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THE HARMONIZATION OF TAX TREATIES AND DOMESTIC LAW

Han, Sung-Soo*

I. INTRODUCTION

The increasing internationalization of commercial transactions creates a need to accelerate efforts to harmonize commercial and regulatory conflicts between states as well as each state’s domestic law with international law. In particular, tax obligations that enterprises and individuals owe to the different states in which they earn income or reside create unique compliance and tax minimization issues. Governments must strive to achieve the fine balance of protecting their tax revenue base while fostering international economic expansion. It is clear that international bodies and sovereign governments are not ignorant of these challenges, and the multi- and bi-lateral tax treaties enacted in response to these issues represent some of the most advanced and robust forms of international legal cooperation. However, conflicts inevitably arise as nations and multinational enterprises seek to create equilibrium between cooperation and self-interest on the international playing field.

This paper discusses conflicts between international and domestic law and describes how international law attempts to manage them. Part (II) provides a general overview and an example of conflicts that occur at an international level in taxation while also describing the multinational and bilateral methods that governments use to harmonize tax laws. Part (III) discusses the interrelationship between tax treaties and domestic tax law. It specifically addresses (A) treaty abuse and shopping, (B) interpretative issues, and (C) international treaty override by domestic governments. Although this paper relates solely to tax treaties, the same approach could also apply to other areas involving international treaties, such as the free trade agreements or the specific laws that govern international commercial negotiable instruments, trade, and tariffs. The main analysis of this paper, which deals with the concept and application of “treaty override,” is especially applicable across the wide spectrum of international treaty law.

II. INTERNATIONAL TAX CONFLICTS AND THE INTERNATIONAL TAX REGIME

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1 For related discussion on this topic, see the author’s prior article, Sung-Soo Han, A Study On The Development Of A Global Community From A Legal Perspective, 7 BYU INT’L L. & MGM’T R. 71 (2010).
It is not uncommon for an individual or corporate entity to reside or incorporate in one country, yet make a taxable gain in another. If they are taxed in both the jurisdiction in which they earned income as well as the jurisdiction where they reside, the income is “double-taxed.” Double taxation, while perhaps protecting some forms of revenue for each nation, has a counterproductive, “chilling” effect on international trade, which decreases the overall benefit international trade has on a nation’s economic growth and fiscal policy. The example just mentioned above is a simple double taxation problem. However, when a multinational enterprise performs transactions across multiple contracting states, it obviously faces more complex and diverse tax issues, such as whether the enterprise is a resident; where the enterprise can declare interest, dividends and royalty payments; and how and where the enterprise can move capital for tax purposes.

From a government’s perspective, deliberate tax evasion is a central threat to its revenue base. Domestic tax evasion occurs when individuals or companies misrepresent or conceal tax liability or deductions. In an international world however, the scope and opportunity for tax evasion increases markedly. Without treaty assistance, domestic tax authorities struggle to track and recover tax revenue on an international scale. The specific issue that this paper focuses on is domestic tax evasion as it applies to international norms: manipulation and abuse of treaty benefits.

