historically provided by U.S. tax treaties through an indirect foreign tax credit.

Pre-2017 U.S. tax treaties did not explicitly address the provision of an indirect foreign tax credit for covered taxes paid with respect to subpart F inclusions under Code Sec. 951.[[44]](#endnote-43) It is not appropriate to draw inferences from this lack of specificity as to the appropriate policy going forward. Prior to 2017, the subpart F rules targeted passive or mobile income that was subject to low rates of foreign tax. Relief from double taxation was not a priority in that context. The 2017 Act introduced a new regime, the GILTI rules, which apply more broadly to business income that could be subject to moderate or high rates of foreign tax. This development has coincided with a much broader consideration of rules that tax the business income of CFCs at the corporate shareholder level, including IIRs that have been enacted by many U.S. treaty partners. Given the expansion of CFC rules to income that might be subject to relatively high rates of tax, an increasingly critical feature of those rules are provisions that ensure relief from double taxation.[[45]](#endnote-44) Moreover, the provision of an indirect foreign tax credit with respect to CFC inclusions is consistent with the longstanding U.S. view that, for tax treaty purposes, U.S. taxes imposed under U.S. CFC rules are imposed on deemed income inclusions at the U.S. shareholder level, and not on income of the CFC itself, and therefore are consistent with tax treaties. Relief from double taxation on income included in the income of U.S. corporate shareholders under U.S. CFC rules is a much higher priority following the 2017 Act, and therefore should be addressed in U.S. treaties.

#### Covered Taxes Paid by Third-State CFC

While the discussion immediately above focused on providing on considering indirect foreign tax credits for covered taxes paid by a U.S. CFC resident in the other contracting state, much of the rationale for providing such credits applies with equal force to covered taxes paid by a U.S. CFC resident in a third state. There is no precedent for this in U.S. tax treaties. Perhaps that historical approach should be reconsidered.

U.S. tax treaties should provide for an indirect foreign tax credit for covered taxes paid by U.S. CFCs resident in a third state with respect to income that is included in the income of U.S. corporate shareholders for the same reason that foreign tax credits should be provided for covered taxes paid by CFCs resident in the treaty state, or covered taxes paid directly by U.S. residents (or attributable to a branch of a U.S. resident): because the failure to do so would leave unaddressed the potential double taxation of income of U.S. residents. Double taxation could arise, for example, in cases where the treaty state imposed a withholding tax on payments of royalties to a third state CFC of a U.S. corporate shareholder. If such royalties had been paid directly to the U.S. corporate shareholder, the U.S. shareholder would be subject to U.S. tax, and the U.S. corporate shareholder would be eligible for a direct foreign tax credit under Code Sec. 901 and under the U.S. tax treaty with the treaty state. The treatment of royalties paid to a third state CFC is similar: the royalties would be included in the income of the U.S. corporate shareholder under the subpart F or GILTI rules, and the U.S. corporate shareholder would be permitted an indirect foreign tax credit under Code Sec. 960 for the withholding tax imposed by the source state (and for any corporate tax imposed by the CFC’s state of residence). In both cases, the treaty provides the source state with primary taxing rights over the royalty payment, the royalty payment is included in the income of a U.S. person and subject to U.S. tax, and double taxation would result absent the provision of double tax relief by the United States.

U.S. tax treaties traditionally have not granted rights with respect to income earned by third-state CFCs. As discussed above, following the 2017 Act, U.S. corporate shareholders are subject to current U.S. taxation on a substantial share of the business income of all of their CFCs. In effect, the income of CFCs has been brought into the U.S. tax base on a current basis, marking a significant departure from pre-2017 U.S. law in which U.S. taxation of such income generally was deferred until repatriation. Part II.A.2 recommends that the U.S. policymakers consider extending U.S. tax treaty benefits to income earned by third-state CFCs of U.S. shareholders because such income is generally subject to tax in the hands of a U.S. resident, the U.S. shareholders. If that recommendation is adopted, then extending an indirect foreign tax credit for covered taxes paid by third-state CFCs follows.

Even if the recommendation in Part III.A.2 is not adopted and income earned by third-state U.S. CFCs is not eligible for some or all treaty benefits accorded by the other state, U.S. policymakers nevertheless should consider providing U.S. corporate shareholders with an indirect credit for covered taxes imposed by the source state on income earned by the third-state U.S. CFC and included in the income of the U.S. corporate shareholder. As noted above, U.S. treaty negotiators will have determined that that some or all of the covered taxes are income taxes that would be creditable if paid directly by a U.S. resident. Permitting an indirect foreign tax credit for covered income taxes paid by third-state CFCs would mirror the domestic foreign tax credit provided by Code Sec. 960, which permits an indirect foreign tax credit to U.S. corporate shareholders on income inclusions under the U.S. CFC rules, and which does not distinguish between taxes imposed by the CFC’s state of residence and taxes imposed by third states at source.[[46]](#endnote-45) And it would further a purpose of U.S. tax treaties, which is to eliminate double taxation of income of U.S. residents that is subject to U.S. taxation so as to facilitate cross-border trade and investment by U.S. residents.

It could be argued, however, that the United States should not agree to provide a foreign tax credit under a U.S. tax treaty for taxes imposed by the other contracting state that are not limited by the tax treaty itself. But that has never represented U.S. tax treaty policy. U.S. tax treaties generally permit each contracting state to impose taxes on its residents as if the treaty had not come into effect, and yet U.S. tax treaties have long permitted an indirect foreign tax credit with respect to covered taxes paid by U.S. CFCs resident in the other contracting state. Even with respect to withholding taxes, many U.S. tax treaties permit each state to apply its domestic withholding tax rules to income of residents of the other state to the extent that the income is not explicitly addressed by another article of the treaty (so-called “other income”).[[47]](#endnote-46) The question of whether the tax treaty limits source-state taxation of an item of income seems separate from the question of whether the United States, as the state of residence, should provide a foreign tax credit for covered income taxes paid with respect to income that is included in the income of a U.S. resident and otherwise subject to U.S. tax. In each case, the U.S. negotiators of the treaty will have determined that the covered taxes are creditable foreign income taxes and will have provided the source state with primary taxing rights over the income subject to tax, and in each case the income will also be included in the income of a U.S. person.

