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TREATY ENTITLEMENTS THROUGH THE LOOKING GLASS: CHANGING THE MEANINGS BUT NOT THE WORDS

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"When I use a word," Humpty Dumpty said in a rather scornful tone, "it means just what I choose it to mean – neither more nor less."

"The question is," said Alice, "whether you can make words mean so many different things."

"The question is," said Humpty Dumpty, "which is to be master – that's all."[*]

Introduction

In a number of earlier papers,[1] observations were made regarding principles underlying tax treaty provisions which restrict the classes of persons to whom tax treaty benefits are extended, including the principles underlying the fiscal domicile article,[2] subject-to-tax requirements of certain older treaties,[3] more modern provisions which in certain limited cases limit, but do not eliminate, treaty benefits to residents who are able to

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[*] Lewis Carroll, Through the Looking Glass (1871).

[1] Feingold, Limitation on Benefits, an Overview, Tax Review No. 123 (December 17, 1990), updated and revised in light of the limitation on benefits provision contained in the U.S.-Netherlands treaty in Feingold, Entitlement to Treaty Benefits: A Comparison of the Dutch and German Solutions, Tax Club (September 13, 1994).

[2] See, e.g., Article 4, U.S.-Switzerland treaty. Unless otherwise indicated, a reference to a provision of an income tax treaty is to a provision of the treaty currently in force. Compare Article 4, 1996 U.S. Model Income Tax Convention, 1 CCH Tax Treaties, ¶214 (hereafter "1996 U.S. Model treaty"), and Article 4, 1981 U.S. Model Income Tax Convention, 1 CCH Tax Treaties, ¶211 (hereafter "1981 U.S. Model treaty"), with Article 4, OECD Model Tax Convention on Income and Capital, updated April 29, 2000 (hereafter "2000 OECD Convention").

[3] See Article VIII(1), 1945 U.S.-U.K. treaty.

[4] See, e.g., Articles 12(8) and 13(6), U.S.-Netherlands treaty.

reduce home country tax rates below certain defined limits,[4] the so-called artiste clause,[5] as well as the more general limitation on benefits provisions incorporated in virtually all modern U.S. tax treaties.[6]

Much has happened after the earlier papers were written: On the treaty front, somewhat similar, but not identical, limitation on benefits provisions have been incorporated in many additional tax treaties. Broader derivative benefits provisions than were contained in the U.S.-Netherlands treaty have been incorporated in several treaties.[7] On the legislative front, section 7701(l),[8] enacted in 1993, broadly

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[4] See, e.g., Articles 12(8) and 13(6), U.S.-Netherlands treaty.

[5] Discussed in Feingold, Article 17 - the Artiste Clause - Time for Reconsideration?, Tax Club (January 20, 1999).

[6] See, e.g., Article 22, 1996 U.S. Model treaty. For an interesting discussion of whether the complexity of the various comprehensive limitation on benefits provisions will likely ensure their limited enforcement, see Loengard, A (Modest) Proposal to Reconsider the "Limitation on Benefits" Provision of U.S. Tax Treaties, in Essays on International Taxation at p. 275 (Herbert H. Alpert & Kees van Raad, eds)(Kluwer 1993).

[7] See and compare Article 23(5), U.S.-Ireland treaty, Article 22(4), U.S.-Denmark treaty, Article 24(2)(c), U.S.-Luxembourg treaty, and Paragraph 7 of the Revised Memorandum of Understanding regarding the income tax convention between Switzerland and the United States reflecting a mutual understanding between Switzerland and the United States regarding the application of the limitation on benefits provision identical to the provisions of Article 24(2)(c) of the U.S.-Luxembourg treaty, with Article 26(4), U.S.-Netherlands treaty. See also Article 12(5),U.S.-Ireland treaty (incorporating rules identical to Article 13(5) of the U.S.-Netherlands treaty).

[8] Unless otherwise indicated, all section references are references to sections of the Internal Revenue Code of 1986, as amended (the "Code").

delegates to Treasury discretion to promulgate regulations to recharacterize any multiple-party financing transactions as a transaction directly among any two or more of such parties where the Secretary determines that such recharacterization is appropriate to prevent avoidance of tax. In 1995, the so-called "conduit-financing" regulations were promulgated pursuant to section 7701(l),[9] engendering controversy regarding their legitimacy and reach, in light of their apparent conflict with benefits seemingly conferred by conflicting tax treaty provisions.[10] In 1997, sections 894(c)(1) and (2) were added to the Code. While literally applying only in the case of entities which are fiscally transparent under U.S. tax principles, its legislative history[11] endorsed regulations of much broader application that had been issued under section 894[12] which extend the situations in which treaty benefits may be denied under section 894(a) to entities which are not transparent under U.S. income tax principles but which are transparent under foreign law principles and (b) to entities which are transparent under U.S.

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9 Reg. §1.881-3.

10 See, e.g., Doernberg, Treaty Override by Administrative Regulation: The Multiparty Financing Regulations, 2 Fla. Tax Rev. 521 (1995); Guenther, Tax Treaties and Overrides: The Multiple-Party Financing Dilemma, 16 Va. Tax Rev. 645 (1997).

11 Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1997, at 250, 251 (1998).

12 Reg. §1.894-1(d) (the "final section 894(c) regulations").

13 Reg. §1.894-1(d)(1), applying the regulation to an entity which is fiscally transparent under either U.S. tax law,

tax principles but not under foreign law principles.[13] More recently regulations were proposed (Prop. Reg. §1.884-1(d)(2)(ii), 66 FR 12445 (February 27, 2001)) of a more questionable nature to deal with certain otherwise deductible payments made by so-called "domestic reverse hybrid entities," an issue specifically reserved in the final section 894(c) regulations. These legislative and quasi-legislative changes appear to announce new "interpretations" of existing tax treaties as having a much narrower universe of intended treaty beneficiaries than would appear to be the case under the literal terms of such treaties.

The courts also have had occasion to address issues relating to tax treaty entitlement, with mixed results.[14] For example, in rejecting the Service's position that, in accordance with section 861(a)(4) and the long-standing policy of the IRS as enunciated in Rev. Rul. 80-362,[15] royalties payable to a

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the law of the foreign jurisdiction in which the entity is based, or the law of the foreign jurisdiction in which the interest holder in the entity is resident, so that an entity which is not fiscally transparent for U.S. tax purposes may still be implicated by the regulation. See also Article 4(1)(d), 1996 U.S. Model treaty. See generally Blessing, Final Section 894(c)(2) Regulations, Tax Mgmt. Memorandum (July 20, 2000).

[14] See SDI Netherlands BV v. Commissioner, 106 T.C. 101 (1996) (hereafter "SDI"); Northern Indiana Public Service Co. v. Commissioner, 105 T.C. 341 (1995), aff'd, 115 F.3d 506 (7th Cir. 1997) (hereafter "Northern Indiana"); cf. Del Commercial Properties, Inc. v. Commissioner, T.C. memo. 1999-411, 78 T.C.M. 1183 (1999).

[15] 1980-2 CB 208.

third-country resident by a Dutch corporation not engaged in a U.S. trade or business and which were computed in part by reference to U.S. exploitation was in part U.S.-source income subject to withholding, the Tax Court in SDI may well have, possibly unintentionally, expanded U.S. tax jurisdiction in situations not covered by a provision such as Article 13(5) of the U.S.-Netherlands treaty, at least in cases where the conduit-financing regulations[16] might otherwise apply, a subject which will be explored below. On the other hand, Northern Indiana seemed, at least for a short while, to put an outside limit to what some may have thought to be the "irrational exuberance" of the Service[17] in applying Aiken Industries, Inc. v. Commissioner.[18] The extent to which the principles of Northern Indiana apply in light of the conduit-financing regulations remains to be resolved.[19]

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16 See Reg. §1.881-3(c), Example (10).

17 See, e.g., Rev. Rul. 84-152, 1984-2 C.B. 381; Rev. Rul. 84-153, 1984-2 C.B. 383; Rev. Rul. 87-89, 1987-2 C.B. 195.

18 56 T.C. 925 (1971), acq. 1972-2 C.B. 1 (hereafter "Aiken Industries").

19 See Rev. Rul. 95-56, 1995-2 C.B. 322 (rendering obsolete, inter alia, Rev. Ruls. 84-152, 84-153 and 87-89 in light of the conduit-financing regulations). See also FSA 19995002, 1999 FSA LEXIS 232 (Sept. 9, 1999) (implying a narrow reading of the conduit-financing regulations in the face of a contrary treaty provision).