A. History of International Tax Treaties

A high level of international cooperation has been achieved to protect individual states and their taxpaying citizens from the inequities of the issues referred to above, primarily double taxation and tax evasion. The modern multinational approach began in the 1920’s with the League of Nations, which drafted the first model tax convention in 1928 for use by member countries. Its work culminated in the widely-used Model Tax Convention. For an example on “residency” issues see infra Part III.B. See, for example, Korean “thin capitalization rule” discussed infra Part III.C. See, for example, Germany’s response to the flight of capital to Ireland discussed infra Part III.A. For example, the Swiss-German tax treaty currently being negotiated will give Germany Switzerland’s “special assistance” in cases where there is evidence of tax evasion by Germans. It is estimated that the German money held by Swiss money managers is $264 billion. The German accord follows standards set out in Switzerland’s agreement with the OECD in March 2009 after the country was threatened with being blacklisted as a tax haven. See Warren Giles, Swiss-German Tax Treaty May End European Bank Secrecy, BUSINESSWEEK, Oct. 1, 2010, available at http://www.businessweek.com/news/2010-10-01/swiss-german-tax-treaty-may-end-european-bank-secrecy.html.
Convention of Mexico (1943). The League of Nations dissolved in 1946, but the mantle of tax cooperation was picked up by the Organization for European Economic Co-operation (OEEC), a body of seventeen European nations administering plans for reconstruction after World War II. The OEEC adopted its first model concerning double tax regimes in 1955. In 1961, the OEEC merged into a supranational body of developed nations, the Organization for Economic Co-operation and Development (OECD), founded by the original European countries, the United States, Canada, and thereafter, fourteen other modern industrial nations. The first OECD draft tax convention was adopted in 1963 and reformatted in 1977, hereinafter referred to as the “OECD Model Convention.” This convention was designed to be ambulatory in nature, updated in accordance with legislative and judicial development concerning economic, commercial, and domestic factors.

The OECD Model Convention has had wide repercussions on the negotiation, application and interpretation of tax conventions, as evidenced by the fact that most bilateral treaties, irrespective of whether they are made by OECD member countries, conform to the pattern and main provisions of the OECD Model Convention. It also served as the basis of the original drafting of the complimentary United Nations model. Notwithstanding its limited membership, the OECD Model Convention “has achieved a consensus position as the benchmark against which essentially all tax treaty negotiations take place,” far wider than the U.N. model. The OECD also publishes a series of Commentaries,

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8 Id.


10 See OECD, supra note 7, at 9.


12 Peter A. Barnes, A Model to Celebrate, OECD OBSERVER, Oct. 2008,
which have become a widely accepted guide to the interpretation and application of the provisions of bilateral conventions.\(^\text{13}\)

**B. International Tax Treaties in Developed Nations**

The use of tax treaties is particularly important for U.S. citizens, who are subject to having taxes levied on their income, wherever in the world they reside or earn their income.\(^\text{14}\) The United States has its own Model Convention,\(^\text{15}\) drawn heavily from the OECD Model Convention. As of 2010, the United States had signed bilateral tax treaties with sixty six different countries, comprised mostly of its major industrial trading partners around the world.\(^\text{16}\) To put this level of activity in perspective, to date, the United States is party to bilateral trade agreements (free-trade agreements) with only nine countries,\(^\text{17}\) not including the countries participating in the North American Free-Trade Agreement (NAFTA) and the Central America-Dominican Republic Free Trade Agreement (CAFTA-DR).

The European Union itself does not have a supranational tax treaty or model. It relies on the existing network of double tax treaties to which most of its members are party in one form or another. Although it has had the opportunity to co-opt the approach of the federated United States in creating a unified system sans tax conflict,\(^\text{18}\) to date it has not done

\[^\text{13}\] OECD, supra note 7, at 10.

\[^\text{14}\] See 26 I.R.C. § 911 (2010). Note however that the treaties also benefit the U.S. resident of foreign citizenship who may be taxed at a reduced rate or be exempt from U.S. taxes on certain items of income that they receive from sources within the U.S. Most U.S. income tax treaties also contain a "saving clause," which stops a citizen or resident of the U.S. from using the provisions of a tax treaty in order to avoid taxation of U.S. source income.

\[^\text{15}\] See U.S. MODEL INCOME TAX CONVENTION, supra note 9.

