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“Tax Treaties and Tax Competition”

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Tax Treaties and Tax Competition

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Most of the literature about tax competition focuses on the role played by source countries. Although there has been much discussion about the extent to which residence countries can or should try to counteract source country competition, there has been little or no discussion about—or even recognition of—residence countries’ independent contribution to the phenomenon of tax competition. Yet the residence countries do more than simply “succumb” to source country tax competition by failing to use their tax systems to ensure that their residents pay tax on income derived in low tax countries at rates comparable to that paid with respect to domestic income. Many residence countries create additional low taxed—or even completely untaxed—foreign income by negotiating tax treaty provisions removing source country taxing jurisdiction in situations where compensatory residence country taxation is absent. Creating tax favored income in this way not only makes it harder for source countries to levy taxes on income generated by foreign investors,1 indirectly increasing foreign over domestic investment, but also reduces residence country tax revenues.2 Moreover, it is a type of competition that

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1 Many source countries have no desire to tax income derived within their borders, preferring to forego taxation to attract additional foreign investment. But those countries which do attempt to tax foreign investors can find those attempts stymied as investors arrange their investments and business activities to generate income of a type exempt from source country tax under the terms of a tax treaty.

2 See TAN infra.
is likely to become more intense as countries move from formal to economic substance based definitions of “residence” for treaty purposes.\(^3\)

This article seeks to fill this gap in the literature by exploring both the source of the problem and the prospects for its amelioration. Part I describes how, as a technical matter, the interaction of tax treaties and domestic law creates undertaxed income. Part II explores the ways in which this undertaxation could, or could not, be rectified. Part III discusses the prospects for such remediation. Part IV concludes.

I. Tax treaties, national tax law, and undertaxation

Every country has its own set of statutory tax rules. Tax treaties, whether bilateral or multilateral, are superimposed on top of these domestic tax systems. In cases of conflict, provisions contained in tax treaties generally prevail over those found in domestic law.\(^4\) However, tax treaties never wholly

\(^3\) See TAN infra.

\(^4\) Under international law, treaty obligations take precedence over domestic law. However, the U.S. has long taken the position that the last in time prevails, that is, that a subsequently enacted statute may supersede a prior treaty “as a matter of U.S. internal law.” See American Law Institute, Federal Income Tax Project, International Aspects of United States Income Taxation II, Proposals of The American Law Institute on United States Income Tax Treaties 63 (1991). Congress amended section 7852(d) of the Internal Revenue Code in 1988 to make this point exquisitely clear. That statute now reads,  

For purposes of determining the relationship between a provision of a treaty and any law of the United States affecting revenue, neither the treaty nor the law shall have preferential status by reason of its being a treaty or law.  

I.R.C. § 7852(d)(1). For an explanation of the Constitutional basis of this position, see Reuven S. Avi-Yonah, International Tax as International Law 175 (2007). Congress has utilized this override power sparingly, see id. at 175-176, with the help of the U.S. courts, which continues to follow the interpretive rule that later-enacted laws will not be construed to override preexisting treaty obligations absent a clear expression of intent by Congress to do so. See John P. Steines, Jr., International Aspects of U.S. Income Taxation 223 (2005)[“[T]he Conference Committee seems to have restored the traditional rule that override is permissible only where the subsequent
supplant the domestic tax systems on which they are superimposed. Many treaties explicitly incorporate
domestic rules to fill gaps in their own coverage.\(^5\) Even in the absence of explicit incorporation, domestic
law often is used to determine outcomes where tax treaties are silent or their terms unclear.

Though this overlapping of treaty and statutory tax regimes solves many implementation problems,
it also creates new ones. In particular, undertaxation can result when domestic rules for the avoidance
of double taxation are combined with treaty tax allocation rules. Income exempted by treaty from
taxation at source sometimes retains entitlement to favorable statutory tax treatment in the country of
residence, tax treatment premised on the existence of taxation by the source country. The result is
undertaxation.

For example, most U.S. tax treaties severely limit the treaty partner’s taxation of income earned
within its borders by U.S. businesses lacking a permanent establishment in the treaty partner. Typically,
treaty terms prevent the partner from taxing interest paid by its residents to U.S. taxpayers lacking a

\(^5\) See American Law Institute, supra note 4, at 40 (describing Article 3, paragraph 2 of the then extant U.S. Model
Treaty). The same language exists in the same location in the current U.S. Model Treaty. See U.S. Model Income
Tax Convention of September 20, 1996, Art. 3, Para. 2. Identical language is found in the OECD and UN model
treaties. See Allison D. Christians, Tax Treaties for Investment and Aid to Sub-Saharan Africa: A Case Study, 71
business connection to the source country,\(^6\) in many cases, the treaty also forbids source taxation of dividend and royalty payments received by U.S. residents outside the context of a trade or business.\(^7\) Finally, most treaties prevent the treaty partner from taxing the general business income of U.S. taxpayers in the absence of a permanent establishment.\(^8\) These treaty restrictions on source country taxation are reciprocal in nature. The U.S. also gives up its right to impose its income tax on these types of income when earned within its borders by residents of its treaty partner. For the specified categories of income, in short, tax treaties reverse the normal presumption favoring the primacy of source tax jurisdiction.\(^9\)

It is commonly imagined that enhanced residence country tax jurisdiction substitutes for this loss of source country taxing jurisdiction.\(^10\) To the extent that this substitution effect occurs, the source tax

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\(^6\) See IV Joseph Isenbergh, International Taxation, U.S. Taxation of Foreign Persons and Foreign Income ¶ 105.2 (3d ed. 2003); [cite to table of treaty withholding rates].