Uniformity vs. Literalism

Certain of the more recent legislative and quasi-legislative changes appear to have as their purpose uniformity regarding interpretative issues relating to additional limitations placed on treaty benefit entitlements, regardless of the particular treaty language.[20] To be sure, the bases for certain of these "additional" limitations are neither new nor controversial. For example, few would argue that merely because a treaty resident qualifies under a detailed limitation on benefits provision contained in a tax treaty with the U.S. that income nominally payable to such resident must qualify for treaty benefits regardless of whether the resident is the "beneficial recipient" of such income as determined in accordance with the abuse of law principles of the laws of the source state. The problem arises where, as in the U.S., there may not be complete consensus as to the proper limitation to be placed on such principles of treaty limitation.[21] For example, under traditional notions of beneficial ownership, can a treaty recipient otherwise entitled to treaty benefits under a comprehensive limitation on benefits provision be disregarded as the beneficial owner of income payable to it where such recipient is not a sham, does not purport to act as an agent and earns a

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[20] Section 894(c)(1); Reg. §1.894-1(d)(4); Reg. §1.881-3(a)(3)(ii)(C).

[21] Compare Aiken Industries with Northern Indiana and SDI.

reasonable profit on the transaction? Would the answer be different if the interposition of the treaty resident in the transaction was motivated in part if not principally by tax considerations?[22] Even assuming, for the moment, that under the law prior to the issuance of the conduit-financing regulations the answer to the question posed were to be no, is it not possible for the U.S. to change its understanding of the law in a manner that would reach a different conclusion? Indeed, it has been argued that Article 3(2), the provision in most treaties that provides that, "unless the context otherwise requires," the definition of an otherwise "undefined" treaty term such as "recipient" is to be determined under the laws of the state seeking to impose the tax,[23] should be considered to refer to such law as it exists on the date of the application of the treaty, rather than the law as it exists on the date the treaty was signed or entered into force.[24] Acceptance of this principle without reservation may prove too much. Certainly, it should not be possible for a contracting state to change its interpretation of an undefined term in a treaty so substantially as to permit a complete change in the meaning of the treaty beyond the reasonable expectations of the parties without such change

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22 Compare Rev. Rul. 84-152, _supra_; Rev. Rul. 84-153, _supra_, _Northern Indiana_ and _Aiken Industries_, with Reg. §1.881-3.

23 See, _e.g._, Article 3(2), U.S.-Netherlands treaty.

24 See Commentary to Article 3(2), 2000 OECD Convention, ¶11.

becoming viewed as more than mere treaty interpretation.

This might suggest to some that there is perhaps some implied limitation on the ambulatory nature of Article 3(2). Others might argue that the limitation is not implied, but rather is express — that is, the "context" of the treaty, including for this purpose the reasonable expectations of the parties as manifested by the words they used and chose not to use, may preclude an interpretation of an undefined term of a treaty based on a changed interpretation of internal law which gives an entirely different meaning to the treaty provision sought to be interpreted beyond the reasonable expectations of the parties at the time the treaty was negotiated.[25] Rather, the argument might be made that such fundamental change to internal law definitions may change the results under a tax treaty only if they are "valid" treaty overrides.[26]

In the latter connection, subject to the proviso that a tax treaty may not impose a tax burden greater than imposed under the Code, under U.S. internal law a tax treaty and a provision of the Code are of equal footing.[27] To the extent possible, Code provisions are to be read as to give due regard to any

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25 See Id. At ¶¶12-13 ("a State shall not be allowed to make a convention partially inoperative by amending afterwards in its domestic law the scope of terms not defined in the Convention").

26 See Doernberg, supra.

27 Section 7852(d).

conflicting provision of a tax treaty.[28] As an important exception to the deference given to a tax treaty provision that conflicts with a Code provision, the courts have long held that a later enacted Code provision may override a contrary tax treaty provision, provided there is a clear indication that the Congress intended to do so.[29] By the same token, a treaty which comes into force after the enactment of a contrary Code provision ought to prevail over the contrary Code provision.

Are the Conduit-Financing Regulations to Be Considered Rules of Treaty Interpretation; and If So, are there Limitations in Their Application?

Section 7701(l) was enacted with effect from August 10, 1993. It grants considerable discretion to the Secretary of the Treasury to promulgate regulations "recharacterizing any multiple-party financing transaction as a transaction directly among any 2 or more of such parties where the Secretary determines that such recharacterization is appropriate to prevent avoidance of any tax." The legislative history of Section 7701(l) indicates that its purpose was to grant Treasury the

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28 Section 894(a)(1). Formerly, section 894(a) provided that income of any kind to the extent required by any treaty obligation shall not be included in gross income and shall be exempt from tax. For a discussion of whether the amendment made to section 894(a) by the Technical and Miscellaneous Revenue Act of 1988 intended any change in its meaning, see Tate & Lyle, Inc. v. Commissioner, 103 T.C. 656, 665 (1994), rev'd on other grounds, 87 F. 3rd 99, 96-2 USTC 50,240 (3d Cir. 1996).

29 Cook v. United States, 288 U.S. 102 (1933).

authority to promulgate rules for dealing with back-to-back financing and other equity arrangements similar to and even beyond those described in Aiken Industries.[30]

Aiken Industries involved the issue of whether interest paid to and received by a corporation resident in a treaty country was exempt from U.S. federal income tax and withholding tax pursuant to the applicable provisions of the treaty in question, where the treaty country corporation had a corresponding obligation to pay out the entire amount of interest it received. In Aiken Industries, the Tax Court held that the exemption from tax and withholding afforded under the treaty would not apply unless the recipient of the interest had beneficially received the interest paid to it by its U.S. affiliates. Furthermore, it held that where there was a corresponding obligation to pay out interest equal to the amount received, the recipient had no beneficial interest therein and therefore could not be the beneficial recipient. While the Service has sought to broaden the holding in Aiken Industries to situations in which the treaty country recipient of interest retained an income spread,[31] in Northern Indiana the Tax Court and the Court of Appeals for the Seventh Circuit refused to

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[30] See H.R. Conf. Rep. No. 213, 103d Cong., 1st Sess. 654-55 (1993), reprinted in 1993-3 C.B. 393, 532-33.

[31] See, Rev. Rul. 84-152, 1984-2 C.B. 381; Rev. Rul. 84-153, 1984-2 C.B. 383; Rev. Rul. 87-89, 1987-2 C.B. 195.

extend the doctrine to such a case.[32]

As noted, the legislative history of section 7701(l) suggests that Congress intended for Treasury to promulgate rules for implementing section 7701(l) that would apply in situations beyond the Aiken Industries holding. Of course, Congress had the power to enact a provision which provided for a broader application of the so-called Aiken Industries doctrine if it intended to do so. What is not clear is Congress' intention regarding how far Treasury could go in expanding on that doctrine. For example, it could be speculated that what Congress intended was for Treasury to adopt rules for applying the then-existing interpretation by the Service of the "law" regarding the application of the Aiken Industries doctrine, including the position of the Service as published in its rulings on the subject. Alternatively, it could be speculated that Congress intended to restrict Treasury from exceeding the bounds placed on the Service by the Courts. In either case, this is just speculation, since Congress did not spell out the standard it intended Treasury to use, raising an issue as to whether the

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[32] Cf. SDI, in which the court assumed a similar conclusion. But cf. Del Commercial Properties, Inc. v. Commissioner, T.C. Memo. 1999-411, 78 T.C.M. (CCH) 1183 (1999) (distinguishing Northern Indiana in a case where there was no business purpose for the interposition of the intermediate company, the intermediate company had no employees or operations and the parties at some point stopped making payments to the intermediate company and eliminated the income spread).

statute or its legislative history set out a sufficient standard for the delegation to Treasury.[33] Assuming an improper delegation is, however, risky business. Nevertheless, at least one commentator has suggested forceful arguments in support of that proposition.[34]

In addition to the question of whether the delegation by Congress in section 7701(l) was proper, the question must be considered whether the conduit-financing regulations as promulgated go beyond the scope of the Congressional delegation and therefore have no statutory basis. In the latter connection, it should be noted that the delegation authorized regulations in the context of multiple-party financing transactions, including those involving the use of equity. As noted earlier, it is not entirely clear that Congress intended to delegate authority to expand Aiken Industries beyond some reasonable bounds. Whether inclusion of the principles set forth in the published pronouncements of the Service on this subject met this test is at least questionable in light of Northern Indiana. However, it appears arguable that Congress intended to permit Treasury to promulgate rules which were similar to its holdings in Rev. Ruls. 84-152, 84-153 and 87-89.

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[33] Cf. Whitman v. American Trucking Associations, Inc., 121 S. Ct. 903 (2001); Synar v. United States, 626 F. Supp. 1374 (D.D.C. 1986).

[34] See Doernberg, supra note 10.

In addition, there is nothing in the statute or its legislative history which indicates that licensing arrangements were intended to be covered, yet the regulations as promulgated include licensing arrangements within the definition of financing transactions subject to the conduit-financing regulations.[35] Nonetheless, it appears arguable that the reference to Aiken Industries in the legislative history of the provision was intended to cover a wide variety of back-to-back arrangements beyond those that merely used capital, and that therefore the inclusion of licensing arrangements within the definition of covered financing transactions was within the scope of the authority delegated to Treasury.