## LOB as Applied to Large MNEs

### Introduction

The LOB rules were introduced into U.S. tax treaties to address concerns that third-state residents were shopping into the U.S. tax treaty network, undercutting U.S. leverage to negotiate the reduction of taxes imposed by other non-treaty states on U.S. residents. Over time, the LOB rules have become complex and bespoke, partly to accommodate the requests of treaty partners for additional objective tests that residents may meet to obtain benefits, and partly to address perceived deficiencies or gaps in these tests.

At their core, the objective tests of the LOB rules focus on two sets of factors to establish the bona fide nexus of a resident business entity with its state of residence. First, is a sufficient share of the economic interest in the resident entity owned by bona fide residents of the state, or of other states that have tax treaties with the United States that would provide benefits that are at least as favorable as those being claimed? The objective tests here typically have two prongs: an ownership prong that looks to whether equity ownership is held by treaty beneficiaries, and a base erosion prong that looks to whether large base eroding payments are being made to non-treaty residents. Companies whose shares are publicly traded historically have been deemed to satisfy this economic interest test with respect to their state of residence because of the practical difficulties in determining, and diminished relevance for treaty-shopping purposes, of the ownership of their shares. Second, if the economic interest tests are not met, does the resident entity conduct an active trade or business in its state of residence to which the income with respect to which tax treaty benefits are being claimed is related?

Over the last 20 years, the LOB rules have been repurposed to advance objectives that are not related to their initial purpose of preserving U.S. negotiating leverage, such as ensuring that U.S. tax treaty benefits are not extended to residents of the other contracting state with significant U.S. ownership or other nexus, or residents of the other contracting state that are not subject to sufficient levels of taxation. Large MNE groups whose ultimate parent company is resident in a state that is party to a relatively favorable treaty with the United States, and with substantial active business operations with such states, must navigate the aspects of the LOB rules that further these policies in order to claim U.S. tax treaty benefits. To the extent the LOB rules restrict or impose costs on obtaining U.S. tax treaty benefits on income earned by these MNE groups, they reduce the value of U.S. tax treaties to the home state of the MNE, or states in which the MNE group operates. At the margin, this undermines the original purpose of LOB rules, which was to increase U.S. negotiating leverage in obtaining reductions to taxes imposed by other states on U.S. residents. Given the prevalence of other international tax developments aimed at similar anti-base erosion objectives, it seems worthwhile considering whether a differing path would better advance U.S. interests in this area.

### Foreign Treaty Residents with a U.S. Connection

Over the last 20 years, the LOB rules have been tightened for foreign entities resident in treaty states with significant U.S. ownership or other connections to the United States. These changes appear intended to preserve U.S. tax over the U.S. income of U.S. taxpayers without regard to the concessions provided in U.S. tax treaties, consistent with the longstanding saving clause of U.S. tax treaties. Foreign treaty residents that seem like disguised U.S. residents, or alter egos of such residents, should not be entitled to U.S. tax treaty benefits on U.S. income by virtue of being owned by U.S. interests.

Two changes to the LOB rules illustrate this phenomenon. First, the objective test for publicly traded companies has been tightened to exclude companies that are primarily traded on U.S. exchanges and primarily managed and controlled in the United States. These changes seem directed at inverted or expatriated companies, that is, U.S. MNEs that invert their structure in the context of a business combination or otherwise to become foreign MNEs. The changes to the publicly traded test also extend to foreign MNEs that were never U.S. MNEs, but over time raise capital through the U.S. equity markets and employ senior U.S. executives. This can lead to some odd incentives, at the very margin discouraging the use of U.S. equity markets or the employment of U.S. executive teams. On balance it is not clear that the changes to the publicly traded company test advance U.S. interests.

An argument can be made that the tightening of the publicly traded test is largely irrelevant because other LOB tests are available to foreign MNEs that are resident in a treaty state and publicly traded. The objective tests that focus on ownership are unlikely to be useful to publicly traded companies. The active trade or business test, however, may be useful to the foreign parent (or a subsidiary resident in a treaty state) as it does not consider ownership. Under the active trade or business test, a treaty resident that has maintains an active trade or business in its state of residence can claim treaty benefits with respect to U.S. income related to that business. Note that the active trade or business test may not entitle the resident to some benefits of the treaty, for example the exemption from dividend withholding tax for direct dividends included in many U.S. treaties over the last 20 years. Moreover, this test has also been tightened in recent years, as illustrated in the 2016 U.S. Model tax treaty, by changing the standard for whether income is related to the active business from a “connected with” standard to an “emanates from” standard. The purpose of the change is to prevent third-state residents from claiming treaty benefits “through an entity that has an active trade or business in a treaty partner with respect to income, in particular intra-group dividends and interest, that does not in fact have a nexus to the activities in the treaty partner.”[[48]](#endnote-47) Needless to say, treaty benefits on intra-group dividends and interest are among the treaty benefits a foreign parent company of an MNE is likely to seek. Accordingly, the future utility of the active trade or business test for a foreign MNE that is publicly traded is uncertain. Finally, a foreign MNE that is publicly traded could seek discretionary relief from the U.S. competent authority. But this process is cumbersome, and the outcome is at the discretion of the U.S. competent authority.[[49]](#endnote-48)

A second set of changes to the LOB rules illustrates the efforts of U.S. policymakers to preserve U.S. tax on the U.S. income of U.S. persons: changes to the objective tests that include an ownership or base erosion prong exclude U.S. persons from “good” owners or payees that can support satisfaction of the prongs. For example, the ownership prong of the ownership / base erosion test of the 2006 U.S. Model tax treaty requires 50 percent or more of the shares of the treaty resident to be owned by certain categories of qualified residents of the same state, whereas the ownership / base erosion test of the 1996 U.S. Model tax treaty references qualified residents of the same state or the United States. Similarly, the derivative benefits test of the 2016 U.S. Model tax treaty provides that U.S. residents can qualify as equivalent beneficiaries for purposes of meeting the ownership or base erosion prongs of that test, provided that the U.S. residents in the aggregate do not own more than 25 percent of the shares of the resident claiming treaty benefits; analogous derivative benefits tests in U.S. tax treaties negotiated prior to the 2016 U.S. Model do not include a limitation on U.S. ownership.