\[^\text{16}\] The U.S. has tax treaties with: Armenia, Australia, Austria, Azerbaijan, Bangladesh, Barbados, Belarus, Belgium, Bulgaria, Canada, China, Cyprus, Czech Republic, Denmark, Egypt, Estonia, Finland, France, Georgia, Germany, Greece, Hungary, Iceland, India, Indonesia, Ireland, Israel, Italy, Jamaica, Japan, Kazakhstan, Korea, Kyrgyzstan, Latvia, Lithuania, Luxembourg, Mexico, Moldova, Morocco, the Netherlands, New Zealand, Norway, Pakistan, Philippines, Poland, Portugal, Romania, Russia, the Slovak Republic, Slovenia, South Africa, Spain, Sri Lanka, Sweden, Switzerland, Tajikistan, Thailand, Trinidad, Tunisia, Turkey, Turkmenistan, Ukraine, Union of Soviet Socialist Republics (USSR), United Kingdom, Uzbekistan and Venezuela.

\[^\text{17}\] The U.S. has trade agreements with: Australia, Bahrain, Chile, Israel, Jordan, Morocco, Peru, Oman, and Singapore. U.S. trade agreements with Panama, Korea, and Colombia are pending congressional approval. The U.S. is also in negotiations on trade agreements with Malaysia, Thailand, the United Arab Emirates, and the Southern African Customs Union (SACU), which includes Botswana, Lesotho, Namibia, South Africa, and Swaziland.

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Most tax treaty work occurs between developed industrial countries. The process of negotiating and chartering a tax treaty is an expensive process, and nations have normally utilized treaties only when it has been in their obvious economic interest. Factors such as the level of trade-ties between nations, the degree of personnel movement (immigrant and non-immigrant), and geographic proximity all influence a country’s decision to negotiate tax treaties. The major exception to this trend is in developing countries where there is a preventative interest in ensuring that a state does not become a “tax haven.” 20 However, with respect to developing nations without tax treaty coverage, the OECD notes that these countries in particular are disadvantaged because their small populations of wealthy citizens who rely on tax treaties negotiated with other countries. 21 Because of this disadvantage, the U.N. has sought to accommodate the interests of developing countries with its tax model (essentially the OECD Model Convention modified to take account of special interests for developing countries). 22 The OECD itself, despite its exclusive membership, has organized annual meetings since 1996 where experts from non-OECD member countries can contribute to the negotiation, application, and interpretation of tax conventions. 23 For the sake of being inclusive, the OECD publishes the reservations and objections of non-OECD members separate to its Model and Commentaries. 24

III. THE INTERRELATIONSHIP BETWEEN TAX TREATIES AND DOMESTIC TAX LAW

Tax treaties and domestic laws are theoretically designed to work in harmony. After all, the treaties are negotiated by sovereign governments to protect their own interests and are based on generally accepted and

22 For example, one modifications is that of “tax-sparing” encouraged as between developed nations and developing nations which “spares” investors from being taxed on the tax incentives they receive from developing nations to foster cross-border investment. See Kim Brooks, Tax Sparing: A Needed Incentive for Foreign Investment in Low-Income Countries or an Unnecessary Revenue Sacrifice? QUEENS L.J., Spring 2009, 505, 508. See also Aldo Forgione, Weaving the Continental Web: Exploring Free Trade, Taxation, and the Internet, L. & BUS. REV. AM. 513, 542 (2003).
23 See OECD, supra note 7, at 429.
24 See id, at 430-63.
time-tested models, such as the OCED Model Convention. Furthermore, there is no coercive force used in the treaty negotiation stages, and in most cases, the treaty is meant to protect sovereign revenue and grow industrial and trade relations. However, as in any seemingly sound treaty, subsequent issues arise. For example, NAFTA provisions (not tax related) allowed Mexican trucks to be driven on U.S. highways, but the United States has delayed its domestic approval process in clear contravention of its treaty obligations, and in a manner which has caused retaliatory bans from Mexico. 25 In a similar manner, domestic implementation and compliance issues arise on a regular basis in relation to tax treaty harmonization with domestic law. In order to understand the impact treaty override has on international legal tax norms, a brief review of treaty shopping, abuse, and interpretation is helpful.