When the Conduit-Financing Regulations Apply, in General

The regulations provide that where an intermediate entity in a financing arrangement is a "conduit entity," the Service (but not a taxpayer) may in its discretion determine that the participation of such entity in the arrangement is to be disregarded.[36]

Under the regulations, an intermediate entity is a conduit entity if the following three conditions are satisfied:

1. The participation of the intermediate entity in

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[35] Reg. §1.881-3(a)(2)(ii)(A)(3).

[36] Reg. §§1.881-3(a)(3) and 1.881-3(a)(2)(i)-(iii).

the arrangement reduces the tax imposed by section 881.

2. The participation of the intermediate entity is pursuant to a tax avoidance plan; and

3. Either the intermediate entity is related to the financing entity or the financed entity, or the intermediate entity would not have participated in the arrangement on substantially the same terms but for the fact that the financing entity engaged in the financing transaction with the intermediate entity.[37]

Interaction of the Regulations and Tax Treaty Provisions

It may be useful at this juncture to consider the interaction of the regulations with the applicable provisions of a treaty. To illustrate some of the issues we will analyze the regulations in light of certain of the provisions of the U.S.-Netherlands treaty (the "Treaty").

Article 13(1) of the Treaty provides an exemption from U.S. tax for royalties paid to and beneficially received by a resident of the Netherlands that is entitled to treaty benefits under the limitation on benefits provision of Article 26 (referred to herein as "BV"). Income exempt from tax pursuant to an applicable provision of an income tax treaty is not subject to

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[37] Reg. §1.881-3(a)(4).

[38] Reg. §1.1441-6; cf. Casanova v. Commissioner, T.C. 214 (1986).

withholding.[38]

Article 13(5) of the Treaty provides that except in certain limited cases royalties paid by a Dutch corporation to a non-U.S. person (referred to herein as "Limited") are exempt from U.S. tax. None of the enumerated exceptions contained in Article 13(5) permitting the United States to tax such royalties applies to royalties paid by a Dutch corporation, which does not maintain a permanent establishment in the U.S., to a non-U.S. person in circumstances where the royalties received by the Dutch corporation are a component part of an active conduct of a trade or business carried on in the Netherlands by the Dutch corporate payor.[39] Where the conditions for the application of Article 13(5) are present, a derivative benefit is accorded pursuant to Article 13(5) to the third-country resident receiving royalties paid by the Dutch corporation. As the Joint Committee on Taxation has stated, Article 13(5) has the effect of converting royalties which under the literal terms of section 861(a)(4) might otherwise be considered U.S.-source income into non-U.S.

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[38] Reg. §1.1441-6; cf. Casanova v. Commissioner, T.C. 214 (1986).

[39] See Article 13(5)(d), U.S.-Netherlands treaty; Department, Technical Explanation of the Convention Between the United States of America and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income Signed at Washington on December 18, 1992 and Protocol Signed at Washington on October 13, 1993, 3 CCH Tax Treaties ¶6121, at 36,584.

[40] Joint Committee on Taxation, Explanation of Proposed Income Tax Treaty (and Proposed Protocol) Between the United

source royalty income.[40]

As we have noted, if Article 13(1) of the Treaty were to apply to royalties beneficially received by BV, it would appear that BV would be entitled to an exemption from tax, in the absence of a permanent establishment, and therefore the withholding agent could have no obligation to withhold on payments to BV. We have also noted that if Article 13(5) of the Treaty were to apply, it would appear that Limited would also be entitled to an exemption from tax on the royalties it received from BV. By permitting the IRS to recharacterize the payments made to BV as having been made directly by the "withholding agent" to Limited without regard to the provisions of the Treaty, Treas. Reg. section 1.881-3(a)(3) may be read to be inconsistent with the application of the otherwise applicable Treaty provisions. As noted earlier, if the attempted override were contained in a later enacted Code provision, it would be given effect under U.S. law. And although duly promulgated Treasury Regulations would likely be considered part of the law, such law must of necessity take its authority from the Code provision which authorized it. Since in this case the Code provision, section 7701(l), was enacted prior to the Treaty becoming law, it does not appear that the treaty override could be given effect.

In the latter connection, we note that in promulgating

States and the Kingdom of the Netherlands, 3 CCH Tax Treaties ¶6119, at 36,456-57 (Oct. 26, 1993).

the conduit-financing regulations, the Treasury Department did not purport to override treaties.[41] Rather, Treasury states that the regulations purport only to set out Treasury's interpretation of the application of the abuse of treaty principles to certain types of transactions. As so read, it would seem as a general matter plausible to apply the principles of the regulations for purposes of treaty interpretation without delving into the issue of whether the regulations can be given effect as a legitimate exercise of the treaty override power of Congress in general, and in particular whether they could be read as overriding a provision of an applicable treaty. Moreover, it appears that Treasury's statement that the regulations were not intended to override an applicable treaty provision will likely be given considerable deference by a court construing whether the necessary intent for an override was demonstrated.

If one is to interpret the regulations as a tool of treaty interpretation rather than as a treaty override, one necessarily must confront the issue of whether the interpretation regarding entitlement to treaty benefits could pass muster in light of a detailed limitation on benefits provisions such as Article 26 of the Treaty and the equally detailed provisions of Article 13(5). Indeed, it may well be argued that the <u>context</u> of

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[41] Conduit Arrangements Regulations, T.D. 8611, Preamble, 1995-2 C.B. 286, 289.

these highly negotiated and technical provisions requires that entitlement to Treaty benefits be tested under these provisions alone, at least absent a case of nominee or agency similar to Aiken Industries.[42]

The Tax Reduction Requirement

Turning to the provisions of the conduit-financing regulations, the first requirement (i.e., tax reduction) is tested by comparing the aggregate tax imposed by section 881 in respect of the financing arrangement with the tax that would be imposed if the intermediate entity were disregarded (i.e., the tax that would apply if the withholding agent had paid royalties directly to Limited).

The regulations provide that this tax reduction requirement is not met in the case of licensing activities with respect to which a treaty resident intermediary is both a licensee and a sublicensor, because in the view of the Treasury Department, the onward payment of the royalty pursuant to the intermediary's obligations to a non-treaty-country licensor remains subject to U.S. federal income tax.[43] However, the regulations were promulgated prior to the decision in SDI, which

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[42] Cf. Treaty, Article 3(2); supra notes 24-26 and accompanying text. Regarding limitation on benefits provisions, see Doernberg, supra note 10.

[43] See Treas. Reg. section 1.881-3(e), Example (10).

by its holding casts doubt as to whether the payment of royalties by BV to Limited in our illustration could be considered as derived from U.S. sources and therefore subject to U.S. tax. If another court felt constrained to follow the decision in SDI, it appears such court might also view the tax reduction requirement as having been satisfied. In a situation involving a treaty which does not include a provision such as Article 13(5), SDI thus might have the effect of *expanding* U.S. tax jurisdiction.

Interestingly, the regulations were promulgated subsequent to the entry into force of the Treaty. The regulations do not specifically refer to Article 13(5) of the Treaty (which is a relatively unusual provision in U.S. treaties). Rather, the regulations provide that where the participation of a conduit entity is disregarded under the regulations, it is disregarded for purposes of applying any relevant income tax treaty. The regulations go on to state in such circumstances that:

> Accordingly, the conduit entity may not claim the benefits of a tax treaty between its country of residence and the United States to reduce the amount of tax due under section 881 with respect to payments made pursuant to the conduit financing arrangement. The financing entity may, however, claim the benefits of any income tax treaty under which it is entitled to benefits in order to reduce the rate of tax on payments made pursuant to the conduit financing arrangement that are recharacterized in accordance with [the

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44 Reg. §1.881-3(a)(3)(ii)(C).

conduit-financing regulations].[44]

Thus, if applicable in our illustration, the regulations would not permit BV to claim the benefits of the Treaty and in particular Article 13(1) of the Treaty. Literally, however, the regulations appear to permit Limited to claim the benefits of any treaty to which it is entitled. While it might be argued that the derivative benefit conferred by Article 13(5) of the Treaty is a benefit which could be claimed by Limited under the literal terms of the regulations, that argument is likely to fail: Where applicable, the regulations treat the payments made by the withholding agent to BV as having been made directly to Limited. A payment made directly to a third-country resident company is not entitled to any tax treaty benefit. Accordingly, it would appear that under the regulations the tax reduction requirement will be met in our illustration.

