

[*Editor's Notebook*, December 1990]

Tax Treaties, Honeybees and Spiders

2 TAX NOTES INT'L 1235-1237 (December 1990)

by *Mike McIntyre*

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According to a parlor game popular in the 1960s, certain qualities of people can be captured by identifying them with a flower. For example, Margaret Thatcher might be a snapdragon, James Baker a water lily, Noboru Takeshita a forget-me-not, and Brian Mulroney a morning glory. In a variation on that game, countries might be compared with flowers. To play the game, match a country in the first column with a flower in the second column. I give my suggested answers, with some brief horticultural notes, on the following page.

Countries

1. Australia
2. Belgium
3. Brazil
4. Canada
5. Germany
6. India
7. Norway
8. Spain
9. United Kingdom

Flowers

- A. bee balm
- B. black-eyed Susan
- C. caladium
- D. dusty miller
- E. hollyhock
- F. jack-in-the-pulpit
- G. nicotiana
- H. orchid
- I. portulaca

There are lots of other possible variations of this game. One variation that I will explore here is the comparison of countries with two arthropods, the honeybee and the spider. My point is to suggest that honeybee countries and spider countries are likely to have very different goals when they enter into tax treaty negotiations, and that a major strategy of the honeybees, in devising their tax treaty strategy, should be to protect themselves against the spiders.

Honeybees are major producers of new wealth. In contrast, spiders live off the wealth created by others. The strategy of a honeybee, in its dealings with the [*1236] outside world, is to preserve for itself the wealth it has created. The spider's strategy is to attract wealth created elsewhere and claim for itself some share of that wealth. By analogy, honeybee countries see themselves primarily as source countries, whereas spider countries function primarily as conduits. I would note that both honeybees and spiders can be useful denizens of the world. This is not an essay on spider bashing.

Following the general guidelines suggested above, try to classify the following countries either as a honeybee or a spider: Brazil, the Cayman Islands, France, Hong Kong, Japan, the Netherlands, Panama, Poland, Switzerland, United Kingdom, United States.

To me, it is clear that Brazil, France, Japan, and the United States are honeybees and that the Cayman Islands, Panama, and Switzerland are spiders, although Switzerland could be a honeybee if it wanted to be. The other countries give me some problems. The Netherlands, although once a spider, has been acting more and more like a honeybee as 1992 approaches. Hong Kong and the United Kingdom ought to be honeybees, but they frequently behave like spiders. Poland used to be a honeybee and probably still is.

As is evident from the examples above, not all countries that I would classify as spiders are classic tax havens, although all of the tax havens are spiders. This classification scheme is meant to be imprecise. Just as a definition of "adult" as a person of a certain age (over twenty-one, for example) would drain the meaning from that useful term, so also crisp definitions of "spider countries" and "honeybee countries" would spoil the arthropod game. All countries, except perhaps a few of the pure tax havens, have some interest in source jurisdiction, and every country seems willing to engage in beggar-thy-neighbor policies when an attractive opportunity arises.

For honeybees, the main objective of a tax treaty should be to increase wealth-producing economic activities within their borders and to preserve their ability to tax the income generated by those activities. Tax treaties between honeybee countries make a lot of sense because they allow for the reduction, perhaps even the elimination, of cross-border impediments to productive investment. They also reduce the incentive for artificial shifts of investment outside the country of source by providing for mutual cooperation between the tax administrations of the treaty partners.

In contrast, a spider country is interested in establishing a network of tax treaties primarily to improve its ability to act as a conduit for wealth created outside its borders. It does not want to discourage capital flows for tax avoidance reasons -- it wants to increase those flows. And its interests are not served by an effective exchange of information agreement, although it might support an ineffective agreement as a fig leaf to maintain respectability.

Considering the differences in their treaty objectives, honeybees and spiders should not expect their treaty negotiations to go smoothly. The recent breakdown in the tax treaty negotiations between the United States and Switzerland, for example, is a disappointment, but it should come as no great surprise. (For a story about that breakdown, see page 1227 of this issue of *TNI*.) Nor should it be surprising that the government of Panama, despite the fact that it was recently installed behind the protection of the U.S. army, is strongly resisting U.S. pressures for a limited information exchange agreement.