\(^7\) See Joseph Isenbergh, supra note , at ¶¶ 105.6 (U.S. Model Treaty reduces withholding rate on dividends to 5 or 15 percent, depending on relationship between payor and recipient), 105.11 (no source taxation of royalties); [cite to table again].

\(^8\) Imposition of “permanent establishment” as a “threshold of taxation” is a “central element” of all tax treaties. See Joseph Isenbergh, supra note , at ¶ 103.9 (permanent establishment concept a “basic proposition—repeated in some way in every treaty”). The definition of a “permanent establishment,” though, is not identical from treaty to treaty.

\(^9\) See Reuven S. Avi-Yonah, supra note , at 169; American Law Institute, supra note , at 2.

\(^10\) See Reuven S. Avi-Yonah, supra note , at 170; Charles H. Gustafson, Robert J. Peroni and Richard Crawford Pugh, Taxation of International Transactions 233 (3d ed. 2006) (“The loss of [source tax] revenue is presumably recompensed by the reciprocal nature of the treaty provisions.”); Joseph Isenbergh, supra note , at ¶ 101.2.1 (“[T]he effect of a treaty provision exempting income from tax in one country is often simply to shift revenues from that country to a different national treasury.”); Joint Committee on Taxation, Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Canada, JCX-57-08 (July 10, 2008) (“[T]he various rate reductions and exemptions agreed to by the source country in treaties are premised on the assumption that the country of residence will tax the income at levels comparable to those imposed by the source country on its residents[.]”).
reductions provided for in tax treaties operate as a “revenue trade,” an exchange of often excessive, gross income based source taxation for taxation of net income in the country of residence. Yet all too often, these treaty arrangements lead to revenue losses rather than even exchanges, and not only because of the elimination of “excessive taxation” or of investment imbalances which lead to inequalities in the amount of income flows between the two treaty partners. Treaties lose revenue because the imagined offsetting increase in residence country taxation never occurs.

In the U.S., the failure to exact an offsetting residence country tax arises from the fact that foreign income exempted from source country tax under the terms of a tax treaty continues to be considered “foreign source income” for foreign tax credit limitation purposes. Thus, the tax benefits of the treaty benefit U.S. investors in relatively high tax countries rather than the U.S. treasury. To understand why this is so, one has to understand how the foreign tax credit system, and the foreign tax credit limitation rules, work.

Ostensibly, the U.S. adheres to a policy of “capital export neutrality” when it comes to the taxation of foreign income of U.S. investors. That is, taxpayers are supposed to pay the same rate of income tax on their foreign earnings as they do on their domestic income in order to make them indifferent between investing abroad and investing in the U.S. This goal is attained through the operation of the foreign tax credit mechanism, which treats foreign income taxes as prepayments of U.S. income taxes. Taxpayers are allowed a dollar of foreign tax credit for each dollar of foreign income tax they pay, and

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12 See I.R.C. §§ 901(a)-(b).

13 See I.R.C. § 901(b).
these foreign tax credits are credited against the U.S. income tax otherwise due on the taxpayer’s income,\textsuperscript{14} thus reducing the amount of income tax payable to the U.S. Treasury. However, it has long been recognized that an unlimited foreign tax credit provides foreign governments with an open checkbook against the federal treasury\textsuperscript{15}; accordingly, the U.S. limits the amount of foreign tax credits a taxpayer may claim to an amount equal to the taxpayer’s pre-credit tax liability multiplied by a fraction, the numerator of which is the amount of the taxpayer’s foreign source income and the denominator of which is the taxpayer’s worldwide income.\textsuperscript{16} This limitation ensures that foreign taxes (in the form of the foreign tax credit) cannot be used to offset the U.S. tax liability generated with respect to U.S. source income.\textsuperscript{17} It also means that U.S. taxpayers pay income tax at the higher of the U.S. or foreign effective tax rate on their foreign source income.

\textsuperscript{14} See I.R.C. § 901(a).

\textsuperscript{15} The fear is that the foreign tax credits would be used to offset the U.S. income taxes due on U.S. income. For example, say the U.S. taxpayer Z earns $100 in taxable income in the U.S. and another $100 of taxable income in foreign country A. Suppose further that the U.S. tax rate on Z is 35%, and the A country tax rate is 50%. In the absence of a credit limitation, Z’s foreign income tax credit would equal 50% of the $100 earned in A (assuming A’s source rules are the same as the U.S. source rules), or $50. Z would be able to credit all $50 against its $70 U.S. tax obligation (50% of $200), leaving Z with a $20 obligation to the U.S. Treasury. Z would not suffer financially from Country A’s relatively high tax rate (the U.S. tax system is truly “capital export neutral”) and as a result, Country A would not suffer any decrease in foreign investment as a result of its high tax rate. However, in addition to foregoing any tax claim with respect to Z’s Country A income, the U.S. would collect only $20 of tax with respect to Z’s U.S. source income. In essence, Country A would have transferred $30 of the U.S. tax claim on Z’s U.S. source income to its national treasury. Of course, this scheme only works insofar as Z has U.S. source (or other country source) income which would otherwise generate a U.S. tax liability. Country A would have a hard time attracting investors if Z rather than the U.S. Treasury had to absorb the extra $20 of taxes.