The Tax Avoidance Plan Requirement

As noted above, even if the tax reduction requirement were met, the Service would not be able to recharacterize the arrangements under the conduit-financing regulations unless the participation of the intermediate entity were pursuant to a tax avoidance plan. In this connection, the factors that are taken into account in determining whether the participation of an

44 Reg. §1.881-3(a)(3)(ii)(C).

intermediate entity is pursuant to a tax avoidance plan include (1) whether the participation of the intermediate entity significantly reduces the tax that otherwise would be imposed under section 881 (which we assume to be the case in our illustration); (2) whether the intermediate entity would have been able to "advance" the property to the financed entity without the "advance" by the financing entity (i.e., Limited) of the property to the intermediate entity (we assume a negative answer in our illustration); (3) the time period between the financing transactions (which we assume to be nil in our illustration); and (4) if the parties are related, whether the financing transaction occurs in the ordinary course of the active conduct of complementary or integrated trades or businesses engaged in by these entities.[45] Where the intermediate entity engages in sufficient business activity for it to be considered to be engaged in an active conduct of a trade or business in its country of residence, and thus entitled to treaty benefits under

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[45] Reg. §1.881-3(b)(2). Where the intermediate entity is related to one or both of the other entities, the regulations provide a presumption (which is rebuttable by the Service) that the participation of the intermediate entity is not pursuant to a tax avoidance plan if the intermediate entity derives the royalties in question in the active conduct of a trade or business within the meaning of section 954(c)(2)(A). Reg. §1.881-3(b)(3)(i) and (ii)(A); see Reg. §1.954-2(b)(6) and (d). It would appear, but is not entirely clear, that this presumption can apply where the intermediate entity receives royalties from a related party. Id.; see also Former Prop. Reg. §1.881-3(c)(3)(ii)(A), 1994-2 C.B. 880, 888.

a provision such as Article 26(2) of the Treaty, and where the income in question is attributable to that business, it would appear logical not to seek to apply the regulations to recharacterize the payments. However, under the regulations a positive result under this factor is not determinative.

There Must Be a Determination

As noted earlier, the conduit-financing regulations are not self-executing. Even if an intermediate entity meets all the tests for treatment as a conduit entity, if the Service does not make a determination that such entity is a conduit entity and that its participation should be disregarded, its presence in the arrangement will not be disregarded and the arrangement will not be recharacterized as an arrangement directly between the withholding agent and Limited. In such case, the withholding agent could have no withholding tax obligation on payments to BV that are otherwise entitled to an exemption afforded by treaty.

Withholding and Enforceability

Further, even if in a particular case the Service could successfully contend that the participation of the intermediary in the financing arrangement was pursuant to a tax avoidance plan, and the arrangement accordingly were recharacterized as a license from Limited to the withholding agent with royalty payments flowing directly between the withholding agent and Limited, such a result does not necessarily carry with it the conclusion that the withholding agent would have a liability for a failure to withhold on the license payments it made to BV.[46]

To be sure, a person required to deduct and withhold taxes under section 1441 but who fails to do so is liable for such tax together with any applicable penalties and interest.[47] However, with respect to a financing arrangement effected through an intermediate entity that qualifies as a conduit entity, a withholding agent will not be held liable for failure to deduct and withhold such taxes unless such person knew or had reason to know that the financing arrangement was a conduit financing arrangement.[48] This would mean that a withholding agent could be held liable for a failure to withhold only if it knew or had reason to know that the participation of the intermediary in the arrangements was pursuant to a tax avoidance plan under the standards noted above. In the latter connection, a withholding agent is considered to have reason to know if its knowledge of relevant facts or of statements contained in the withholding certificates (such as Forms 1001 or W8-BEN) or other documentation is such that a reasonably prudent person in the

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[46] Cf. Central de Gas de Chihuahua v. Commissioner, 102 T.C. 515 (1994); R. T. French Co. v. Commissioner, 60 T.C. 836 (1973) (raising but declining to decide the "tantalizing" issue of whether withholding could be required with respect to income deemed to have been paid under section 482). But cf. Rev. Rul. 92-85, 1992-2 C.B. 69 (applying withholding to a deemed dividend under section 304).

[47] Section 1461.

[48] Reg. §1.1441-7(f)(2)(i).

position of the withholding agent would question the claim for a reduction of the otherwise applicable withholding tax.[49]

The application of this standard is by no means clear. Read literally, given the strict liability which could flow from a failure to withhold, how could a well-advised reasonably prudent person not question the claim in all but the clearest cases? Related to this issue is the issue of whether a withholding agent must acquaint himself with the applicable law to be considered reasonably prudent, a standard which if applicable goes well beyond the standard for acceptance of withholding certificates.

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49 Reg. §1.1441-7(b)(2).

Are the Rules Interpretative?

As noted, the position of the U.S., insofar as the conduit-financing regulations are concerned, is that they do nothing more than incorporate existing U.S. tax principles regarding beneficial ownership, and are to be used as an interpretative tool. As such, they do not override any tax treaty provision. In many instances, the application of the conduit-financing rules will yield results similar to that which could have been anticipated under the case law. However, they may also be applied to situations in which under prior case law the treaty recipient would have been considered the beneficial recipient. To that extent the regulations appear to change U.S. tax law. The question to be resolved is whether such change may be given effect in circumstances where an intermediary qualifies for treaty benefits under the active conduct of a trade or business test of an applicable limitation on benefits provision, such as Article 26(2) of the Treaty. As noted above, while the regulations provide that the active conduct of a trade or business is certainly a factor to be taken into account in applying the rules, and in certain cases may create a presumption against their application, the regulations literally appear to permit a recharacterization even in such circumstances. If in such circumstances a recharacterization is sought by the Service, it may be possible to raise as a defense that the context of the treaty in question does not permit such result.

Interpreting Whose Law Governs in Article 4 Cases

In some cases, changes in U.S. law definitions which change the outcome of issues under tax treaties may give effect to the original intention of the parties and in other cases such changes may raise a whole host of additional issues. For example, few would argue with the notion that where undefined in a particular fiscal domicile article of a treaty, the term "partnership," insofar as such term is relevant for the determination of whether income has been beneficially received or derived by a resident,[50] should be defined by reference to whether the entity in question is a fiscal transparency under the law of the country of its purported "residence."[51]

Consider, for example, the case of an entity, "P," which is otherwise "resident" in a treaty country, "T." Assume P is considered a partnership for U.S. federal income tax purposes but is taxable as an entity under the laws of T and otherwise qualifies for the benefits of the U.S. treaty with T. Further assume that P has three interest holders, one a resident of T ("TR"), one a resident of a non-treaty country "X," and one a resident of the U.S. "U." Under a literal reading of the treaty fiscal domicile article of the type described, P would be considered a resident of country T for purposes of the U.S. tax

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50 See, e.g., Article 4(1)(a)(i), U.S.-U.K. treaty.

51 Cf. Article 4(1)(e), 1996 U.S. Model treaty; Reg. §1.894-1(d).

treaty with T, since its income would be taxable "in its hands" as the income of a resident of country T. Thus, income payable to P that would otherwise be subject to U.S. tax would be entitled to tax treaty benefits. Of course, U, as a U.S. resident with respect to which tax treaty benefits do not apply, would remain subject to U.S. tax on his distributive share of P's income. What about X? Under U.S. tax principles, X must include his distributive share of P's income. X, not being a resident of a country with which the U.S. has a treaty, would not be entitled to any tax treaty benefits. Treatment of P as a resident of T for purposes of the U.S. treaty with T would appear to provide a derivative treaty benefit to X, a person not otherwise entitled to tax treaty benefits. The result in the above example would be the same if P were not treated as a partnership for U.S. tax purposes, except of course, that U would not be required to include in his income his distributive share of P's income. Note, that, except for U, the result remains the same regardless of the treatment of P as a transparency under U.S. law.

Suppose, however, that under U.S. law P were not regarded as a transparency, but under the laws of T it were so regarded. It is not immediately obvious that the usual treaty interpretation rules would permit an entity which is not treated as a fiscal transparency under U.S. law to be so treated for

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[52] Cf. Article 4(1)(a)(i), U.S.-U.K. treaty (applicable

purposes of a treaty.[52] Indeed, under the usual rules,[53] an undefined term, in this case the term "partnership," would be defined by reference to the laws of the state seeking to apply the convention, which, insofar as is relevant here, would mean the U.S. Of course, adoption of U.S. notions of fiscal transparency is not particularly relevant if such notions differ under foreign law, an issue which no doubt comes up more frequently given the elective nature of the fiscal transparency provisions of U.S. law.[54]

Adoption of a U.S. definition which looks to foreign law notions of transparency[55] for purposes of the fiscal domicile article would, however, appear to give rise to a better result,[56] even if not supported by a literal reading of Article 3(2). Nonetheless, the adoption of a special definitional rule under U.S. law applicable only in the treaty context may raise questions concerning whether the use of such definitional rules is a valid application of Article 3(2). Under such a rule, the term "partnership" is defined by reference to foreign law wherever relevant for tax treaty purposes, but otherwise apparently would be determined by reference to U.S. law. As

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"in the case of a partnership"), Section 894(c)(1) and (2).