A. Treaty Abuse and Shopping

Within the rubric of treaty law lies the general problem of avoidance or “shopping” activities that were not directly envisaged or addressed by a specific treaty. This is the practical limitation on any treaty activity, especially those directed at taxpayers: once it is enacted, sophisticated teams of accountants and lawyers with aggressive tax practices will create “work-throughs” and “work-arounds” to minimize their clients’ tax liability. Further, tax treaties are not by nature “nimble.” They require significant time to replace or amend. A tax treaty is normally effective for decades upon its conclusion, and it is not easy to simply insert an anti-avoidance rule—that is, a specific rule that attempts to counter aggressive tax avoidance schemes, into a tax treaty after its conclusion. Apart from the practicalities of negotiation, tax treaties are designed to be difficult to change, in order to provide multinational investors with long-term planning guidance. Therefore, “early adopters” of aggressive tax-shopping or abuse strategies can be years ahead of any international law reform.

The OECD has long been concerned with treaty abuse as a major challenge to the interaction between tax treaties and specific provisions in domestic law. It admits that it is naïve to think that treaty drafters can imagine all abusive schemes in advance and prospectively draft a treaty to protect against them. 26 However, the OECD has been responsive to some treaty abuse issues by adding to its Model Convention the

"beneficial owner" and “special relationship” rules, applicable to interest and royalties. States have also attempted to be nimble in their treaty drafting; for example, U.S. treaties now include a comprehensive “limitation of benefits” provision. Similarly, Britain includes provisions to cover interstate dividends, royalties, etc.

Notwithstanding the efforts to be responsive to threats of abuse, these actions have limitations. One of the problems with treaty anti-abuse measures is that in order to adequately respond to complex avoidance strategies, complex rules may be required. This can be counterproductive because it may restrict the ability of the domestic legislatures to respond (i.e. it may be seen to “cover the ground”). In addition, complex rules are difficult to draft in a timely fashion. Furthermore, a complex anti-abuse mechanism carries the risk of being literally interpreted and thereby “catching” non-abusive transactions.

That said, not all aggressive tax schemes are “abuse” of the treaty regime. Some efforts to avoid tax liability are expressly what the treaty is enacted to do (i.e. avoid double taxation). Abuse therefore is a fluid concept, and the OECD itself does not give a precise definition. An attempt to define “treaty abuse” has some value when defined in these terms: “where the particular use of a tax treaty (i) has the sole intention to avoid the tax of either or both of the contracting states, and (ii) defeats fundamental and enduring expectations and policy objectives shared by both states and therefore the purpose of the treaty in a broad sense.” In other words, the term implies an indirect contravention of treaty law, one that is opposed to the goal and objectives of the treaty. Defining “treaty abuse” requires looking at concepts of bona fides and “intent,” including the intent of the government, the treaty, and the tax-payer. Obviously this is imprecise and subjective, but tax lawyers are invariably accustomed to concepts of judging “form over substance.” In any event, states are better equipped to make this judgment when taking into account local

27 See OECD, supra note 7, arts. 10, 11, and 12.
28 See id., art. 11, para. 6 and art. 12, para. 4.
29 “Limitations on benefits” provisions restrict third country residents from obtaining treaty benefits; for example, a foreign corporation may have a minimum percentage of citizen/resident shareholders entitled to a reduced rate of withholding under a treaty.
30 See UK/Australia Double Tax Convention, U.K.-Austl., Aug. 21, 2003, art. 10, para. 7 and art. 12, para. 7.
31 See OECD, supra note 7, at 9.
32 See id.
33 See id. at 12.
circumstances and legal traditions.