\textsuperscript{16} See I.R.C. §904(a).

\textsuperscript{17} In the example in footnote 15, supra, for example, Z’s tax credit would be limited to 35% X 100/200, or $35. Z thus would have to pay the U.S. Treasury $35 in income tax, for a total (foreign and U.S.) tax burden of $85, or $15 more than if Z had earned all $200 in the U.S.
Though foreign taxes imposed at higher than U.S. rates may not be used to offset the U.S. income tax liability generated with respect to U.S. source income, they can be used to offset any residual U.S. tax liability that would otherwise have attached to those taxpayers’ low-taxed foreign income. This offset occurs because the limitation is not calculated on an “item-by-item,” or even a “country-by-country” basis. Rather, all foreign income derived by a taxpayer is allocated to one of two categories, the “passive” category or the “general” category, and a separate limitation calculated with respect to each such category.\(^\text{18}\) Within each category, both the income and foreign taxes paid with respect to the income are “blended.” All foreign taxes incurred with respect to the income falling within each category can be credited against the U.S. income taxes due on any income falling within that category; the only restriction is that the taxes allocable to that category may not exceed the category’s limitation amount. A taxpayer with excess foreign tax credits generated with respect to some income items can use those credits against the U.S. tax due on other, lower taxed income items falling in the same income category, thus reducing the amount of tax collected by the U.S. Treasury with respect to foreign source income.

The likelihood of any particular taxpayer having excess tax credits differs over time, as relative corporate tax rates (both nominal and effective) fluctuate. At present, the nominal U.S. corporate income tax rate exceeds that of many of its treaty partners and economic competitors, reducing the number of taxpayers with excess credits, but this state of affairs is not typical and may not last.\(^\text{19}\) And, importantly, most corporate income exempted from source tax under the terms of its tax treaties falls into the “general” category, which is the category most likely to include income likely to be highly taxed. Although on its face the definition of “passive income” falling within the “passive income category”

\(^{18}\) See I.R.C. §904(d).

\(^{19}\) [give historical data re swings between excess credit and not; also note various proposals for reduction in corporate tax rate for tax competition reasons]
includes interest, dividend and royalty income, all major elements of treaty exempted income, the “passive category” definition contains so many exceptions that it may be more accurate to say “the rule” is the exact opposite when dealing with corporate taxpayers. For example, rents and royalties received from unrelated persons are kicked out of the “passive” category when earned in the context of a taxpayer’s trade or business. This business need not be carried on in the source country. Thus, a U.S. taxpayer may escape taxation at source on rents and royalties under the terms of a treaty because the income was not derived in connection with a trade or business carried out in the treaty country; however, such income may well escape from the definition of “passive income” for tax credit limitation purposes because it was earned in the course of a trade or business conducted elsewhere, including the U.S. Nor does rental or royalty income received from a related party necessarily fall in the passive category. Such income may be reallocated to the general category under the look-through rule applicable to distributions by controlled foreign corporations. Alternatively, it may fall within the definition of “active rents or royalties,” exempted from passive category income regardless of whether received from a related or unrelated person. Interest income may be characterized as general category income because it is deemed derived in the context of a financial services business.

20 See I.R.C. § 904(d)(2)(A) (incorporating by reference definition of foreign holding company income found in I.R.C. § 954(c)).
21 See infra TAN .
23 And even if it is, the income would not be taxed at source unless and until the taxpayer maintained a permanent establishment in the source state.
26 See I.R.C. § 904(d)(2)(C).
Allowing treaty exempted income to be treated as foreign source income for foreign tax credit limitation purposes effectively transfers the financial benefit of the treaty from the government, which paid for the exemptions by foregoing its own source tax claims, to taxpayers with excess foreign tax credits from other foreign operations. The current tax treatment, in short, looks like an example of “corporate welfare.”

But the U.S. is far from the only country to provide such benefits to its residents, though the mechanics of delivering this benefit differ in other countries. Many countries have adopted a “territorial” system of taxation. That is, they entirely forego their right to tax foreign source business income, limiting their tax base to domestic income and foreign sourced investment income. More than a few countries allow their residents’ treaty protected foreign source income to be treated as exempt foreign business income for purposes of their territorial tax regimes. Like the U.S., they often consider interest, dividends, and royalties to be active business income when earned by corporations in the context of active business operations. Nor does the presence or absence of a foreign permanent establishment, the predicate for taxation of business income at source under most tax treaties, have any role to play in determining whether an income item constitutes “foreign business income.” [This part needs to be expanded with examples and cites.]

As in the U.S., then, their treaty relationships lose money coming and going. They sacrifice source tax revenues without insisting on an even partially offsetting increase in residence tax revenues. Rather than being revenue neutral, tax treaties lose money, and lose more than merely the amount that could be described as “excessive taxation.” This financial loss is borne by national treasuries and taxpayers as a group, while the benefits (at least in the first instance) flow to the treaty partners’ resident multinationals.
Although arguments can and have been made for subjecting transnational income to only one set of national income taxes, few argue for the proposition that transnational income (and only transnational income) should escape both source and residence taxation. Why, then, are treaties used to create such nontaxed income? One possibility is that such income cannot be effectively taxed. The next section of the paper looks at this issue, or, more particularly, at how such income could be taxed in the country of residence.

