Editor's Notebook

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A Defense of Treaty Overrides

by Mike McIntyre

Treaty partners ought to observe their treaties, including their tax treaties. *Pacta sunt servanda* is not only good international law, it is good domestic policy. Except in the most extraordinary circumstances, a country would be ill advised to breach in a material way the obligations that it has assumed under international law by entering into an income tax treaty.

The international network of income tax treaties developed since World War II almost certainly would unravel if countries felt free to materially breach their tax treaties. Some commentators are fearful that the unravelling has begun, due to the so-called treaty override provisions that the U.S. Congress has enacted in recent years. I do not share those fears because I do not believe that the United States has materially breached its treaty obligations under international law.

Let me begin my defense of treaty overrides by stating the obvious. I would criticize, under almost any circumstances, a breach of a tax treaty that I considered to be a material breach under international law. I would not defend, for example, a treaty override that allowed the United States, under its domestic legislation, to collect withhold tax from the typical foreign investor residing in a treaty state at a rate of 30 percent when it had unambiguously agreed by treaty to withhold at a rate not in excess of 15 percent. Leaving aside exceptional and unforeseen circumstances, the only treaty overrides that I defend are those that are compatible with the requirements of international law.

I would divide all of the override legislation that has actually been adopted by the United States into three nonexclusive categories: interpretive overrides, nonmaterial overrides, and prospective overrides that have been or may be acceded to by U.S. treaty partners. Overrides fitting into one or more of these categories would not violate existing international law.

The proper classification of some of the override actions taken by the U.S. Congress is subject to legitimate debate. In the absence of a treaty dispute resolution mechanism to the contrary, however, the United States does not breach a treaty by adopting in good faith a treaty interpretation that is favorable to it, even if that interpretation is quite aggressive and is contested by affected taxpayers or by treaty partners.

I have been able to fit all of the treaty overrides that I have looked at into at least one of my categories. But I must concede that the fit is occasionally procrustean. And like the Congress, I have looked at only a sample — perhaps a small sample -- of the many potential overrides. Congress has indicated, in the legislative history to the 1988 act, that it would make an appropriate response to treaty conflicts that are brought to its attention in the future.

Interpretative Overrides

The United States began its practice of legislating treaty overrides with the 1962 tax act. That act established the first controlled foreign corporation (CFC) regime. It was designed to deal with various tax haven practices by U.S. taxpayers and was fiercely opposed by some business interests. Congress and Treasury officials in the Kennedy administration were rightly concerned that the CFC rules would be challenged in the courts and that some U.S. court might strike them down.

If form, the CFC rules complied with U.S. tax treaties. It was possible that a court would hold, however, that the taxation of a U.S. parent corporation on the undistributed tax haven income of its foreign affiliate amounted in substance to a tax on the foreign affiliate. A direct tax on a foreign affiliate typically would violate U.S. tax treaties because foreign affiliates of U.S. corporations typically were not receiving U.S. source investment income and were not operating within the United States through a permanent establishment.

In my opinion, the 1962 treaty override legislation, as it applied to the CFC regime, simply substituted the U.S. Congress for the U.S. courts as the body empowered to interpret tax treaties. Congress is free to make that substitution under international law absent some treaty rule to the contrary, and no U.S. tax treaty assigns the task of interpreting tax treaties to U.S. domestic courts. (For discussion of Canada's use of a treaty override to substitute a legislative for a judicial interpretation of tax treaties, see page 000 of this issue of *TNI*.)

The 1962 act did not simply eliminate the role of U.S. courts in determining the validity under U.S. tax treaties of the CFC legislation. It stated that all of the changes made by that act were to be given effect notwithstanding the provisions of any existing tax treaty. The legislative history of the act indicates, however, that Congress knew of no other potential conflicts between the act and existing tax treaties.

It later came to light that the separate basket limitation imposed on interest income by the 1962 act might be prohibited under the language of some tax treaties. That language guaranteed that the United States would give residents of the treaty partner a foreign tax credit equivalent to the credit granted under U.S. law at the time the treaty was enacted. Such language is obviously inappropriate for a tax treaty, given the instability of domestic legislation and the complexity of operating 35 or more different foreign tax credit systems. It may be something of a stretch, nevertheless, to say that the override of the credit guarantee was merely interpretative. If there was a breach, however, it surely was a nonmaterial one, as evidenced by the acquiescence of foreign governments to the U.S. position.

Since 1962, international tax advisors have become much more aggressive in claiming conflicts between U.S. statutory rules and its tax treaty rules. I must confess that I have been astounded by some of the audacious claims that came to light during the discussions of treaty overrides in the past two years.

The overrides contained in the 1988 tax act (TAMRA) were intended by Congress to prevent domestic courts from accepting what it characterized as "hypertechnical" treaty claims that had come to its attention. It also wanted to forestall the many other aggressive treaty claims that it suspected were waiting in the weeds. In particular, Congress wished to prevent taxpayers from using the nondiscrimination clause contained in most U.S. treaties to block the enforcement of the new statutory rules applicable to foreign persons. (See page 000 of this issue of *TNI* for excerpts from the legislative history of TAMRA.)