“Treaty shopping” is a particular type of abuse. It refers to a practice whereby third-country corporate and personal nationals use a “tax-haven” to gain advantages not provided in their home state. For example, the practice of “borrowing” a tax treaty by forming an entity (usually a corporation) in a country that has a favorable tax treaty with the country of source generally constitutes treaty shopping. No doubt treaty drafters in the last forty years have become more sophisticated in response, but invariably, treaty-shopping activity has developed in kind, using mechanisms such as “conduit” or “stepping-stone” companies to position themselves or their assets in the treaty nation. Both the OECD and the UN consider such mechanisms “improper” because they interfere with the reciprocity of interests underlying the treaty and undermine further international cooperation (as tax payers of ultimate beneficiary country can circumvent their way into treaty status).

With these issues in mind, domestic law makers may try to bridge the gap between tax treaties and abuse with specific legislation or executive action. For example, in the 1990’s, the German government realized that the provisions of its Germany-Ireland Tax Treaty, which exempted the interest and dividends from German tax that a German company derives from an Irish subsidiary, was leading German companies—especially banks—from routing substantial investment

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36 The term, shopping was appropriated from the term forum shopping, which describes the situation in U.S. civil procedure in which a litigant tries to “shop” jurisdictions to get a more favorable decision. See BECKER, HELMUT & WÜRM, TREY WAY SHOPPING: AN EMERGING TAX ISSUE AND ITS PRESENT STATUS IN VARIOUS COUNTRIES 2 (1988).

37 Although some would consider them separate, “abuse” is in contravention of the treaty and “shopping” is not in contravention of the treaty itself but of not being a proper beneficiary of it ab initio.

38 The OECD lists four key factors to determine whether a jurisdiction is a “tax haven”, (i) zero or only nominal taxes (ii) lack of governmental transparency, (iii) the existence of laws or administrative practices that prevent the effective exchange of information for tax purposes with other governments on taxpayers, and (iv) the absence of a requirement that the activity be substantial in the tax haven country. See OECD HARMFUL TAX PRACTICES: TAX HAVEN CRITERIA, available at http://www.oecd.org/document/63/0,3343,en_2649_33745_30575447_1_1_1_37427,00.html


41 See OECD COMM. ON FISCAL AFFAIRS, INT’L TAX AVOIDANCE AND EVASION, FOUR RELATED STUDIES 90 (1987).


income through existing or special purpose Irish subsidiaries, taxed at favorable rates in Ireland. In response, the German parliament passed Article 20(2) of the International Transactions Tax Act (ITTA) to prevent treaty shopping activities of capital investment. The new rules of the ITTA focused on two mechanisms. One mechanism treated the profit of an overseas subsidiary established in Ireland as the dividend of a Germany parent company by applying the Germany Controlled Foreign Company rules to an overseas capital investment company that enjoys the tax exemption benefit of the tax treaty and tax the profit in Germany. Another mechanism does not award the tax exemption benefit by a tax treaty in the case of an overseas permanent establishment but allows a foreign tax credit in cases where the overseas permanent establishment is actually involved in the capital investment activity. Thus, although an overseas entity enjoys a tax treaty benefit in Ireland, it is subject to taxation in Germany, and as a result, all of the tax exemption effect in Ireland is absorbed by the German government.

The focus of this German law and those like it is not generally considered a repudiation of the treaty as a whole, nor is it premised on a lack of respect for international law and treaty obligations. It merely addresses a specific abuse situation. As discussed above, in this case, governments are usually in a better position than a supranational approach to tackle the issue of German banks shopping into Ireland. The question is how this action, which contravenes a treaty on its face, (i.e., it prevents a tax payer from having access to a benefit which the treaty provides that it should) can still be consistent with the treaty itself. It seems almost like a contradiction in terms.