II. Residence Country Claw-Backs: The Mechanics

Although treaties allocate the rights to tax income “arising in” the treaty partners, they rarely if ever lay out when items of income should be deemed to arise in one country or the other. Almost without exception, source rules are set by domestic statutory law. Given this, the solution to the “no where” taxation of treaty-protected income seems almost laughably simple: countries can change their source rules to provide that any income exempted from foreign source taxation under the terms of a tax treaty, be considered domestic income. Such a rule could be drafted to take precedence over any other

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27 Territoriality has both critics and defenders. Though its critics decry the incentive it provides for tax avoidance and tax competition, see [insert cites], its defenders view territoriality as necessary for the protection of the national sovereignty of source countries and regard tax competition as a tool for the efficient allocation of international capital. See [insert cites].

28 A few have come close. See Michael Lang, The Application of the OECD Model Tax Convention to Partnerships 30 (2000) (“[i]t is completely clear and unquestioned that double non-taxation is the result of the application of the tax treaty. This has to be accepted....one cannot argue against a certain interpretation of a treaty provision that the object and purpose of the treaty make it necessary to avoid double non-taxation situations.”). However, it is unclear whether Professor Lang is making a principled argument in favor of the principle of double non-taxation, or is merely describing the current state of the world.

29 Depending on the country, such a rule might be contained in tax treaties themselves, or separately provided for by domestic legislation. In the U.S., domestic legislation would be required because, as a Constitutional matter, taxes may not be imposed by treaty. The power to “lay and collect Taxes” was committed to Congress; moreover, [a]ll Bills for raising Revenue shall originate in the House of Representatives.” U.S. Constit., Art. 1, Sec. 7 (1) and
conflicting source rules. Domestic income enters only the denominator and not the numerator of the foreign tax credit limitation fraction in tax credit countries such as the U.S. And income must be foreign to qualify for the exemption of foreign business income under a territorial system. If treaty protected income was deemed domestic source income under the law of the residence country, it would not qualify for either of these schemes for the alleviation of double taxation, and would instead be subject to the full burden of residence country taxation.

The fact that few countries follow this course, though, indicates either that the solution is not as simple as it seems, or that the “solution” creates some other problems. Both of these issues are discussed in further detail below.

A. Complications: Intervening Permanent Establishments

Thus far, the analysis has centered on a simple, two-country situation, involving a taxpayer resident in one treaty partner and earning income in the other treaty partner. Many situations, however, are more complicated than that. A corporation could, for example, have a permanent establishment in a third country (which may or may not have a treaty with either or both the country of residence or the country of source) through which it earns the income that has been protected by the terms of the tax treaty. That is, Corporation A, a resident of Astoria, may establish a permanent establishment in Caytoria, through which it earns income in Britoria. Though the Britorian income may be exempt from Britorian tax under the tax treaty between Astoria and Britoria, it may be subject to tax in Caytoria—even if Astoria and Caytoria are parties to a tax treaty identical to the one entered into between Astoria and Britoria.

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8(1). Treaties are negotiated by the President and confirmed by the Senate, U.S. Const., Art. 2, Sec. 2(2), with the House of Representatives playing no formal role.
and Britoria. The imposition of a Caytorian tax could justify the application of the Astoria’s regime for eliminating double taxation to the income benefiting from the Astorian-Britorian tax treaty, an application that would be denied if such income was re-sourced to be Astorian source income. In short, a treaty exemption from source taxation unaccompanied by an increase in residence country taxation does not always leave a taxpayer “undertaxed,” since a taxpayer may be paying tax on that income in a third country.

This possibility could be dealt with in carefully crafted legislation. The re-sourcing rule could contain an exception for income derived through a foreign permanent establishment, and which is taxable in the country in which said permanent establishment is located on account of that permanent establishment. However, a blanket exception for income taxed in a third country raises the possibility that taxpayers will create permanent establishments in low tax countries solely to avoid the re-sourcing rule. If taxpayers were to do this, residence countries would gain little if any revenue from a re-sourcing rule; all that would happen would be that taxpayers would be forced to disgorge part of their treaty gains in the form of transaction costs attendant upon arranging for third country taxation, as well as, of course, the third country taxes themselves.

A country could fight back against such schemes by imposing a minimum foreign tax requirement on the permanent establishment exception to the re-sourcing rule. Countries could require that the foreign tax equal at least a percentage of the residence country (or source country) tax rate for the exception to

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30 Another avoidance technique could be utilized at the country level. Countries could negotiate treaties calling for the imposition of a very low withholding tax at source rather than a total exemption, thus helping their investors avoid imposition of the residence country tax. For reasons a country might decide to go this route, see supra TAN.
the re-sourcing rule to apply, just as the U.S. conditions exemption from the subpart F regime on payment of a substantial foreign tax.

[Add discussion of possible effects of changes to definition of “permanent establishments” in OECD model tax treaty commentary.]

However, restricting the application of the re-sourcing rule in this way might simply force taxpayers to use another stratagem. Instead of creating permanent establishments in low tax countries, taxpayers may create foreign subsidiaries in low tax countries, and carry out their foreign business operations through those foreign subsidiaries. This possibility is discussed in the next section.