As with the changes to the publicly traded test, the changes to the other objective tests to exclude U.S. persons seem intended to preserve U.S. tax on the U.S. income of U.S. taxpayers. And like the changes to the publicly traded test, these changes can lead to some very odd results, and therefore some odd incentives. Assume, for example, a company resident in one state that is owned in equal shares by three persons: a resident of the same state, a resident of a second state, and a resident of a third state. Assume further that each state has a tax treaty with the United States, and all three treaties provide identical benefits. The company in this fact pattern would qualify for treaty benefits under the derivative benefits test in the 2016 U.S. Model tax treaty. If one of the three owners decides to sell its interests to a U.S. person, however, the company would no longer qualify. It is not clear how this result advances U.S. interests.

Again, it could be argued that the company has recourse to the active trade or business test or discretionary relief, and therefore that the odd results at the margin of the ownership / base erosion and derivate benefits tests are irrelevant. But those alternatives can be problematic, as explained above.

An alternative path for U.S. policymakers is to recalibrate the objective tests to better focus them on their original third-state treaty shopping objective, and leave the U.S. taxation of U.S. persons to U.S. domestic law. The changes to the publicly traded test began appearing in U.S. tax treaties in the early 2000s, around the same time Code Sec. 7874 was enacted to counteract U.S. corporate expatriations.[[50]](#endnote-49) There have been many changes to U.S. domestic law since that time that further discouraged U.S. corporate expatriations, including targeted changes that penalize inversions[[51]](#endnote-50) and broader changes that improved the competitiveness of the U.S. tax system.[[52]](#endnote-51) Perhaps as a result of these domestic law changes, there have been no high-profile U.S. corporate expatriations in recent years. Given that several favorable U.S. tax treaties with publicly traded tests do not include anti-inversion language, it does not appear that such language is necessary to counteract U.S. corporate expatriations.

U.S. domestic law also includes many provisions that address the income earned by U.S. persons through foreign entities, for example the CFC rules and the rules governing ownership of passive foreign investment companies. To the extent U.S. policymakers are dissatisfied with the application of U.S. domestic law to U.S. income earned indirectly by U.S. persons through foreign entities, consideration should be given to modifying these rules. Changes to U.S. domestic law are better suited than changes to U.S. tax treaties to address the U.S. taxation of U.S. income earned directly or indirectly by U.S. persons for several reasons. Changes to U.S. domestic law can be applied immediately to all U.S. persons. And changes to U.S. domestic law go through the normal U.S. political process, which may lend them more legitimacy than changes to U.S. tax treaties negotiated with other states.

### Non-Taxation within Foreign MNEs

The LOB rules have increasingly focused on issues of low- or nontaxation of income of the resident claiming U.S. treaty benefits, or more broadly the MNE group of which that resident is a part. The base erosion prongs of early LOB rules seemed intended to ensure that the treaty resident was not being used as a conduit by a non-treaty resident, consistent with the original anti-treaty shopping intent underlying the LOB rules. Over time, however, aspects of the LOB rules have focused more broadly on base erosion or non-taxation within MNE groups that are not owned or used as conduits by non-treaty residents. Examples of these rules include the triangular branch rules, the requirements (in tests that evaluate ownership) for all owners in a chain to qualify as treaty residents, and the rules in the 2016 U.S. Model tax treaty on special tax regimes. Each of these rules seems intended to ensure that the resident claiming U.S. treaty benefits, or more broadly the MNE group of which that resident is a part, is paying sufficient tax on the U.S. income with respect to which treaty benefits are claimed. Underlying these rules is the premise that the U.S. reductions on source-basis taxation of U.S. income offered in its treaties are appropriate only where the U.S. income is actually taxed at sufficient rates by the residence state (or a third state); in other words, tax treaties are intended to eliminate double taxation, not to promote non-taxation.

Over the last 15 years, combatting international base erosion has been the dominant driver of international tax policymaking. The OECD BEPS initiative addressed base erosion concerns through recommended changes to substantive tax rules, including limits on the deductibility of interest expense and hybrid payments, that have been adopted by the United States and many of its tax treaty partners. More fundamentally, many U.S. tax treaty partners have adopted IIRs pursuant to the OECD’s Pillar Two initiative, which impose a minimum tax at the level of resident state parent entities on the income of large MNE groups. The minimum tax is set at a 15 percent rate and is applied on a jurisdiction-by-jurisdiction basis.

Going forward, U.S. policymakers should consider the effect of global minimum taxes on U.S. tax treaty policy. One aspect to consider is the manner in which the U.S. LOB rules should apply to MNE groups whose income is subject to global minimum tax rules. One approach could be to have a simplified set of LOB rules that generally permits treaty benefits under the U.S. treaty with the residence state of the ultimate parent entity of in scope MNE groups so long as the residence state maintains an IIR or similar CFC regime and the MNE group is not owned or controlled by a small group of non-treaty residents. As discussed in Part III.A.2, perhaps U.S. policymakers could consider providing some or all treaty benefits not only to the companies resident in the state of the ultimate parent entity of the MNE group, but also to third-state CFCs that are part of the MNE group under the Pillar Two rules and therefore subject to the resident state’s IIR. This would greatly simplify the application of the LOB rules to large MNE groups while adequately guarding against treaty shopping and double non-taxation.