The OECD Commentary on Article 1, paragraphs 9.1 and 9.2 (inserted in 2003) recognizes two possible rationales to deflect this contradiction. The first rationale is to characterize treaty abuse and therefore a country’s response to treaty abuse as outside of the actual scope of the treaty, (i.e., the treaty only applies to tax payers who act in good faith and in line with the purpose and intent of the treaty itself). The second rationale is to consider that because the tax itself is levied at a domestic level, domestic action to prevent abuse is inherently a domestic issue. These approaches, albeit having some appeal, are somewhat circular in logic and ignore some fundamentals of treaty law supremacy,

44 See CHARLES HACCUS, IRELAND IN INT’L TAX PLANNING 897-98 (2004).
thus their logic has been criticized.46

Despite these shortcomings, the OECD appears to support domestic efforts to prevent abuse. OECD Commentary states at 9.4 that “States do not have to grant the benefits of a double taxation convention where arrangements that constitute an abuse of the provisions of the convention have been entered into.” Hence, states can point to clear OECD authority for taking unilateral action to prevent abuse or shopping of their treaty obligations or benefits—irrespective of its inconsistency with the textual norms of a treaty it itself is a party to.

B. Interpretative Issues

The interpretation of “terms” and “provisions” of a treaty may be performed by State actors in the absence of clear guidance in the treaty itself by reference to a state’s own law without it being considered an impeachment or override of the treaty itself. “Interpretation” is an important part of treaty compliance because tax treaties are generally not overly complex documents. The OECD Model Convention is 37 pages and 30 articles long and typifies the usual content of operative clauses in most bilateral conventions.47 It is comparatively brief next to Title 26 of the United States Code dealing with tax, which has almost 10,000 sections spanning over 3,000 pages. The natural implication then is that it is difficult to resolve all issues related to international transactions in treaty form. Accordingly, a common issue occurs as to whether domestic tax law can be applied to matters that are not provided in a tax treaty.

In relation to specific terminology issues, such as when trying to define the meaning of a term that is not provided in a tax treaty, paragraph 2, Article 2 of OECD Model Tax Convention provides that the undefined term will have the legal meaning of the taxing state above any other state. For example, paragraph 2, Article 2 of the United States–Republic of Korea Tax Convention 197648 provides that the laws of the state “whose tax is being determined” is used to define otherwise undefined terms. However, when a term is not easily interpreted and given meaning by the laws of both states, reflecting the cooperative purpose of the bilateral treaty, paragraph 3, Article 25 of the OECD Model Tax Convention provides a general guiding principal that “the competent authorities of the Contracting States shall endeavor to resolve

47 Note, however, that the official OECD Commentaries on the Model Convention amount to 383 pages and increase in size with each new edition.
by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention.49 While this does not create specifically enforceable legal mechanisms, it does use the sort of language that international courts50 would use in requiring a “good faith” resolution, in some respects, stopping state actors from making disingenuous interpretations of clear language.51

A similar issue exists in resolving conflicts related to the interpretation of tax treaty “provisions” apart from mere specific tax treaty “terms.” A “provision” is usually not defined in the treaties, but generally, it should be considered to be the effect or application of an article in a treaty (or operative subpart of an article). Although paragraph 2, Article 3 of the OECD Model Tax Convention provides guidelines as to how to interpret the terms of a tax treaty, it does not mention anything about how to interpret its provisions. Commentary 3 of the Introduction of the 2005 OECD Model Tax Convention emphasizes that OECD members should conform to the Model Convention “as interpreted by the Commentaries thereon” when applying and interpreting the “provisions” of their bilateral tax conventions. The Commentaries for member countries therefore take on an important role.

For example, the important concept of “resident” for tax purposes is reasonably central to determining liability. Paragraph 1, Article 3 of the current Korea-U.S. Tax Treaty provides that “resident,” when in the U.S., refers to the U.S. legal definition of the term, and when in Korea, vice-versa. However, the situation is complicated because Korean income tax law52 applies a different definition that is not mutually exclusive to U.S. income tax law in determining individual residency.53 Therefore it is