B. Complications, Continued: Intervening Foreign Corporations

A time-honored technique of tax reduction in the international sphere is the use of an intermediary foreign corporation. Interposing a lightly or nontaxed foreign corporation between the country of “ultimate” residence and the country from which income is being derived often lowers the total amount of taxes paid on transnational income. Instead of creating a permanent establishment in Caytoria, the Astorian resident Corporation A, may create a new, wholly owned subsidiary, Corporation C, in Caytoria, through which it carries out its business operations in Britoria. U.S. taxpayers, for example, have long postponed the imposition of the capital export neutral tax credit regime by engaging in foreign activities through foreign incorporated subsidiaries. With some exceptions, the foreign income generated by and through such corporations escapes the U.S. tax net until realized by the U.S. parent in the form of a dividend or stock sale. Countries that enacted re-sourcing rules might find taxpayers avoiding those rules by utilizing a similar stratagem. Instead of carrying out foreign business activities through domestic enterprises, their resident multinationals would carry them out through subsidiary foreign corporations.
Indeed, corporations may go one step further and “expatriate” or at least restructure so that the entity resident in the low tax country is the parent, and the former parent becomes the subsidiary. Corporation C, the resident of Caytoria, may become the parent and Corporation A, the resident of Astoria, the wholly owned subsidiary.

In some sense, these techniques are not objectionable. After all, once the entity investing in the foreign country ceases to be a resident of a treaty country, the entity is no longer qualifying for protection from source tax under the terms of that country’s tax treaty. Corporation C, the Caytorian subsidiary of Corporation A earning income from Britorian sources, cannot use the Astoria-Britoria treaty to protect its income against Britoria’s tax. The only treaty Corporation C could use to escape that Britorian tax would be the Caytoria-Britoria treaty—assuming such a treaty existed. As a technical matter (unlike the permanent establishment variation described in the previous section) one could say that since Astoria does not pay for any protection from Britorian tax enjoyed by Corporation C, there is no problem insofar as Astoria is concerned. If there is a problem, it is one that affects only Caytoria and Britoria, and would be due to the terms of the bilateral tax treaty between those two countries. Or, to put it another way, why should Astoria care if Caytoria and Britoria reciprocally agree to tax neither the residents of their treaty partners nor their own residents on certain categories of income?

Of course, if Astoria has no residents benefiting from its tax treaty with Britoria because Astoria residents always invest in Britoria through Caytorian corporations, one might wonder why Astoria bothers to enter into a bilateral tax treaty with Britoria (or visa versa) to begin with. Such a treaty would cost Astoria the source tax revenues it could collect from Britorian investors without generating any increase in residence tax collections (or benefiting Astorian investors). It was concern over precisely this
disincentive for entering into tax treaties that led the U.S. to begin insisting on the inclusion of treaty shopping provisions in its own tax treaties\(^3\) beginning in about 1980.\(^2\) Over the years, these provisions have become more elaborate and sophisticated, as well as more ubiquitous, making it harder for third country nationals to access benefits available under the terms of bilateral tax treaties.\(^3\) Mere residence in Caytoria, in short, may not be enough to allow a wholly-owned Corporation C to avoid Britorian tax under the terms of a Caytoria-Britoria tax treaty.

Moreover, it may become harder for Corporation C to be deemed a resident of Caytoria for purposes of Astorian law, eliminating its usefulness as a tax avoidance mechanism. Under current U.S. law, the residency of a corporation is established by its country of incorporation.\(^4\) Establishing residency, then, is a paper transaction, accomplished with relative ease and at little expense. Though some nontax consequences flow from the choice of residence,\(^5\) these consequences have been

\(^{3}\) See Testimony of Treasury Deputy Assistant Secretary for International Tax Affairs Michael F. Mundaca, supra note , at (“Our tax treaties are intended to provide benefits to residents of the United States and residents of the particular treaty partner on a reciprocal basis...if third-country residents are able to exploit one of our tax treaties to secure reductions in U.S. tax...the benefits would flow only in one direction...”).

\(^{2}\) See Reuven Avi-Yonah, supra note , at 173 (“Most U.S. treaties did not have elaborate anti-treaty shopping mechanisms before the 1980’s”).

\(^{3}\) Some opportunities remain, though it is unclear how practical they are. See Jeffrey L. Rubinger, Treaty Shopping: Is It Still a Viable Option?, Corp. Bus. Tax’n Monthly 15, 23 (May 2007).

\(^{4}\) See I.R.C. §§ 7701(a)(4), (a)(5).

\(^{5}\) The non-tax consequence that has received the most attention is the applicable corporate law regime. Shareholder rights and corporate obligations generally are determined by the law of the state of the corporation’s residence. Many have alleged that tax-motivated changes in corporate residence have impaired the rights of shareholders. See Mitchell A. Kane & Edward B. Rock, Corporate Taxation and International Charter Competition, 106 Mich. L. Rev. 1229, 1232 (2008) (arguing that different tests of residency should apply for corporate and tax law purposes to allow corporations and investors to access their preferred corporate law regime without suffering adverse tax consequences); Michael S. Kirsch, The Congressional Response to Corporate Expatriations: The Tension Between Symbols and Substance in the Taxation of Multinational Corporations, 24 Va. Tax Rev. 475, 552-56 (2005) (detailing controversy over changes in shareholder rights resulting from inversion transactions); David Cay
outweighed for many by the tax advantages of residing in a low tax jurisdiction.\textsuperscript{36} Other countries have more substantive residency rules, requiring more of an economic presence in the country of incorporation for such residency to be respected.\textsuperscript{37} The OECD is at least discussing an initiative aimed at convincing countries to move to even more substance based definitions of residency. The proposal now under discussion would determine residency on the basis of the location of a corporation’s headquarters and where “day to day” decisions about its operation are made.\textsuperscript{38}

Though the advent of treaty shopping provisions and the reform of residency rules may make re-sourcing rules more effective, they may also make them less likely to be adopted in the first instance. The explanation of this counter-intuitive proposition is contained in the next section, which discusses barriers to the adoption of a re-sourcing rule.