## Implementing Tax Agreements into U.S. Law

A premise of the discussion of in Parts III.A - C above of substantive reforms to U.S. tax treaties is that the United States has a functioning process for incorporating tax agreements negotiated with other states into U.S. law. As outlined in Part II.E, that has not been the case for well over a decade. Even when working well, the traditional process for negotiating and implementing international tax agreements into U.S. law – bilateral negotiations conducted by the Treasury Department, with approval of signed agreements by the Senate pursuant to the process for making treaties outlined by the U.S. Constitution – is cumbersome and hinders changes across the treaty network. For example, it has taken a generation of hard work by U.S. negotiators to implement modern LOB rules into the U.S. tax treaty network. While this effort has been successful in meeting policy objectives, the incremental changes throughout the process of negotiating and renegotiating treaties over decades has resulted in a jumble of rules that is difficult to rationalize and, by the end of the process, may no longer be fit for purpose. While returning to the pre-2010 process would represent a substantial improvement over recent years, it would not provide the U.S. tax treaty program with an effective way to implement broad changes even if there were political and policy consensus that such changes are desirable. It may be worthwhile to consider alternatives.

### Reciprocal Relief by Statute

One alternative to the traditional tax treaty process is to provide statutory relief from certain U.S. taxes to residents of another state that is conditioned on that other state providing reciprocal relief to U.S. residents. Models for this approach already exist in U.S. law, albeit in narrow contexts. For example, Code Sec. 872(b) and Code Sec. 883 exempts certain international shipping income earned by foreign persons from U.S. tax so long as the state of residence of the foreign person provides a reciprocal exemption to U.S. persons. Notably, Code Sec. 883(c) has rules similar to, but much less complex than, the LOB rules of U.S. tax treaties that are intended to prevent “shopping” by residents of states that do not provide reciprocal benefits. Code Sec. 893 exempts certain wages earned by employees of foreign governments so long as a reciprocal exemption is provided by that government to the wages of employees of the U.S. government. Congress can also provide for conditional increases in taxes on nonresidents; for example, Code Sec. 891 and Code Sec. 896 provide authority to the President to increase U.S. taxes on residents of other states if those other states impose discriminatory or excessive taxes on U.S. residents.

In addition, Congress is currently considering a broader statutory mechanism to provide certain benefits consistent with tax treaties to residents of Taiwan.[[53]](#endnote-52) Taiwan is the largest trading partner of the United States that is not a party to a U.S. tax treaty or similar agreement. Under pending legislation, certain U.S. tax benefits would be provided to residents of Taiwan once the Treasury Department certifies that Taiwan is providing reciprocal tax benefits to residents of the United States. The benefits include reductions to U.S. withholding taxes on dividends, branch profits, interest, royalties, and certain gains; replacement of the U.S. trade or business standard with a permanent establishment standard; and favorable treatment of income from employment. These benefits are provided to qualified residents of Taiwan, conditioned on restrictions akin to the LOB rules. The provisions are broadly consistent with analogous provision of the 2016 U.S. Model tax treaty, although the withholding tax rates are higher and the LOB rules are somewhat narrower. In addition, many provisions of typical U.S. tax treaties – such as rules on transfer pricing and attribution of profits, relief from double taxation, and mutual agreements to resolve disputes – are not included. The pending legislation would authorize the President to negotiate an agreement with Taiwan to address these and other items customarily contained in U.S. tax treaties; this item is discussed in the next part.

While the pending Taiwan legislation is motivated by the unique political status of Taiwan, it illustrates a more generalizable approach to advancing the objectives of the U.S. tax treaty program. Congress could provide by statute for reductions in U.S. taxes on foreign persons resident in any state, conditioned on the provision of reciprocal treatment U.S. persons by that state. Consistent with the Taiwan legislation, Congress could extend general benefits related to reduced withholding taxes,[[54]](#endnote-53) the permanent establishment standard, and income from employment to residents of states (subject to statutory LOB rules) that provide reciprocal benefits to U.S. residents. Although the pending Taiwan legislation does not include other tax treaty-like benefits, such as transfer pricing rules and mutual agreement procedures, there is no reason in principle why a statute could not authorize the Treasury Department to enter into administrative agreements with foreign tax authorities to resolve transfer pricing or other tax disputes, and provide a standard under which such disputes will be resolved. As an example, the Treasury Department has entered into tax agreements with Puerto Rico, the United States Virgin Islands, and other territories, each of which provide that the two tax authorities may consult together to endeavor to agree to the same allocation of income so as to achieve consistent application of the tax laws of the respective jurisdictions.[[55]](#endnote-54)

Providing tax treaty-like benefits by statute on a reciprocal basis has advantages and disadvantages as compared to negotiating bespoke bilateral tax agreements. Once enacted, a statute becomes effective immediately and potentially with broad effect as other states follow suit. Changes to the statute would apply immediately and across the system. And reciprocal statutes do not preclude bespoke agreements to provide additional benefits. That said, a statute cannot easily provide for specialized provisions that coordinate the tax system of the United States with that of any particular state, although the tax systems of many U.S. trading partners are converging to some extent as a result of the adoption of minimum tax rules under Pillar Two. Congress would have to consider whether to provide the possibility of reciprocal benefits to residents of any state, including states that do not tax foreign income or (at the extreme) states with which the United States does not maintain diplomatic relations, or whether to do so only with a list of states, such as members of particular international organizations or trade blocs, or states with high levels of foreign trade with the United States.