49 See also U.S. MODEL INCOME TAX CONVENTION OF NOV. 15, 2006, Technical Explanation, art. 3, para. 2 (stating that “if the meaning of a term cannot be readily determined under the law of a Contracting State, or if there is a conflict in meaning under the laws of the two States that creates difficulties in the application of the Convention, the competent authorities, as indicated in paragraph 3(f) of Article 25 (Mutual Agreement Procedure), may establish a common meaning in order to prevent double taxation or to further any other purpose of the Convention”).
52 Income Tax Act, art. 1, para. 1, (Act No. 9672/2009) (Kor.). The Korean standard as found in Paragraph 1, Article 1 of the Korean Income Tax Law provides that a resident is “[a] person who holds his domicile in Korea or has held his temporary domicile in Korea for one year or more.” In addition, in Article 2 of the Presidential Decree, the Korean Income Tax Law provides that “the domicile shall be determined based on the objective facts such as a family living together and a property situated in Korea, and the abode shall be the place where an individual stays for a substantial period but does not lead a normal life unlike a domicile.” The Presidential Decree also provides that “where an individual who resides in Korea has (i) an occupation which requires more than one year of continuous stay in Korea or (ii) has a family living together and is judged to reside for more than one year in light of his occupation and property, he shall be treated as having a domicile in Korea.”
53 Section 7701(b) of the U.S. Internal Revenue Code treats an alien individual as a U.S.
entirely possible that a Korean may be a “resident” of both countries simultaneously. A tie-breaker rule provided for in paragraph 2, Article 3 of the Korea-U.S. tax treaty\(^{54}\) can be applied, which looks at factors such as permanent residence, vital interests and citizenship, but again, the end result can be “equal,” and in this case the treaty provides that the question is settled by “mutual agreement.”\(^{55}\) This provides a top-down example of how interpretation questions are dealt with in tax treaty practice, invariably a combination of analyzing the treaty text, domestic law, and in the absence or certainty of good faith, application of mutual agreement.

In this respect, interpreting treaty terms by referencing and applying domestic law is countenanced as complimentary to treaty practice and is part of the harmony between international and domestic law. However, that is not to say that countries do not use “interpretation” as a weapon in tax treaty disputes. For example, in paragraph 3, Article 11 of the Austria-Spain tax treaty\(^ {56}\), government securities were taxed only in the issuance state. The unintended consequence of this provision, from the Austrian perspective, was that pursuant to the Spanish government’s issuance of short-term government securities, a marked increase of capital moved from Austria to Spain in order to use the issuance state’s resident where such an individual is (i) lawfully admitted for permanent residence, (26 C.F.R. § 301.7701(b)-1(b)(1) (2009) “Green card test: An alien is a resident alien with respect to a calendar year if the individual is a lawful permanent resident at any time during the calendar year. A lawful permanent resident is an individual who has been lawfully granted the privilege of residing permanently in the United States as an immigrant in accordance with the immigration laws. Resident status is deemed to continue unless it is rescinded or administratively or judicially determined to have been abandoned.”) (ii) meets the substantial presence test, (An individual meets the substantial test with respect to any calendar year if (i) such individual was present in the United States on at least thirty-one days during the calendar year, and (ii) the sum of the number of days on which such individual was present in the United States during the current year and the two preceding calendar years (when multiplied by the applicable multiplier: current year – 1, first preceding year – 1/3, second preceding year – 1/6) equals or exceeds 183 days.) or (iii) makes a first year election.

\(^{54}\) Where by reason of the provisions of paragraph (1) an individual is a resident of both Contracting States: (a) He shall be deemed to be a resident of that Contracting State in which he maintains his permanent home; (b) If he has a permanent home in both Contracting States or in neither of the Contracting States, he shall be deemed to be a resident of that Contracting State with which his personal and economic relationships are closest (center of vital interests); (c) If his center of vital interests is in neither of the Contracting States or cannot be determined, he shall be deemed to be a resident of that Contracting State in which he has a habitual abode; (d) If he has a habitual abode in both Contracting States or in neither of the Contracting States, he shall be deemed to be a resident of the Contracting State of which he is a citizen; and (e) If he is a citizen of both Contracting States or of neither Contracting States the competent authorities of the Contracting States shall settle the question by mutual agreement. For the purpose of this paragraph, a permanent home is the place where an individual dwells with his family