[53] See Article 3(2), 1996 U.S. Model treaty; cf. Reg. §1.894-1(d).

[54] See Reg. §301.7701-3.

[55] See Reg. §1.894-1(d).

[56] See generally Smith, Tax Treaty Interpretation by the Judiciary, 49 Tax Lawyer 845 (1996).

noted above, as applied to the definitional problem in Article 4, the rule would provide for a good faith result probably consistent with the intention of the parties.[57]

A more satisfying basis for the adoption of foreign law principles for purposes of determining fiscal transparency in the context of Article 4 is that such approach is consistent with providing treaty benefits to persons who are resident and denying such benefits to persons who are not. Since the term "resident" is defined as a person who under the laws of the other state is subject to tax therein by reason of residence, domicile, nationality or place of management or place of incorporation,[58] the laws of the other state must necessarily determine whether a person is subject to tax on the income in question. If under such laws, an interest holder otherwise resident in the other state is taxable on the income of an entity whether or not distributed, it would appear that such income has been derived by a person who is a resident of the other state. Under this approach, the adoption of foreign law principles of transparency appears consistent with the definition of resident under Article 4. Stated differently, the operative treaty term being interpreted is the term "resident," rather than "partnership," and "resident" is a term which _is_ defined in the treaty. As a

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57 See generally Smith, _supra_ note 56.

58 See, _e.g._, Article 4(1)(a), U.S.-Switzerland treaty.

result, Article 3(2) has no application. Unfortunately, this approach reads out of the operative language of those treaties that specifically refer to partnerships the phrase "in the case of a partnership." Moreover, given that the regulations that adopt this principle[59] are effective only with respect to payments made on or after June 30, 2000,[60] it seems that the U.S. view is that a different interpretation might apply for earlier payments.

In any event, this analysis gets us only half the way home: we still must deal with the entity which, for purposes of our simple illustration, we will assume will not be treated as a transparency under "traditional check-the-box" U.S. law but will be treated as a transparency under foreign law, i.e., the law of the residence of the interest holders. Furthermore, we will assume that such entity is the beneficial recipient of U.S.-source income which absent treaty protection would be subject to U.S. tax at a 30% rate. The special rule contained in Reg. §1.894-1(d)(1) operates to the extent an entity is transparent for foreign tax purposes and its income is includible as the income of an interest holder whether or not distributed, but apparently only to the extent such interest holder is entitled to a reduced rate of tax on such income pursuant to the

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59 Reg. §1.894-1(d).

60 Reg. §1.894-1(d)(6).

provisions of a tax treaty to which such interest holder is entitled to benefits as a resident. The special rule literally does not explicitly ignore such entity for U.S. tax purposes. Thus, an entity may be both regarded in part and treated as a transparency in part.[61]

Payments Made by a Domestic Reverse Hybrid Entity -- a Definitional Dilemma

While a more detailed analysis of the regulations proposed on February 27, 2001[62] regarding payments made by so-called "domestic reverse hybrid entities" is beyond the scope of this paper, it is worth noting at least certain of the definitional and interpretative issues which they appear to raise.

Where applicable, the proposed regulations would recharacterize as a dividend, for all purposes of the Internal Revenue Code and any applicable income tax treaty, a portion[63] of the otherwise deductible payments (for example, interest) made by a U.S. entity that is regarded as a corporation for U.S. federal

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[61] It should be noted that if rules of treaty interpretation similar to those provided in Reg. §1.894-1(d) were to be applied by a treaty partner, an S corporation, all the shares of which were owned by a nonresident U.S. citizen, would not be entitled to tax treaty benefits.

[62] Prop. Reg. §1.894-1(d)(2)(ii).

[63] Generally, limited to the amount of dividends received by the domestic reverse hybrid entity from an 80% or more owned U.S. corporation.

income tax purposes but treated as a transparency under foreign law (*i.e.*, a "domestic reverse hybrid"), but only if a reduction in the "U.S. withholding tax rate" would be allowed under an applicable treaty provision but for such recharacterization. Thus, for example, if a domestic reverse hybrid entity ("D") receives a dividend from its wholly-owned subsidiary ("S") and pays interest to a related foreign entity ("T") which is considered a resident of a treaty country ("A"), and the applicable treaty between the U.S. and A exempts interest from U.S. tax, but reduces the rate of U.S. tax on dividends to, for example, 5%, and if under the laws of A, D were treated as a transparency, then all or some portion of the interest paid to T would be treated as a dividend subject to the 5% withholding tax applicable to dividends under the applicable U.S. tax treaty with A. Moreover, in such case D would be denied a deduction for the interest recharacterized under the proposed regulations. If, in the above illustration, the U.S. withholding tax rate applicable to interest was not less than the applicable U.S. withholding tax applicable in the case of dividends, the provision would not apply. However, it is unclear whether a domestic reverse hybrid entity could seek to avoid the nondeductibility of the payment it made simply by having the recipient concede the higher rate of U.S. withholding tax applicable to dividends.[64]

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64 *Cf.* Prop. Reg. §1.894-1(d)(2)(ii)(5).

Several preliminary observations are in order: First, although the provision appears to be promulgated under section 894(c), as noted earlier, section 894(c)(1) does not literally apply, and section 894(c)(2) literally authorizes the issuance of regulations only in the case of an entity which is treated as a transparency for U.S. tax purposes. Since by definition a domestic reverse hybrid entity is <u>not</u> treated as a transparency for U.S. tax purposes, the statutory basis for the proposed regulations does not appear to be either section 894(c)(1) or (2). Rather, it appears that consistent with the legislative history of section 894(c), the proposed regulations have been proposed as interpretive regulations under section 894(a) and as such would provide an interpretation concerning the "due regard" that should be given to the application of a treaty obligation to a taxpayer.

Pointing to section 894(a) as the basis for the proposal is not entirely satisfying, however, at least insofar as the proposal would affect the tax consequences of a U.S. corporation with respect to which no tax treaty benefits could apply by virtue of the savings clause contained in each U.S. tax treaty. Indeed, the proposed regulations do not purport to deny a <u>tax treaty benefit</u> to the U.S. entity; rather, they purport to deny such U.S. entity a deduction to which it would otherwise be allowed, possibly in violation of the nondiscrimination clauses of most tax treaties.[65] Nor does there appear to be any express indication that the statute, which the proposed regulations purport to interpret, intends to override conflicting tax treaty provisions. However, one may not need to consider whether the provision is in violation of an applicable nondiscrimination clause where, as in this situation, the disallowance of the deduction does not appear to have any statutory basis.[66]

Putting aside for the moment the issue of deductibility of the recharacterized payment, it is worth noting that the recharacterization under the proposed regulations of what would otherwise be characterized as interest under an applicable interest article of a treaty cannot be supported by ordinary rules of treaty interpretation. Indeed, Article 3(2) could not be applicable as the context would appear otherwise to require.[67]

Apparently ignoring this limitation, the proposed regulations start out by providing generally that a payment shall

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[65] See, e.g., Article 24(3), 1996 U.S. Model treaty; Article 24(3), U.S.-Austria treaty; Article 24(4), 2000 OECD Convention. The Commentary to Article 24(4) of the 2000 OECD Convention, after noting that the provision is designed to end a particular form of discrimination, states: "it is however open to a Contracting State to modify these provisions in bilateral conventions to avoid its use for the avoidance purposes." Paragraph 55 to Commentary on Article 24(4), 2000 OECD Convention (emphasis added).

[66] Compare section 163(j); section 267(a)(3); Tate & Lyle, Inc. v. Commissioner, 87 F.3d 99, 96-2 U.S.T.C. 50,340 (3d Cir. 1996).

[67] While without doubt, amounts purporting to be interest may be recharacterized under so-called thin capitalization rules and such recharacterization would be upheld for purposes of applying a treaty, it is less than clear that amounts which are concededly interest under general U.S. tax principles may be so recharacterized for treaty purposes. See also the discussion regarding the application of Article 24(4), 2000 OECD Convention.

be characterized under U.S. law.[68] The proposed regulations then go on to provide as an important exception to this rule the operative rules discussed above. The effect of the operative rules is that in certain contexts (i.e., when the provision applies) U.S. law characterization follows the characterization of the payment for foreign law purposes in the same manner as if the dividend payment made by the domestic reverse hybrid's U.S. subsidiary were made by such subsidiary directly to the treaty resident, in effect ignoring the domestic reverse hybrid entity. However, unlike the case of the conduit-financing regulations, the underlying subsidiary making the dividend payment to the domestic reverse hybrid entity is not treated as having made that payment directly to the treaty resident. Rather, it appears that the domestic reverse hybrid entity remains the payor and is the withholding agent with regard to such recharacterized payment.