Congress and the executive branch will gain valuable experience with this process if the pending Taiwan bill is enacted into law. That experience could inform a more general consideration of providing tax treaty-like benefits by statute on a reciprocal basis.

### Congressional-Executive Agreements

A second alternative to the traditional tax treaty process is congressional-executive agreements. Congressional-executive agreements are agreements entered into by the executive branch that are based on legal authority provided by legislation enacted through the bicameral process. Congression-executive agreements have been prevalent in the international trade area; the agreements related to the World Trade Organization, as well as the United States Mexico Canada Agreement, were implemented into U.S. law as congressional-executive agreements. The United States has also entered into certain categories of executive agreements related to tax, for example executive agreements related to the exchange of tax information. The United States has not entered into any executive agreements that provide benefits similar to the benefits of a comprehensive income tax treaty.

In addition to providing for benefits by statute on a reciprocal basis, the pending legislation concerning Taiwan discussed above authorizes the negotiation of an executive agreement with Taiwan.[[56]](#endnote-55) The legislation prescribes a detailed process for negotiation and implementation, including consultation with relevant congressional committees and procedures for implementing legislation. It also provides parameters for negotiation, providing that the agreement must conform with provisions customarily included in U.S. income tax treaties, as exemplified by the 2016 U.S. Model tax treaty, and cannot include elements outside the scope of the 2016 Model.

This executive agreement process authorized by the pending Taiwan legislation is reminiscent of the process set out for international trade agreements from time to time under fast track or trade promotion authority. Under trade promotion legislation, Congress authorizes the President to negotiate trade agreements that follow specified guidelines and negotiating objectives. If a negotiated agreement is within those parameters, it is considered by Congress under streamlined procedures. The House and the Senate each must introduce implementing legislation, and consider it within a certain time period, and neither house may amend the agreement. Filibuster in the Senate is limited, and the legislation may be approved by a majority vote in each of the House and the Senate. The purpose of trade promotion authority is to provide a favorable process for the negotiation and implementation of agreements with other states that may be politically contentious.

It is not clear whether congressional-executive agreements would provide a better process for international agreements than the current tax treaty process. Tax treaties historically have been less politically contentious than international trade agreements, and indeed have overwhelming bipartisan support. Congressional-executive agreements could provide some advantages, however, including the legitimacy that may come from greater involvement of the House of Representatives in the process in light of the Origination Clause of the U.S. Constitution.[[57]](#endnote-56) As with the provision of tax treaty-like benefits by statute, Congress and the executive branch will gain valuable experience with providing tax treaty-like benefits through a congressional-executive agreement process if the pending Taiwan bill is enacted into law. That experience could inform a more general consideration of providing tax treaty-like benefits through such agreements.

### Multilateral Tax Agreement

A third alternative to the traditional tax treaty process is a multilateral tax agreement, implemented into U.S. law either as a treaty or a congressional-executive agreement. The United States has never entered into a substantive multilateral tax agreement. The OECD Multilateral Instrument (MLI)[[58]](#endnote-57) developed as part of the BEPS process shows the technical viability of a substantive multilateral tax treaty. The MLI allows signatories to modify their existing bilateral tax treaties in a customizable manner. Each signatory designates its bilateral tax treaties to which the MLI may apply, and which provisions of the MLI it wishes to apply to some or all of its designated bilateral tax treaties. To the extent the preferences of two parties to a bilateral tax treaty match, the referenced provision of the MLI is incorporated into that bilateral tax treaty. The OECD maintains a matching database that shows which provisions of the MLI have been incorporated into each signatory’s bilateral income tax treaties. However, while the MLI provides a framework for modifying existing bilateral tax treaties en masse, it includes only a few provisions at the margin of those agreements, rather than the basic building blocks of typical bilateral tax treaties.

The advantages and, especially, the disadvantages of a multilateral tax agreement are fairly easy to identify at a high level. Advantages include a streamlined process for effectively negotiating or modifying dozens of bilateral agreements, and increased conformity across the network of agreements. A multilateral agreement, however, would require a profound change in mindset for U.S. policymakers. Relevant congressional committees would need to be actively engaged to build support for such an undertaking and to have a substantive input into the process. It is noteworthy that the United States is not a signatory to the MLI. The current experience of negotiators of the OECD Pillar One MLC, which has provoked hostility in Congress, is sobering. It is not at all clear that considering a multilateral tax agreement to provide the benefits traditionally provided by U.S. tax treaties is worth the candle.

# Conclusion

[to come]