Foreign government objections to the 1988 treaty overrides have not centered on nondiscrimination issues. But many U.S. tax advisors are livid at what they consider to be the watering down of the nondiscrimination clause. They are concerned that foreign governments will respond to the U.S. action by weakening the protection that U.S. taxpayers now receive against allegedly discriminatory actions. And some of them are also angry that an extremely useful tax avoidance tool has been taken away from them. I understand and have sympathy for some of the objections to the partial demise of the nondiscrimination clause. I cannot conclude, however, that its partial demise through definitive legislative interpretation violates international law.

Nonmaterial Overrides

The doctrine of *pacta sunt servanda* does not prohibit all breaches of treaties. To violate international law, a breach must be material. What constitutes a material breach under international law is seldom clear. Tribunals traditionally have applied a "facts and circumstances" test, which is to say that they require a long statement of relevant considerations and then make a decision based on their internalized concept of fair dealing.

I am not familiar with any judicial pronouncements on what would constitute a material breach of a tax treaty under international law. In my very personal view, I would hold that a breach of a tax treaty, to be material, must take away from a treaty signatory a significant bargained-for benefit and must undermine the objectives of the breached treaty. In addition, the treaty signatory that would lose the bargained-for benefit must make timely objection to the breach and the offending party must refuse to redress it. Under this standard, the United States has not yet materially breached any of its tax treaties with its override legislation.

Take as an example the separate basket limitations on the foreign tax credit adopted in 1962 and greatly expanded in 1986. As explained above, the language of some U.S. tax treaties has been interpreted as preventing the United States from imposing such limitations on the credit for taxes paid to the treaty states. Congress inadvertently overrode that treaty language in 1962 and did so explicitly in 1988. Assuming that these overrides were breaches of U.S. treaty obligations, I maintain that the breaches are not material. The benefit taken away is not very substantial, at least in part because the United States could take way most of the benefit, at the cost of an extra layer of complexity, without violating the language of its treaties. In addition, the imposition of reasonable limitations on the credit are consistent with the purposes of income tax treaties.

As another example, consider the stapled stock override adopted as part of the 1984 tax act. The stapled stock rule, contained in Code section 269B, treats a foreign corporation as a domestic corporation, subject to current taxation by the United States, if its stock has been paired with the stock of a domestic corporation so that the shareholders cannot trade the stocks separately. The point of the rule is to prevent U.S. corporations from avoiding CFC status for a sister foreign corporation without giving up effective control of that foreign corporation.

The stapled-stock rule applies, under the 1984 act, notwithstanding the provisions of U.S. tax treaties. The rule would violate a U.S. tax treaty if the stapled entity was resident in a treaty country. I assume that some treaty breaches occurred, although most stapled entities were established in tax havens. The breaches would be nonmaterial under my standard for two reasons. First, the harm to a treaty partner was small because the basic result of the stapled-stock rule could have been achieved without a treaty override through a complicated revision of the CFC rules. Second, none of the U.S. treaty partners are likely to have bargained for the right of their residents to operated as stapled entities.

Prospective Overrides

As part of the 1980 tax act (FIRPTA), the United States announced its intention to override treaty limitations on its power to tax gain derived from the sale, directly or indirectly, of an interest in real property located within the United States. The override was delayed for five years, however, to allow the Treasury Department time to renegotiate U.S. tax treaties. For the most part, U.S. treaty partners were agreeable to the changes needed to accommodate the FIRPTA rules. The general acceptance of the FIRPTA override by U.S. treaty partners is consistent with the common treaty policy of reserving to the source country the right to tax real property gains.

I do not recall any other examples of perspective overrides by the United States, although some of the bills currently under consideration by Congress include prospective override provisions. Canada included what might be considered a prospective override provision when it enacted its CFC legislation (FAPI) in 1972. I suspect that the other countries that have adopted CFC legislation have assumed that international acceptance of the U.S. action in 1962 has largely eliminated the treaty problems presented by the deemed dividend rule.

The merits of prospective overrides are subject to question. Their purpose is to facilitate treaty negotiations. A former Treasury official responsible for U.S. treaty negotiations has suggested that they complicate rather than facilitate treaty negotiations. (See 1 *Tax Notes Int'l* 160 (August 1989).) A metaphorical gun to the head tends to get treaty partners angry, and angry treaty partners may lose their appetite for compromise. Whether good or bad, however, it seems clear that prospective overrides cannot violate international law unless they actually become effective.

Future Directions

Foreign governments have every right to be unhappy with some of the treaty override legislation coming out of Washington. Although I find no violation of international law, I acknowledge that my position is aggressive. I respectfully suggest, however, that some of the claims made by U.S. treaty partners of treaty violations and violations of international law are equally aggressive.

In any event, I certainly find a serious breach by the United States of the comity on which successful cooperation on international tax issues is built. Although the facts may be otherwise, the United States is giving the impression to its treaty partners that it is going down its list of treaty obligations and deciding unilaterally which ones it will choose to observe. That impression is reinforced when some U.S. officials in the State Department and Treasury, in an attempt to block overrides that they oppose, make common cause with the political opponents of override legislation.

The time has come, I believe, for reducing the problems caused by uncontrolled treaty overrides by developing bilateral or multilateral mechanisms that would legitimize most legislative interpretations of treaties and that would regulate nonmaterial breaches of treaties. We need standards, and we need flexible and swift procedures for making minor treaty revisions. We need remedies for treaty breaches, especially for nonmaterial breaches, in addition to the largely useless remedy of termination.

The heat and light generated by the treaty override controversy ought to be channelled to a constructive purpose. I welcome suggestions from readers on how that might be done.