Finally, as noted above, the amount of the payment which would be recharacterized under the proposed regulations is not treated as an ordinary section 301 distribution, but is required to be treated as a dividend, literally without regard to whether the domestic reverse hybrid entity has current or accumulated earnings and profits. Since the examples assume there would be current or accumulated earnings and profits, it is not clear whether this was intended.

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68 Prop. Reg. §1.894-1(d)(2)(ii)(A).

Uniformity vs. Lack of Uniformity.

Regardless of how one views the interaction of the conduit-financing regulations and the hybrid rules under section 894 with tax treaties, it is apparent that it is their intention to provide for uniformity in treaty application regardless of the potentially relevant and in certain cases different treaty language.[69] On the other hand, there are indications of an intention not to provide for uniformity of meaning even as regards identical terms of substantially similar tax treaty provisions.

Of course, identical terms of substantially identical treaty provisions may be defined differently in the various

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[69] See, e.g., Reg. §§1.894-1(d)(4) and 1.881-3(a)(3)(ii)(C). Note that the interpretive rule of Reg. §1.894-1(d) applies only to payments on or made after June 30, 2000. Reg. §1.894-1(d)(6); cf. Linkletter v. Walker, 381 U.S. 618 (1965) (announcing the prospective-only application of a Constitutional interpretation).

[70] See and compare the definition of "substantially and regularly traded" in Article 22(6)(g), U.S.-Denmark treaty, Article 9(a)(i), 1997 Protocol to U.S.-Ireland treaty and Article 24(2)(d), U.S.-Luxembourg treaty, with Article 26(8)(f), U.S.-Netherlands treaty. As an additional illustration, the term "recognized stock exchange," is defined similarly in virtually all U.S. tax treaties having a modern limitation on benefits provision, except that in the case of the Netherlands and Luxembourg treaties with the U.S. such term does not apply to closely-held companies. See Article 26(8)(e), U.S.-Netherlands treaty; Article 24(8)(b), U.S.-Luxembourg treaty.

[71] See, e.g., Article 22, U.S.-Turkey treaty; Article 30, U.S.-France treaty; Article 16, U.S.-Austria treaty; Article 12A, U.S.-Belgium treaty.

treaties themselves,[70] or not at all.[71] As noted, a term not defined in a treaty generally will have the meaning assigned to that term under the (tax) laws of the country seeking to impose its tax, unless the context otherwise requires.[72] For this purpose, the "context" includes the treaty, its protocols and any written mutual agreements or understandings relating thereto. While not entirely free from doubt, the context should not include unilateral Service or U.S. Treasury pronouncements which do not rise to the level of context as defined narrowly. Absent such contextual proscription, an undefined treaty term may be defined by reference to U.S. tax law. Where under U.S. tax law there is more than one definition of the same term, it would appear that the definition to be used is the one which is most

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[70] See and compare the definition of "substantially and regularly traded" in Article 22(6)(g), U.S.-Denmark treaty, Article 9(a)(i), 1997 Protocol to U.S.-Ireland treaty and Article 24(2)(d), U.S.-Luxembourg treaty, with Article 26(8)(f), U.S.-Netherlands treaty. As an additional illustration, the term "recognized stock exchange," is defined similarly in virtually all U.S. tax treaties having a modern limitation on benefits provision, except that in the case of the Netherlands and Luxembourg treaties with the U.S. such term does not apply to closely-held companies. See Article 26(8)(e), U.S.-Netherlands treaty; Article 24(8)(b), U.S.-Luxembourg treaty.

[71] See, e.g., Article 22, U.S.-Turkey treaty; Article 30, U.S.-France treaty; Article 16, U.S.-Austria treaty; Article 12A, U.S.-Belgium treaty.

[72] Article 3(2), 2000 OECD Convention. For an excellent discussion regarding Article 3(2), see Avery Jones, et al., The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model, 1984 British Tax Review 14.

[73] See Commentary to Article 3(2), 2000 OECD Convention ¶13.1.

analogous.[73] For this purpose, U.S. law includes duly enacted statutory provisions and applicable regulations promulgated thereunder, as well as case law which interprets the foregoing. Published rulings and other pronouncements by the Service, including notices, may or may not constitute U.S. law for this purpose. However, if the meaning assigned the term defined therein is one which the taxpayer seeks to have control the issue, it appears more likely that a court would view such statement of the law as controlling.

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[73] See Commentary to Article 3(2), 2000 OECD Convention ¶13.1.

Sometimes an otherwise undefined term is defined in a U.S. Treasury Technical Explanation of a treaty (a "Technical Explanation").[74] If the definition of such term in the Technical Explanation reflects a mutual agreement,[75] then such definition would appear to be a part of the treaty context, in which case a different definition under U.S. law should not be permitted, since the "context would otherwise require."[76] However, if a definition of a term in a Technical Explanation reflects merely Treasury's unilateral interpretation of that term, although such interpretation should be accorded some weight in determining the applicable U.S. tax law definition of that term, in such case the definition contained in the Technical Explanation may not be controlling, particularly if there are other definitions of the same term contained in Technical Explanations of other treaties which definition is not part of the treaty context. Thus, an issue of some importance where there are other possible U.S. tax law definitions of an undefined term in a treaty is whether a definition contained only in a Technical Explanation reflects a mutual agreement or a unilateral interpretation.

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[74] See infra, note 86; see generally, Vogel, Double Tax Treaties and their Interpretation, 4 International Tax and Business Lawyer, Vol. 1, at p. 36 (1986), regarding the effect of Treasury Technical Explanations.

[75] See Article 25(3), 2000 OECD Convention.

[76] See, e.g., Article 3(2), U.S.-Netherlands treaty which makes this explicit.

Resolution of this issue is not made easier simply because a particular Technical Explanation states, as is often the case, that the Technical Explanation reflects the policies behind the particular treaty as well as understandings reached with respect to the application and interpretation of the treaty. Nor is the issue necessarily resolved simply because the Technical Explanation was provided to the treaty partner.[77] Silence on the part of the other country when confronted with the text of the Technical Explanation does not necessarily mean acquiescence, although it may be some evidence of it. However, it does not appear that mere silence should rise to the level of a mutual agreement[78] absent some manifestation of the intention of the parties to that effect. To avoid any ambiguity on the issue, such intention should be reflected in some written bilateral pronouncement such as a memorandum of understanding.

Another issue of some import is whether a taxpayer may obtain the benefit of a more liberal definition accorded a term under U.S. domestic tax law than the definition of that term in a treaty or its context. In the latter connection, it is axiomatic that a tax treaty may not impose a less advantageous tax result on a taxpayer than the result under the Code. On the other hand,

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[77] See, *e.g.*, U.S. Treasury Technical Explanation of the U.S.-Switzerland treaty, 4 CCH Tax Treaties ¶9147 at 42,069 (last paragraph of introduction).

[78] See Article 25(3), 2000 OECD Convention.

it seems that there should be no proscription against limiting a benefit afforded under a tax treaty in any manner that the contracting parties may determine, including the incorporation of a narrow definition of a term, the fulfillment of the definition of which is necessary to be entitled to the treaty benefit, even though outside the context of the treaty such term could be defined more broadly under U.S. domestic tax law. In that case, the failure to meet the narrow treaty definition would have the permitted effect of precluding the taxpayer from qualifying for the particular treaty benefit; it would not have the proscribed effect of imposing a greater tax burden than otherwise would be due absent the treaty.

Publicly-Traded Exception, a Lack of Uniformity with Respect to Identical Terms

With this background in mind, it is instructive to examine the text and Technical Explanations of each of the U.S. income tax treaties which contain a limitation on benefits provision that treats a resident company as qualifying for treaty benefits if such company's principal class of shares is a class of shares in which there is "substantial and regular trading" on a "recognized stock exchange."[79] In virtually every one of these treaties, the term "recognized stock exchange" is defined to

[79] See the attached tables for a listing of such treaties.

include, inter alia, the NASDAQ. However, in the U.S. treaties with the Netherlands and Luxembourg, the NASDAQ (as well as certain exchanges other than a stock exchange registered with the U.S. Securities and Exchange Commission as a National Securities Exchange (e.g., the NYSE)) is specifically excluded from being considered a recognized stock exchange with respect to a so-called "closely-held company," a term defined as a company of which 50% or more of the principal class of shares is owned by persons other than qualified persons or EU residents, each of whom beneficially owns 5% of such shares for more than 30 days during a taxable year.[80]

Research has found no other U.S. treaty which so limits the definition of recognized stock exchange. Absent such a limitation contained in a treaty that defines recognized stock exchange or a provision of a later-enacted statute which is both inconsistent with the treaty definition and intended to override it, it appears that a closely-held company exception to the definition of recognized stock exchange should not be read into a tax treaty.[81] Nor does it appear likely that even if an interpretative regulation which provided a contrary rule for

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[80] See Article 26(8)(e), U.S.-Netherlands treaty; Article 24(8)(b), U.S.-Luxembourg treaty.