1. \* Rocco Femia is a member of Miller & Chevalier Chartered. [↑](#footnote-ref-1)
2. See generally American Law Inst., Federal Income Tax Project: International Aspects of United States: Income Taxation II – Proposals of the American Law Institute on United States Income Tax Treaties, pp. 1 (1991) (hereafter ALI Proposals). The view of the purpose of U.S. tax treaties by senior officials of the U.S. Treasury Department responsible for their negotiation has been remarkably consistent over time and across Administrations. See, e.g., Opening Statement of Robert B. Stack, Treasury Department Assistant Secretary (International Tax Affairs, Senate Committee on Foreign Relations (Oct. 29, 2015) (“This Administration is committed to eliminating barriers to cross-border trade and investment, and tax treaties are one of the primary means for eliminating such tax barriers”) and Testimony of Barbara Angus, International Tax Counsel, United States Department of the Treasury, Before the Senate Committee on Foreign Relations on Pending Income Tax agreements (March 5, 2003) (“This Administration is dedicated to eliminating unnecessary barriers to cross-border trade and investment. The primary means for eliminating tax barriers to trade and investment are bilateral tax treaties.”). [↑](#endnote-ref-1)
3. See ALI Proposals at 5-12. [↑](#endnote-ref-2)
4. See Mitchell B. Carroll, ‘‘The Historical Development of Income Tax Treaties,’’ in Income Tax Treaties 51, 57-58 (J. Bischel ed., Practicing Law Inst. 1978). [↑](#endnote-ref-3)
5. See Richard E. Andersen, Analysis of United States Income Tax Treaties, at ¶ 1.02 (Thomson Reuters/WG&L, with updates through April 2024). [↑](#endnote-ref-4)
6. See Article 1(4) of the 2016 U.S. Model tax treaty (“Except to the extent provided in paragraph 5 of this Article, this Convention shall not affect the taxation by a Contracting State of its residents (as determined under Article 4 (Resident)) and its citizens.”). [↑](#endnote-ref-5)
7. See Charles W. Cope, U.S. Income Tax Treaties: Notes and Comments on Some Present and Future Policies, 71 Taxes 955, at 963-64 (Dec. 1993); and H. David Rosenbloom, Toward a New Tax Treaty Policy for a New Decade, 9 American Journal of Tax Policy 77, 93-94 (1991). [↑](#endnote-ref-6)
8. This view was ultimately adopted in the Commentary to the OCED Model Tax Convention as part of the 2002 Update to that model, with observations by a handful of states. See Commentary on Article 1 at ¶ 81 (2017). [↑](#endnote-ref-7)
9. See, e.g., Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, JCS–41–84, 387-398 (Dec. 31, 1984) (“Congress believed that the imposition of a withholding tax on portfolio interest paid on debt obligations issued by U.S. persons might impair the ability of U.S. corporations to raise capital in the Eurobond market.”). [↑](#endnote-ref-8)
10. See ALI Proposals at 150-152. [↑](#endnote-ref-9)
11. See, e.g., Statement of Leslie B. Samuels, Assistant Secretary (Tax Policy), Department of the Treasury, before the Senate Committee on Foreign Relations (Oct. 27, 1993) (‘‘My purpose now is to assure the Committee that this Administration continues to view treaty abuse as an important issue. . . . We intend, as promptly as time and resources permit, to modify all of our existing treaties to include modern, effective, anti-abuse provisions’’). [↑](#endnote-ref-10)
12. For a comprehensive discussion of the LOB rules of U.S. tax treaties, see J. Ross Macdonald, “Time Present and Time Past”: U.S. Anti-Treaty Shopping History, Policy and Rules, 70 Tax Lawyer 5 (Fall 2016). [↑](#endnote-ref-11)
13. Between 1994 and 2010, the United States renegotiated existing tax treaties to reduce or eliminating withholding taxes on royalties in at least six cases (Australia, Canada, Finland, France, Italy, and Japan), and on interest in at least three cases (Canada, Italy, and Switzerland). There were no tax treaties renegotiated in that period that increased withholding tax rates. [↑](#endnote-ref-12)
14. Since 2000, the United States has agreed to eliminate withholding taxes on certain direct dividends with Belgium, Denmark, Finland, France, Germany, Japan, Mexico, the Netherlands, New Zealand, Spain, Sweden, and the United Kingdom. [↑](#endnote-ref-13)
15. See OECD, Action Plan on Base Erosion and Profit Shifting, at 7 (2013) (“Globalisation has resulted in a shift from country-specific operating models to global models based on matrix management organisations and integrated supply chains that centralise several functions at a regional or global level. Moreover, the growing importance of the service component of the economy, and of digital products that often can be delivered over the Internet, has made it much easier for businesses to locate many productive activities in geographic locations that are distant from the physical location of their customers.”). [↑](#endnote-ref-14)
16. See OECD, Action Plan on Base Erosion and Profit Shifting, at 7-8 (“These developments have been exacerbated by the increasing sophistication of tax planners in identifying and exploiting the legal arbitrage opportunities and the boundaries of acceptable tax planning, thus providing MNEs with more confidence in taking aggressive tax positions.”). [↑](#endnote-ref-15)
17. See OECD, Harmful Tax Competition – An Emerging Global Issue (1998) (“Globalisation … has also created an environment in which tax havens thrive and in which governments may be induced to adopt harmful preferential tax regimes to attract mobile activities.”). [↑](#endnote-ref-16)
18. See OECD, Action Plan on Base Erosion and Profit Shifting, at 8 (asserting that the minimization of tax burdens by MNEs “has led to a tense situation in which citizens have become more sensitive to tax fairness issues”). [↑](#endnote-ref-17)
19. Pub. L. 115–97, known as the Tax Cuts and Jobs Act of 2017 (the “2017 Act”). [↑](#endnote-ref-18)
20. Following the initial outputs of the OECD BEPS project, the OECD/G20 Inclusive Framework on BEPS in 2021 agreed to pursue a two-pillar solution to address the tax challenges from the digitalization of the economy. Pillar One proposed to reallocate a share of the residual profits of the largest and most profitable MNEs on a destination basis. Pillar Two proposed a system of minimum taxes for large MNEs. See OECD/G20 BEPS Project, Statement on a Two-Pillar Solution to Address the Tax Challenges Arising From the Digitalisation of the Economy (July 1, 2021). [↑](#endnote-ref-19)