III. Residence Country Clawbacks: Nontechnical Considerations

\textsuperscript{36} See Mitchell A. Kane & Edward B. Rock, supra note , at .

\textsuperscript{37} The United Kingdom, for example, determines corporate residency in part on the basis of the corporation’s country of “effective management.” See Daniel Sandler, Tax Treaties and Controlled Foreign Company Legislation: Pushing the Boundaries 3 (2d ed. 1998). However, judicial and regulatory decisions have interpreted that standard to mean that corporate residency depends on where the board of directors’ meetings are held and where the corporation maintains its primary bank account. See Hugh J. Ault, Comparative Income Taxation: A Structural Analysis 371-73 (1997) (same for United Kingdom, Canada and the Netherlands).

\textsuperscript{38} See OECD, The 2008 Update to the OECD Model Tax Convention, July 18, 2008, at 6-7, [hereinafter 2008 OECD Up[date] available at http://www.oecd.org/dataoecd/20/34/41032078.pdf (replacing paragraph 24 of the commentary on current Article 4 of the OECD Model Tax Convention, which defines corporate residence as “the place where the most senior person or group of persons (for example, a board of directors) makes its decisions,” with a new paragraph determining place of corporate residence on the basis of “all relevant facts and circumstances”).
As the previous section of this essay suggests, the problem of treaty undertaxation may be becoming more rather than less amenable to legislative solution, as a technical matter. Political will, however, is another matter entirely. Changes in treaty terms and definitions of residency may make avoidance of a re-sourcing rule more difficult if not impossible. But obstacles to adoption of such rules remain. Indeed, one of the changes that make such rules more effective—the strengthening of residency requirements—may make such rules less attractive to residence countries.

The argument is simple. Companies, and the investors in those companies, want to keep their tax burdens as low as possible. If only some countries enact re-sourcing rules, companies will attempt to establish residence in those countries which have refrained from doing so, all other things being equal. Countries enacting re-sourcing rules thus run the risk that, over time, their multinational residents will expatriate voluntarily, or be taken over (or driven out of business) by foreign companies. While reasonable people may argue that in today’s world, it does not matter much whether GE survives as a U.S. company or becomes a foreign company, in a world where corporate residence is determined by the location of corporate headquarters, the choice of corporate residence will also determine the location of corporate headquarters. If GE chooses (or is forced) to move to a country without a re-sourcing rule, the U.S. would lose not only the jobs directly associated with GE’s corporate headquarters and any tax revenues associated with those jobs, but also the jobs and associated tax revenues of other businesses that depend on the presence of that headquarters. From an economic perspective, residence will become a subset of source, rather than a separate concept.

39 Some scholars have begun challenging the contention that higher residence country taxation poses a competitive harm, contending [need to get articles and elaborate].

40 And they do. See [insert cites to both sides of the debate].
Though from the taxpayers’ perspective, the “frictions”\(^{41}\) associated with changing corporate residency will increase as the change in OECD commentary becomes operative law,\(^{42}\) from countries’ perspective, so too will the stakes. The tax policy question facing individual nation states is whether, as an empirical matter, those frictions—the need to move corporate headquarters and associated employees—will be high enough to prevent most corporations from changing (or being forced to change) their corporate residency. If they are not, countries may well decide that it is better to forego the revenue obtainable through enactment of a re-sourcing rule than run the risk of losing more revenue through the relocation of company headquarters and jobs.

One way around this dilemma would be for “residence countries” to cooperate, to effectively form a cartel in which all agree to simultaneously enact re-sourcing rules. For example, countries could enter

\(^{41}\) “Frictions” are the monetary, business and personal costs of attaining more tax-favored treatment. Several scholars have pointed to the critical role played by these costs in ensuring the survival of the income tax. See David M. Schizer, Frictions as a Constraint on Tax Planning, 101 Colum. L. Rev. 1312, (2001); David A. Weisbach, Line Drawing, Doctrine, and Efficiency in the Tax law, 84 Corness L. Rev. 1627, (1999). The arguments in favor of the OECD’s change in the definition of residency stem from the perception that the new rule will increase the frictions associated with changes in corporate residency; in particular, proponents of similar proposals believe that forcing senior executive officers to change the location of their workplaces (and likely personal residences) as a precondition to changing corporate residence will forestall many corporate residence changes. See Staff of the Joint Comm. On Tax’n, 109\(^{th}\) Cong., Options to Improve Tax Compliance and Reform Tax Expenditures 179-81 (Comm. Print 2005), available at http://www.house.gov/jct/s-2-05.pdf ;Michael S. Kirsch, The Congressional Response to Corporate Expatriations: The Tension Between Symbols and Substance in the Taxation of Multinational Corporations, 24 Va. Tax Rev. 475, 574 (2005).