[81] Cf. Senate Foreign Relations Committee Report on the U.S.-Luxembourg treaty, 3 CCH Tax Treaties ¶5752, at 35,199-83.

[82] No such regulation appears to exist at the present time. But cf. The discussion infra regarding "regular trading."

purposes of application to treaties were to be promulgated,[82] that such interpretation would be given effect; indeed, the context would appear to require otherwise. One can only speculate that the closely-held limitations to the term "recognized stock exchange" contained in the U.S. tax treaties with the Netherlands and Luxembourg have been incorporated for policy considerations relevant only to these two treaties; however, there is no indication in any of the official material relating to these treaties that special policy considerations were the basis for the difference, let alone what those policy considerations might be. Possibly, the concept of the closely-held exceptions had been borrowed from the limitation in the branch profits tax ("BPT") regulations[83] to the term "regularly traded," which as noted below was introduced in 1992. In light of the fact that the U.S. official negotiating position regarding this issue is to exclude such limitation, there does not appear to be any policy consideration that would suggest a basis for the discriminatory treatment against the Netherlands and Luxembourg. Nevertheless, the difference in definition remains.

As another illustration, the term "regularly traded" is

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[82] No such regulation appears to exist at the present time. But cf. The discussion infra regarding "regular trading."

[83] Reg. §1.884-5(d)(4).

defined in the text only of the U.S. tax treaties with Luxembourg, the Netherlands, Denmark and Ireland. In the case of the U.S. tax treaties with the Netherlands, Denmark and Ireland the regularly-traded test is met for the principal class of shares if two conditions are met: First, there must be aggregate trading with respect to such class at least equal to 6% of the average outstanding shares in the previous year. This aggregate trading requirement is waived, however, in the case of the U.S.-Ireland treaty with respect to a class of shares which was not listed on a recognized stock exchange for the previous year.[84] No such similar waiver appears to exist with respect to the U.S. tax treaties with the Netherlands, Denmark or Luxembourg. Thus, literally, under the U.S. tax treaties with Luxembourg, the Netherlands and Denmark, it appears that the publicly-traded exception cannot apply to a company in the first year in which its shares are listed. This limitation does not exist under the U.S. treaty with Ireland, nor does it exist under the branch profits tax regulations. No policy reason is given for the different rules.

A second condition applies in the case of the U.S. tax treaties with Ireland, Denmark and the Netherlands, but not in the case of the U.S.-Luxembourg treaty. In order to satisfy this condition there must be more than de minimis trading in the class

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84 See Protocol to U.S.-Ireland treaty, ¶9(a)(i)(B).

in each calendar quarter of the year under the U.S.-Denmark and U.S.-Ireland treaty and more than de minimis trading every month under the U.S.-Netherlands treaty. Literally, under this test, a company cannot know whether it would qualify for a year until the last quarter or last month, which raises issues concerning whether a company which is relying solely on the publicly-traded safe harbor may provide an ownership certificate to a withholding agent before the last quarter or last month, as the case may be, of any year or whether a withholding agent that accepts such certificate before there is certainty that the test will be met, will meet the "know or reason to know" test described above. Absent receipt of such a certificate upon which a U.S. withholding agent may rely, a U.S. withholding agent who fails to withhold would do so at its peril. By contrast, the de minimis trading test under the analogous branch profits tax regulations is met if there has been more than de minimis trading on at least 60 days during the year; and the aggregate trading test (10% under the branch profits tax regulations) is met if there is sufficient trading during the year.[85] Thus, in any case where the regularly traded requirement of a tax treaty is to be determined under U.S. internal law (see discussion, infra), it would be possible to qualify under the publicly-traded exception for the first year of such trading and it is likely that a treaty

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[85] Reg. §1.884-5(d)(4).

resident would know if it qualified under the de minimis test much earlier in the year.

Having noted the different definitions accorded identical terms in different treaties with respect to the publicly-traded definition contained in the four treaties noted above, it should be noted that 33 additional United States treaties, while containing a publicly traded provision, do not contain a definition of regularly traded in the treaty itself. However, in three of these cases, the Technical Explanations of the treaties provide a specific definition;[86] and in still others the Technical Explanation incorporates the U.S. internal law BPT rule with an important exception.[87]

At this juncture, it might be useful to note that every one of the treaties which does not provide a specific definition of regularly traded contains a provision similar to Article 3(2) of the 2000 OECD Model Convention. As has been noted, such a

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[86] U.S. Treasury Technical Explanation of U.S.-Estonia Treaty, Art. 22, 2 CCH Tax Treaties ¶2812, at 25,873; U.S. Treasury Technical Explanation of U.S.-Latvia Treaty, Art. 23, 3 CCH Tax Treaties ¶5512, at 34,781; U.S. Treasury Technical Explanation of U.S.-Lithuania Treaty, Art. 24, 3 CCH Tax Treaties ¶5562, at 34,981.

[87] U.S. Treasury Technical Explanation of U.S.-South Africa Treaty, Art. 22, 3 CCH Tax Treaties ¶8245, at 40,217-52; U.S. Treasury Technical Explanation of U.S.-Switzerland Treaty, Art. 22, 3 CCH Tax Treaties ¶9147, at 42,069-54 U.S. Treasury Technical Explanation of U.S.-Thailand Treaty, Art. 18, 3 CCH Tax Treaties ¶9445, at 42,525-43; U.S. Treasury Technical Explanation of U.S.-Venezuela Treaty, Art. 17, 3 CCH Tax Treaties ¶11,152 at 44,999-48.

provision means that where a treaty does not provide a specific definition to the term "regularly traded," the definition of that term will ordinarily be determined under U.S. internal law. Unfortunately, U.S. internal law provides several different definitions of publicly traded.[88] Acting on a clean slate, a court would have to determine which of these conflicting definitions should be used to determine the meaning of the term for tax treaty purposes. Although there is no reported case which has had occasion to address this issue in the context of the publicly traded exception, the IRS appears to take the view that in the absence of a mutual understanding to the contrary, the applicable U.S. internal law rule will be the rule under the BPT.[89]

The BPT rule provides that for a class of shares to be regularly traded there must be more than de minimis trading on each of 60 (not necessarily consecutive) days during the testing year with respect to such class and that there must be aggregate trading of at least 10% of the average outstanding shares in that class during such year.[90] In 1992, the regulations were amended to further limit the publicly-traded definition contained therein. Under the regulations as amended, a class of shares

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88 See and compare Reg. §§1.884-5(d)(4), 1.897-9T(d), 1.367(a)-1T(c)(3) and 1.1296(e)-1(b).

89 Tech. Adv. Mem. 96-39-010 (June 13, 1996).

90 See Reg. §1.884-5(d)(4).

will not be viewed as regularly traded regardless of the amount of actual trading if more than 50% of such class is owned by persons who each own at least 5% of such class. This rule was not in effect when certain U.S. treaties which have no treaty definition of regularly traded came into force (e.g., the U.S.-Belgium treaty). Furthermore, the amendment is clearly a change in U.S. law. This raises the issue of whether in interpreting the regularly-traded requirement of a tax treaty that has no treaty definition of that term, and absent some clear understanding to the contrary, the closely-held limitation contained in the BPT regulations would be read into the treaty.

Significantly, the U.S. Treasury has taken the view in its Technical Explanation of the U.S. tax treaties with certain countries in which there is no treaty definition of regularly traded that it had reached an understanding regarding the definition of regularly traded which varies from the rule contained in the branch profits tax provisions noted above. Thus, e.g., the Technical Explanations of the U.S. treaties with Switzerland, South Africa, Thailand and Venezuela provide that while generally the BPT definition of regularly traded will obtain for purposes of that treaty, the closely-held limitation will not.[91] The question arises whether the exclusion of the limitation reflects a mutual understanding applicable only to

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91 See *supra* note 87.

those treaties with respect to which such understanding has been reached, or whether the exclusion reflects the U.S. interpretation to be used more generally, including with respect to treaties such as the U.S.-Belgium treaty. In any event, as in the case of the Technical Explanation of the 1996 U.S. Model treaty, under the aforementioned treaties, if one passes both the de minimis and 10% aggregate trading tests for a year on one or more recognized exchanges, including NASDAQ, the test is met for such year without regard to whether the company in question is closely held.