21. See Rocco Femia and Layla Aksakal, The Use of Tax Treaty Status in Legislation and the Impact on U.S. Tax Treaty Policy, 58 Tax Notes International No. 4, at 341-342 (April 26, 2010). [↑](#endnote-ref-20)
22. The term “investment hub” has been defined by the OECD in the context of its Pillar One work as a jurisdiction with a total inward FDI position above 150 percent of GDP, suggesting that the jurisdictions are intermediaries between sources and destinations of capital. The United States has tax treaties with seven investment hubs – Barbados, Cyprus, Ireland, Luxembourg, the Netherlands, Switzerland, and Malta – and recently terminated a tax treaty with an eighth, Hungary. The prevalence of treaties with investment hubs that are members of the European Union may be attributable to concerns of U.S. trading partners regarding the compatibility of U.S. LOB rules in bilateral income tax treaties with EU law. See James R. Shorter, Jr., The Impact of EU Law on Gross-Border Taxation Issues Relating to Limitation on Benefits Provisions in Income Tax Treaties between EC Member Countries and the United States, 17 International Law Practicum 53 (2004). [↑](#endnote-ref-21)
23. Countries enacting diverted profits taxes or digital services taxes generally asserted that these measures were not covered by any applicable tax treaty. [↑](#endnote-ref-22)
24. U.S. Constitution, art. II, Section 2, Clause 2. [↑](#endnote-ref-23)
25. At the same time, the U.S. tax treaty with Hungary was terminated, and the U.S. tax treaty benefits with respect to Russia and Belarus have been suspended. [↑](#endnote-ref-24)
26. The U.S.-Chile tax treaty was approved 95-2. Protocols with Spain, Switzerland, Japan, and Luxembourg were approved 94-2, 95-2, 95-2, and 93-3, respectively. [↑](#endnote-ref-25)
27. ALI Proposals at 9-10. It is noteworthy in this regard that the United States maintains under its domestic law an extraordinarily high rate of withholding tax on most outbound payments of 30 percent, which is higher than the net corporate income tax rate of 21 percent. [↑](#endnote-ref-26)
28. See Commentary to Article 11 of the OECD Model Tax Convention, ¶ 7.7 (added July 15, 2005 by the report entitled “The 2005 Update to the Model Tax Convention”). [↑](#endnote-ref-27)
29. Expanding the definition of U.S. resident to include U.S. CFCs would provide other benefits, for example by authorizing the U.S. competent authority to address transfer pricing adjustments imposed by a treaty state with respect to a transaction with a third-state CFC in light of the potential impact on the U.S. tax base of such adjustment. [↑](#endnote-ref-28)
30. See Code Sec. 250. [↑](#endnote-ref-29)
31. See, e.g., Article 22(4) of the 1996 U.S.-Switzerland income tax treaty. [↑](#endnote-ref-30)
32. See OECD, Application of the Model Tax Convention to Partnerships, Example 9 (1999) (acknowledging that two tax treaties could apply to the same income flow, and providing that the source state should provide the lowest amount of tax allowed under the two treaties). [↑](#endnote-ref-31)
33. Based on Annex I to the draft Pillar One Amount A Multilateral Convention issued in October 2023, almost half of all MNEs with revenues in excess of €20 billion and pre-tax profit margin in excess of 10% are U.S. MNEs. [↑](#endnote-ref-32)
34. Commentators have made similar arguments for at least 30 years. See H. David Rosenbloom, Toward a New Tax Treaty Policy for a New Decade, 9 American Journal of Tax Policy 77, 82-84 (1991). [↑](#endnote-ref-33)
35. See Paul W. Oosterhuis, Revisiting an Age-Old Issue: What Taxes Should Be Treated as Income Taxes?, 113 Tax Notes International 471, 479 (Jan. 22, 2024) (proposing “a new project, which would acknowledge the appropriateness of taxing a portion of the income from a broad range of nonresident services and royalties in the income payor jurisdiction, but only by adopting the concept behind U.N. Model Treaty Article 12B. That Article provides for a withholding tax on digital services but gives service providers the option to file on a net income basis. The withholding tax becomes a stick to persuade taxpayers to volunteer to be subject to net income tax.”). As part of this, perhaps U.S. policymakers could agree to a similar net income election to ameliorate the impact of Code Sec. 59A. [↑](#endnote-ref-34)
36. See, e.g., Article 6(5) of the 2016 U.S. Model income tax treaty. [↑](#endnote-ref-35)
37. See Paul W. Oosterhuis, Revisiting an Age-Old Issue: What Taxes Should Be Treated as Income Taxes?, 113 Tax Notes International 471, 479 (arguing that even a formulaic or arbitrary determination of net income is preferable to taxation of gross income). [↑](#endnote-ref-36)
38. See Letter from Jason Smith (Chairman, Committee on Ways and Means), Mike Johnson (Speaker of the House), and other Republican members of the Committee on Ways and Means to Mathias Cormann, Secretary General of the OECD (September 17, 2024) (“Should foreign governments seek to target Americans through the UTPR or other mechanisms in the OECD global tax deal, we will be forced to pursue countermeasures.”). [↑](#endnote-ref-37)
39. See U.S. Treasury Technical Explanation to the 2006 U.S. Model income tax treaty (“The credits allowed under paragraph 2 are allowed in accordance with the provisions and subject to the limitations of U.S. law, as that law may be amended over time, so long as the general principle of the Article, that is, the allowance of a credit, is retained.”) (emphasis added). There is pending litigation regarding the interpretation of this language in the context of U.S. individuals who have claimed foreign tax credits under the U.S.-France treaty to offset Net Investment Income Tax, which is not a tax against which foreign tax credits may be applied under U.S. domestic law. See Toulouse v. Commissioner 157 T.C. 49 (2021) (denying a foreign tax credit) and Christensen v. U.S., No. 20-935 (Ct. Claims 2024), appeal pending (permitting a foreign tax credit). However this issue is resolved, it is distinguishable from the question of whether a foreign tax credit for a covered income tax is permitted under the provisions of a treaty consistent with the 2006 U.S. Model notwithstanding a change to the regulatory definition of creditable tax. [↑](#endnote-ref-38)