As I discussed earlier in this space, a country that seeks to attract tax-evasion money will never willingly provide foreign governments with routine information about the financial affairs of their residents and nationals. (See "Offshore Banking and Gresham's Law, 2 *Tax Notes Int'l* 819 (August 1990).) To do so would put their own financial institutions out of business. Honeybees negotiating with spiders must accept this reality if they want a tax treaty with a spider.

Considering the importance of information exchange to honeybee countries, a respectable case could be made that they should not even bother to negotiate a tax treaty with

spider countries. In my view, however, a spider and a honeybee [*1237] should be able to reach agreement on a tax treaty that would be beneficial to both sides.

What I envision would be a barebones treaty. It would give appropriate relief from double taxation, and it would guarantee to the residents of each state the procedural rights provided in the OECD model treaty. Its permanent establishment clause would be narrow, allowing full source taxation of most business income, and the nondiscrimination clause would include a tax avoidance exception, along the lines of the escape provision contained in the U.S./Australia treaty. Some relief from withholding taxes might be provided. For example, the absurdly high U.S. statutory rate of 30 percent needs to come down, perhaps to as low as 15 percent in appropriate cases. A significant withholding tax should continue in force, however, to take away the ability of the spider country to operate as a conduit. Effective unilateral procedures for policing abuses of the treaty, including perhaps the use of a refund system to give withholding tax relief, should be put into place.

The honeybee country should attempt to obtain a tough limitations on benefits provision in order to control treaty shopping. The best protection against treaty shopping, however, is the presence of relatively high withholding rates and a weak permanent establishment clause. The important point is that the honeybee should not give up any source jurisdiction to get a watered-down exchange of information agreement. To give up something to get an exchange of information clause like that of the present U.S./Switzerland tax treaty is to give up something for practically nothing.

The present U.S./Switzerland treaty, which went into force in 1951, is much more than a barebones treaty. It provides for an exemption for royalty income and a reduced withholding rate on interest and dividends. It contains a reasonably broad permanent establishment clause. Its exchange of information clause is largely illusory, and it has no limitation-on-benefits clause. Fortunately, it provides for its own termination. Either treaty partner can terminate the treaty, after a six-month waiting period, by giving formal notice of an intent to terminate. As a step toward obtaining an acceptable tax treaty with Switzerland, the United States ought to give that notice.

Let me make clear that I am not criticizing the Swiss. Over the past four decades, Switzerland has taken a leadership position, at various international forums, in advocating a narrow information exchange clause in tax treaties. It has defended with integrity its basic moral position -- that facilitating international tax evasion is acceptable conduct. And it has generally given a fairly liberal reading of the vacuous exchange of information agreements that it has entered into. For example, it has been willing, on at least some occasions, to obtain information at the request of its treaty partners on matters relating to fiscal fraud. I understand that it has also taken some administrative steps to deal with treaty-shopping problems under its treaty with the United States. If I were a honeybee and wanted to have a tax treaty with a spider, Switzerland would be my spider of choice.

In summary, honeybee countries have legitimate reasons to be concerned about entering into or preserving a tax treaty with a spider country. What the honeybees need to do is to develop two model treaties, one for their dealings with honeybees and one for their dealings with spiders. The former model would provide for extensive information exchange on a routine bases. The latter model would protect the source jurisdiction of the honeybees by sharply limiting the ability of the spiders to operate as conduits for income generated by the honeybees.

MJM Answer Key: 1B (striking appearance, unruly growth), 2D (pale foliage shows to advantage the bright colors of intermingled flowering plants), 3G (opens at night), 4H (sensitive), 5A (vigorous grower), 6F (preachy), 7C (likes long shadows), 8I (delicate beauty that flourishes in rugged soil), 9E (traditional, susceptible to rust).