The Technical Explanations of the U.S. treaties with Estonia, Latvia and Lithuania indicate that with respect to such treaties there is an understanding concerning the regularly traded definition which provides for a 6% aggregate trading test to be met during the year (not the previous year) as well as the de minimis test in each of 60 days during the year (as is the case under the BPT). There is no closely-held exception under these rules. Unlike the case of the U.S.-Luxembourg treaty, the regularly-traded definition under these treaties literally can be met for the first year of trading; and as in the case of the rules under U.S. internal law, the de minimis test can be met much earlier than under the U.S.-Netherlands treaty. Note that this understanding provides rules which combine certain of the rules for regularly traded contained in U.S. tax treaties which have specific definitions that vary with the BPT regulations with other rules contained in the BPT regulations.

While it is possible for the differing rules regarding the definition of identical terms under different tax treaties to be explained on the basis of policy considerations, it is unclear what these considerations might be, particularly regarding whether limitations should or should not be applied to the definition of regularly traded or recognized stock exchange under one treaty but not under others with respect to closely-held companies. Nor is it apparent why the test for determining regular trading is to be determined by reference to prior year trading for some treaties but not others. The differences obviously cannot be explained on the basis of treaty interpretation, nor do policy considerations appear to be a logical place to look for answers. Looking to the language of each treaty for evidence of what the parties intended will inevitably not provide the answer.

Rather, one must look for announcements of understandings (presumably mutual) in places where one might not expect them to be. In the case of the numerous treaties that have no treaty language which would justify a different meaning, one must either accept that Treasury's announcement in its Technical Explanation of the mutually agreed understandings is correct, or question the definition provided by Treasury. However, if one were to question the definition provided by Treasury, it is unclear what the default definition would be. Perhaps, then, Treasury's view is that a treaty term "means just what [Treasury] choose[s] it to mean — neither more nor less."

Treasury, like Humpty Dumpty, "can make words mean so many different things."[92]

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[92] Lewis Carroll, Through the Looking Glass (1871).

(*Cont'd.*)

TABLE 1:

LIMITATION ON BENEFITS – "REGULARLY TRADED" PROVISION

Country	Date Signed	Treaty	Tech. Expl.	Comments
Australia	82	No	No	
Austria	96	No	No	
Barbados	84	No	No	
Belgium	70	No	No	Limitation on Benefits Article was added by Article 3 of supplemental protocol signed in 1987 and entered into force in 1989.
Canada	80	No	No	
China	86	No	No	
Cyprus	84	No	No	
Czech	93	No	No	
Denmark	99	**Yes**		1.) Other than de minimis quantities each quarter; and 2.) Aggregate number of shares of that class traded during previous taxable year is at least 6 % of the average number of shares outstanding in that class during that taxable year.
Estonia	98	No	**Yes**	1.)More than de minimis quantities on at least 60 days; and 2.) Aggregate number of interests in the class traded during the year is at least 6% of the average number of interests outstanding during the year.
Finland	89	No	No	
France	94	No	No	
Germany	89	No	No	
India	89	No	No	
Indonesia	88	No	No	
Ireland	97	**Yes**		1.) Other than de minimis during every quarter; and 2.) Aggregate number of shares of the class traded during the previous fiscal year is at least 6% of the average number of shares outstanding in that class during that taxable year. If not listed in previous fiscal year, shares considered to have satisfied second requirement.
Israel	75	No	No	
Italy	84	No	No	
Kazakhstan	93	No	No	

TABLE 1

(Cont'd.)

Latvia	98	No	**Yes**	1.) More than de minimis quantities on at least 60 days during taxable year; and 2.) Aggregate number of interests in the class traded during the year is at least 6% of the average number of interests outstanding during the year.
Lithuania	98	No	**Yes**	1.) More than de minimis quantities on at least 60 days during taxable year; and 2.) Aggregate number of interests in the class traded during the year is at least 6% of the average number of interests outstanding during the year.
Luxembourg	96	**Yes**		Aggregate number of shares of that class traded during the previous taxable year is at least 6% of the average number of shares outstanding in that class during that taxable year. Closely held company traded on NASDAQ not qualify.
Mexico	92	No	No	
Netherlands	92	**Yes**		1.) Other than de minimis quantities every month; and 2.) Aggregate number of shares of that class traded during the previous taxable year is at least 6% of the average number of shares outstanding in that class during that taxable year. Closely held company traded on NASDAQ not qualify.
New Zealand	82	No	No	
Portugal	94	No	No	
Russian Federation	92	No	No	
Slovakia	93	No	No	
South Africa	97	No	**Yes**	Branch Profits Test - but closely held rule in branch profits test not apply. Test : 1.) More than de minimis quantities on at least 60 days and 2.) Aggregate number of shares in the class traded during the year is at least 10% of the average number of shares outstanding during the year.
Spain	90	No	No	
Sweden	94	No	No	
Switzerland	96	No	**Yes**	Branch Profits Test - but closely held rule in branch profits test not apply. Test : 1.) More than de minimis quantities on at least 60 days and 2.) Aggregate number of shares in the class traded during the year is at least 10% of the average number of shares outstanding during the year.

TABLE 1

(*Cont'd.*)

Thailand	96	No	**Yes**	Branch Profits Test - but closely held rule in branch profits test not apply. Test : 1.) More than de minimis quantities on at least 60 days and 2.) Aggregate number of shares in the class traded during the year is at least 10% of the average number of shares outstanding during the year.
Tunisia	85	No	No	
Turkey	96	No	No	
Ukraine	94	No	No	
Venezuela	96	No	**Yes**	Branch Profits Test - but closely held rule in branch profits test not apply. Test : 1.) More than de minimis quantities on at least 60 Days and 2.) Aggregate number of shares in the class traded during the year is at least 10% of the average number of shares outstanding during the year.
US Model	96	No	**Yes**	Branch Profits Test - but closely held rule in branch profits test not apply Test : 1.) More than de minimis quantities on at least 60 Days and 2.) Aggregate number of shares in the class traded during the year is at least 10% of the average number of shares outstanding during the year.

(*cont'd.*)

TABLE 2:

TREATIES THAT DEFINE "REGULARLY TRADED"

Country	Date Signed	Treaty	Tech. Expl.	Comments
Denmark	99	Yes		1.) Other than de minimis quantities each quarter; and 2.) Aggregate number of shares of that class traded during previous taxable year is at least 6 % of the average number of shares outstanding in that class during that taxable year.
Estonia	98	No	Yes	1.)More than de minimis quantities on at least 60 days; and 2.) Aggregate number of interests in the class traded during the year is at least 6% of the average number of interests outstanding during the year.
Ireland	97	Yes		1.) Other than de minimis during every quarter; and 2.) The aggregate number of shares of the class traded during the previous fiscal year is at least 6% of the average number of shares outstanding in that class during that taxable year. If not listed in previous fiscal year, the shares considered to have satisfied second requirement.
Latvia	98	No	Yes	1.) More than de minimis quantities on at least 60 days during taxable year; and 2.) Aggregate number of interests in the class traded during the year is at least 6% of the average number of interests outstanding during the year.
Lithuania	98	No	Yes	1.) More than de minimis quantities on at least 60 days during taxable year; and 2.) Aggregate number of interests in the class traded during the year is at least 6% of the average number of interests outstanding during the year.
Luxembourg	96	Yes		Aggregate number of shares of that class traded during the previous taxable year is at least 6% of the average number of shares outstanding in that class during that taxable year. Closely held company traded on NASDAQ will not qualify.

(cont'd.)

Netherlands	92	**Yes**		1.) Other than de minimis quantities every month, and 2.) Aggregate number of shares of that class traded during the previous taxable year is at least 6% of the average number of shares outstanding in that class during that taxable year. Closely held company traded on NASDAQ will not qualify.
South Africa	97	No	**Yes**	Branch Profits Test - but closely held rule in branch profits test not apply. Test : 1.) More than de minimis quantities on at least 60 days and 2.) Aggregate number of shares in the class traded during the year is at least 10% of the average number of shares outstanding during the year.
Switzerland	96	No	**Yes**	Branch Profits Test - - but closely held rule in branch profits test not apply. Test : 1.) More than de minimis quantities on at least 60 days and 2.) Aggregate number of shares in the class traded during the year is at least 10% of the average number of shares outstanding during the year.
Thailand	96	No	**Yes**	Branch Profits Test - but closely held rule in branch profits test not apply. Test : 1.) More than de minimis quantities on at least 60 days and 2.) Aggregate number of shares in the class traded during the year is at least 10% of the average number of shares outstanding during the year.
Venezuela	96	No	**Yes**	Branch Profits Test - but closely held rule in branch profits test not apply. Test : 1.) More than de minimis quantities on at least 60 days and 2.) Aggregate number of shares in the class traded during the year is at least 10% of the average number of shares outstanding during the year.

(cont'd.)

US Model	96	No	**Yes**	Branch Profits Test - but closely held rule in branch profits test not apply. Test : 1.) More than de minimis quantities on at least 60 Days and 2.) Aggregate number of shares in the class traded during the year is at least 10% of the average number of shares outstanding during the year.