40. See former Reg. § 1.901-2(a)(1)(ii) (“Except to the extent otherwise provided in paragraphs (a)(3)(iii) and (c) of this section, a tax either is or is not an income tax, in its entirety, for all persons subject to the tax.”) and Reg. § 1.901–2(a)(1)(i) (2022) (“A foreign tax either is or is not a foreign income tax, in its entirety, for all persons subject to the foreign tax.”). [↑](#endnote-ref-39)
41. While the terms of a treaty cannot be overridden by regulation, Congress retains the power to enact legislation inconsistent with a treaty obligation, provided Congress makes clear its intent to override conflicting treaty provisions. See Code Sec. 7852(d). [↑](#endnote-ref-40)
42. See Charles W. Cope, U.S. Income Tax Treaties: Notes and Comments on Some Present and Future Policies, 71 Taxes 955, at 957 (explaining that U.S. negotiators generally included a covered tax in the double taxation article if they determined that the tax was creditable under U.S. law, but in “a close case, after consultations with Congressional staff, a credit may be granted by treaty”). See also ALI Projects at 232-33 (recommending the same approach). [↑](#endnote-ref-41)
43. See, e.g., S. Exec. Rep. No. 106-8, 106th Cong., 1st Sess., U.S.-Italy Treaty (Nov. 3, 1999) (“The Committee believes that treaties should not be used to provide a credit for taxes that may not otherwise be creditable under U.S. law. It may be more appropriate for such results to be accomplished in the normal course of internal U.S. tax legislation.”) [↑](#endnote-ref-42)
44. Commentators have argued persuasively that, as an interpretive and policy matter, pre-2017 covered taxes under U.S. tax treaties should remain eligible for indirect foreign tax treaties under such treaties. See Ege Berber, Wade Sutton, Aaron Junge, and Kellen Yent, Tax Treaties and Indirect Foreign Tax Credits, 177 Tax Notes Federal 199 (Oct. 10, 2022). [↑](#endnote-ref-43)
45. See, e.g., OECD, Designing Effective Controlled Foreign Company Rules, Action 3 - 2015 Final Report (2015), ¶¶ 123-124 (Recommending that CFC rules “include provisions to ensure that the application of these rules does not lead to double taxation”, including in “situations where the attributed CFC income is also subject to foreign corporate taxes. The recommendation for addressing this situation “is to allow a credit for foreign taxes actually paid.”). [↑](#endnote-ref-44)
46. This would be consistent with international standards. See OECD, Designing Effective Controlled Foreign Company Rules, Action 3 - 2015 Final Report, ¶ 123 (in recommending the provision of foreign tax credits to address double taxation arising from CFC rules, treating foreign withholding taxes in the same manner as other corporate taxes). [↑](#endnote-ref-45)
47. This provision is consistent with the UN Model Tax Convention. [↑](#endnote-ref-46)
48. See Preamble to 2016 U.S. Model Income Tax Convention at 4-5 (February 17, 2016). [↑](#endnote-ref-47)
49. See Rev. Proc. 2015-40, Section 3.06(2)(b) (“A decision by the U.S. competent authority not to grant discretionary benefits is final and not subject to administrative review.”). [↑](#endnote-ref-48)
50. For a comprehensive discussion of Code Sec. 7874 and related rules, see Scott M. Levine, The U.S. Anti-Inversion Regime: Is it Time for the Hotel California to Adopt a New Check-Out Policy?, 101 Taxes 3, 161 (March 2023). [↑](#endnote-ref-49)
51. The 2017 Act introduced additional penalties on 60 percent inversions, including (1) making dividends from such companies to U.S. persons permanently ineligible for the preferential rate of Code Sec. 1(h)(11); (2) increasing the transition tax under Code Sec. 965 to 35 percent; and (3) treating payments for cost of goods sold as base erosion payments for purposes of Code Sec. 59A. See also Reg. § 1.385-3 (limiting deductibility of outbound interest on certain related party debt). [↑](#endnote-ref-50)
52. For example, the reduction in the U.S. corporate income tax rate from 35 percent to 21 percent. [↑](#endnote-ref-51)
53. For a summary of the pending legislation related to Taiwan, see Arlene Fitzpatrick, Taiwan-U.S. Double Tax Matters – Finding a Solution, Tax Notes International (April 8, 2024). [↑](#endnote-ref-52)
54. See Paul W. Oosterhuis, Revisiting an Age-Old Issue: What Taxes Should Be Treated as Income Taxes?, 113 Tax Notes International 471, 480 (suggesting a statutory election of a net income alternative to the U.S. withholding tax on royalties for residents of states that have adopted reciprocal provisions with respect to withholding taxes on royalties and, where applicable, services.) [↑](#endnote-ref-53)
55. Tax Coordination Agreement Between the United States of America and the Commonwealth of Puerto Rico (1989) and Tax Implementation Agreement Between the United States of America and Virgin Islands (1987). The agreement with the United States Virgin Islands was authorized by Section 1277 of the 1986 Act. That section provided that certain substantive tax provisions of the Internal Revenue Code were to be effective only if: “an implementing agreement is in effect between the United States and the Virgin Islands with respect to the establishment of rules under which the evasion or avoidance of United States income tax shall not be permitted or facilitated by such possession. Any such implementing agreement shall be executed on behalf of the United States by the Secretary of the Treasury, after consultation with the Secretary of the Interior.” [↑](#endnote-ref-54)
56. On October 29, 2024, the Treasury Department announced that “the United States and Taiwan … will begin negotiations on a comprehensive agreement to address double taxation issues.” [↑](#endnote-ref-55)
57. The Origination Clause provides a special role for the House of Representatives with respect to revenue-raising legislation. See U.S. Constitution art. I, Section 7, Clause 1 (“All Bills for raising Revenue shall originate in the House of Representatives; but the Senate may propose or concur with Amendments as on other Bills.”). Commentators have argued that the House of representatives should play a role in the tax treaty process. See Rebecca M. Kysar, On the Constitutionality of Tax Treaties, Yale Journal of International Law, Vol. 38 (2013) (“Contrary to current practice, constitutional text, structure, history, and precedent, as well as normative considerations, mandate that tax treaties be implemented or approved through legislation passed by both houses of Congress”). [↑](#endnote-ref-56)
58. The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (2018). [↑](#endnote-ref-57)