\(^{42}\) There may well be a substantial time lag before this new definition of “residency” becomes effective. It is far from clear (indeed, the opposite seems more likely) that the latest changes in the OECD treaty commentary should affect the interpretation of treaties in effect at the time of the change, see Michael Lang, supra note , at 15 (citing the OECD Committee on Fiscal Affairs for proposition that only changes in commentary “reflect[ing] the consensus of the OECD Member Countries as to the proper interpretation of existing provisions and their application to specific situations” should be given retroactive effect), even if those treaties incorporate the precise language of the OECD Model Treaty, which many do not.
into a multilateral treaty obligating each country to enact such rules, subject to the condition that a specified list of countries also agree to be bound. The EU used a similar arrangement to effectuate its savings initiative.\textsuperscript{43} If all the plausible residence countries agreed to such a deal, taxpayers would not gain anything, at least in the area of re-sourcing, by changing their country of residence. However, it is hard to envision such a cooperative arrangement arising in the current world. It only takes one country to prevent the formation of a successful cartel. Further, even if a cartel can be formed encompassing all the current residence states, new countries may try to market themselves as potential residence states. The more effective the existing cartel, the more a country has to gain from becoming a viable residence state outside the cartel. In theory, although such a new entrant could be bought off, it might require the members of the existing cartel to pay it almost all the gains derived from participating in the cartel.

If residence countries cannot cooperate, another possibility would be to put source countries in the role of coordinator. Not all source countries would be willing to play a role in a coordination game, inasmuch as some (and indeed many) are perfectly happy to help foreign investors reduce their residence country income tax obligations. Particularly for countries which do not themselves levy much of a source tax, that is, countries which have traded tax revenues for increases in investment attractiveness, the prospect of taxpayers turning taxable domestic income into treaty protected income poses no fiscal or policy threat. However, those countries that do try to levy a tax on incoming foreign investment\textsuperscript{44} presumably would welcome attempts to reduce nontaxation of treaty protected income because doing so make it harder for investors to reduce the taxes paid to their own national treasuries.

\textsuperscript{43} [Describe Savings Initiative, also varying opinions on its success or failure.]

\textsuperscript{44} These countries do exist. Even as forceful a , and the list may be growing. China, for example, is beginning to move away from tax concessions as a method of attracting foreign investors. See Jinyan Li, The Rise and Fall of Chinese Tax Incentives and Implications for International Tax Debates, 8 Fla. Tax Rev. 669, 677-678 (2007).
Effective residence country taxation of income protected from source taxation by treaty would reduce taxpayers’ economic incentive to characterize income as treaty protected income (as opposed to business income subject to tax at source by the source country); taxpayers would have less and perhaps nothing to gain from such strategies depending on the relative source and residence country tax rates.

Source country coordination could be effected in one of two possible ways. Source countries could require offsetting residence country taxation as a condition of granting any source tax concessions contained in their tax treaties. Alternatively, the terms of tax treaties could change to allow greater source taxation rights coupled with broader residence country tax relief. As explained below, each of these alternatives has its own strengths and weaknesses.

In the first option, source countries could condition source tax reductions on the existence of appropriate residence country taxation of the affected income. In most countries, including the U.S.,\textsuperscript{45} such offsetting taxation could be provided for under the terms of the bilateral treaty. And there is some precedence for including such provisions in bilateral tax treaties. The 2006 U.S. Model Treaty,\textsuperscript{46} like the OECD’s commentary on Article 1 of its Model Treaty,\textsuperscript{47} purports to deny the benefit of treaty source tax reductions to payments made to partnerships and other transparent entities when their partners are not subject to tax in the treaty partner “as residents.” However, it is unclear how effective this approach

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\textsuperscript{45} Technically, such provisions would not constitute the imposition of a tax, which cannot be done by treaty, see supra note \textsuperscript{45}, but simply the refusal to excuse an existing tax.


\textsuperscript{47} See Model Tax Convention on Income and Capital, Commentary.
is, which leads to suspicion of the efficacy of extending this approach would be. Source countries may find it difficult to determine the treaty partner’s tax treatment of particular income items received by foreign residents. Further, it is unclear whether taxes actually need to be imposed on treaty-protected income in a residence country for a taxpayer to be “taxed as a resident.” Though the proposed OECD commentary to Article 4 of the treaty, which defines “residence”, states that the “subject and purpose...is to exclude persons who are not subjected to comprehensive taxation (full liability to tax) in a State,” it goes on to make clear that its intent is not to “exclude from the scope of the Convention all residents of countries adopting a territorial principle.” Even if a partner is “taxed as a resident,” in a territorial state, its foreign sourced income would be exempted from residence country taxation. Clearly, treaty language would have to be much more specific about the type and amount of residence country taxation for this approach to work.

Finally, most source countries have many currently outstanding treaties which, by definition, do not require offsetting residence country taxation as a condition of its source tax reductions. Residence countries may be reluctant to renegotiate their existing treaties absent assurance that the country’s other treaties would be similarly renegotiated in short order for fear that differential tax treatment would lead to the expatriation of “their” multinationals to countries with which such renegotiation had

48 For starters, the item of income may be subject to tax in the hands of a “resident” taxpayer without that taxpayer incurring a tax liability, as might be the case under a territorial regime. See . Further, the source country could have to gather a significant amount of information to determine whether the caveat applies at all. Though enforcement of the limitation brings financial gains, it is uncertain whether those gains are worth the enforcement costs. See .

49 See 2008 OECD Update, at 6 (para. 8.3).

50 See id.
not occurred. And even if all treaties were renegotiated to include similar restrictions on source tax reductions, countries might worry that the source country would enforce the restrictions differently for investors from different countries.

The problems of uneven and speculative enforcement would diminish if the allocation of taxing power to the source country was more automatic—if source countries were explicitly granted rights in tax treaty arrangements to tax nonbusiness income and/or allowed to impose a tax on business income even in the absence of a permanent establishment. Further, the prospect of gleaning additional tax revenue (as opposed to speculative decreases in tax avoidance) might make source countries themselves more amenable to entering into such treaty arrangements in the first place.

There is nothing magical about the current division of taxing jurisdiction—or tax revenues—between source and residence countries. As long as one country’s expanded tax claim is compensated for by reductions in the tax claim of the other treaty partner, such expansions should not increase the risk of duplicative taxation. When treaty partners have approximately offsetting investment flows, the revenue consequences of subordinating residence country taxation to increased source taxation also should be minimal, as residence tax losses should be offset by source tax gains. It is only when treaty partner investment and income flows are unequal that the flow of tax revenues changes. Given the discussion above, which points out how seldom residence states actually gain from treaty arrangements that supposedly favor them, it is possible that few countries will actually lose tax revenues, while many will gain revenues, by increasing the reach of source country taxing jurisdiction. And even net revenue

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51 The reasons for such concern were discussed earlier. See supra TAN .

52 They could, however, raise the possibility of excessive taxation if withholding tax rates were set too high. Of course, what constitutes “too high” would differ from situation to situation; as discussed infra TAN , that is one of the problems with this alternative.
losers might foresee revenue gains down the road, as foreign investment becomes less attractive vis a
vis domestic investment due to the reduction of the associated tax benefits.

Nor are treaty arrangements which provide more source country taxing jurisdiction an
unprecedented innovation. Years ago, experts at the United Nations developed an alternative model tax
convention that contained fewer source tax concessions for use when income and investment flows
between the treaty partners were sufficiently one-sided that the standard treaty terms would generate
unacceptably unequal revenue consequences. And the U.S. has on at least one occasion broadened
source country taxing jurisdiction by treaty to cover income items regarded as U.S. source income under
U.S. statutory law.

From a residence country’s point of view, the biggest danger in entering into treaty arrangements
allowing greater taxation at source would be that their residents would find themselves placed at a
competitive disadvantage relative to residents of countries with more taxpayer friendly treaty
arrangements with the source state. Once again, residence country tax competition would become an
issue. One possible solution to this difficulty would be the inclusion of a “most favored nation clause” in
tax treaties providing for greater taxation at source. Such clauses could limit the scope and level of
source taxation to the lower of that allowed by the particular bilateral treaty or that allowed by any
other tax treaty entered into by the source country. Though “most favored nation clauses” have not
been found in tax treaties to date, the prospect of greater source tax revenues may go a long way
towards dissipating this disapproval, at least on the part of source countries. “Most favored nations

53 See Ilan Benshalom, The Quest to Tax Interest Income: Stages in the Development of International Taxation, 27

54 See [U.S. India Treaty treatment of technical services]
clauses” would also provide source countries interested in imposing source taxes with a financial
incentive to renegotiate their existing treaty relationships. The downside, of course, would be that it
might take many years for the additional source taxation to come into being. Further, taxpayers and
residence countries may continue to be suspicious as to the availability of more favorable tax treatment
for residents of other jurisdictions as a matter of administrative practice.

That last fear should be somewhat assuaged by the likely nature of the tax imposed by the source
country on the income that becomes taxable by it. Most likely, the income will be subject to a
withholding tax levied on the gross income amount. There is relatively little room in such a tax for
administrative relief or maneuvering.

While perhaps reducing fears about continued residence country tax competition, the fact that this
option relies on use of a gross income based tax is its biggest downside, as well as the source of some of
its upside gains. Contrary to contentions of lesser-developed countries, selfishness was not the only root
of the emphasis on residence over source taxing jurisdiction. The other concern was, and remains, the
ability—or rather, the inability—of source countries to levy effective net income based taxes on income
earned by taxpayers only tangentially present in their jurisdictions, such as passive investors and
businesses without permanent establishments. The lack of extra-jurisdictional enforcement powers all
but requires that the taxes imposed on such taxpayers be enforced by withholding computed with
respect to gross income. Yet taxation based on gross income often leads to over or under taxation,
relative to taxes levied on net income, and can severely distort economic activity. Whether such
distortions would be greater or lesser than those created by the effective exemption of such income
from tax, as occurs under current law, though, is an open question.

IV. The Path Forward?
As is usually the case, there are no easy solutions to the tax problems created by the interplay of multiple, inconsistent tax systems. Indeed, as is often the case, attempts to solve one problem often heighten other problems. Strengthening entity residence requirements, while critical to strengthening curbs on treaty shopping and reducing inversion transactions, raises the stakes for residence country tax competition more generally. That competition may make it more difficult to solve not just the problem identified in this paper but also may interfere with attempts to wield residence country cooperation as a tool against tax competition by source countries.

If there is an answer to this dilemma, it may come from changes in the definition of “permanent establishment.” The broader the definition of a permanent establishment, the less income qualifies for exemption from source tax by treaty. Further, the income that becomes taxable at source will be subject to tax on a net, rather than gross, income basis. But how and where should recipients of deductible expenditures be taxed?