\(^{55}\) Income Tax Convention, U.S.-S. Kor., supra note 48, art. 3, para. 2(e).

exemption rule. In response, the Austrian tax authority changed its position to define “government securities” provided in paragraph 3, Article 11 of the Austria-Spain tax treaty to mean only mid- or long-term securities. In order to entrench this position domestically and avoid domestic tax payer’s disputes relating to the interpretation of the Austria-Spain tax treaty, the Austrian parliament adopted a new domestic law providing that paragraph 3, Article 11 of the Austria-Spain tax treaty would not be effective from January 1, 1995, and then it amended the existing Austria-Spain tax treaty.

If there is no consensus on interpretation—despite (or perhaps because of a lack of) good faith negotiations—specific adjudicative intervention may be required. The International Court of Justice (ICJ), which is the United Nations’ principal judicial body, can hear disputes between states if the states have subjected themselves to ICJ jurisdiction. This requirement limits the ICJ’s effectiveness. Only states themselves have standing to bring a case before the ICJ. Questions of interpretation with regard to application of a treaty can also arise before domestic administrative authorities or courts when a taxpayer, either a private citizen or entity, disagrees with how its domestic country has interpreted the treaty with respect to a benefit it wishes to receive. The interpretation of tax treaties may also be the subject of civil action between taxpayers themselves.

C. International Treaty Override

Treaty override is the exclusion of a treaty or the negating of its effect, in whole or in part, by a treaty member by means of a deliberate
act of supervening domestic legislation. Treaty override impedes harmonization and cooperation because such actions by one state create disincentives for other states to join and uphold international treaties. If countries that are signatories to a treaty may merely legislate “over the top” of their treaty obligations, then countries will invariably question the utility of treaties. This concern is especially pertinent to tax treaties because they govern an important component of international commerce. Unilateral and arbitrary override of treaty provisions by government players obviously disrupts the certainty and predictability of tax status for multinational trade. Treaty override can have the unilateral impact of infringing upon the taxing rights of the other contracting state and, in that way, it upsets the balance that cooperative powers have made in treaty form between their own interests and international cooperation, causing a tit-for-tat unwinding of cooperative tax laws.

Treaty override is inconsistent with the principle of “pacta sunt servanda” incorporated in the Vienna Convention, which provides that “every treaty in force is binding upon the parties to it and must be performed by them in good faith.” The Convention also states that “a party may not invoke the provisions of its internal law as justification for its failure to perform a treaty.”

Because the international implications of treaty override are serious (and usually resisted by the impugned nation), it is important to know when an action that circumvents a treaty is an override and when it is not. Unfortunately there is no clear consensus on the parameters of what a treaty override is. This paper has discussed the practical implications of treaty interpretation and measures taken by a state to prevent treaty abuse. It is generally accepted that it is not treaty override merely to interpret a treaty term or provision in a domestic setting, nor is it a treaty override in some cases to enact legislation to support anti-avoidance. Treaty override is therefore defined often by what it is not, rather than what it is. It is in this gray area that most cases usually lie. This measure of uncertainty is unsatisfactory and counterproductive to the high level of international  

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63 See Derek Devgun, International Fiscal Wars for the Twenty-First Century: An Assessment of Tax-Based Trade Retaliation, 27 LAW & POL'Y INT'L BUS. 353, 374 (1996). “The OECD Committee on Fiscal Affairs noted in its 1989 report on treaty override that ‘there is growing dissatisfaction with the continued use of [treaty override] legislation which would erode confidence in the international tax treaty network as a whole,’ even in situations where an objective might justify its use (such as to counteract treaty shopping). As a result, the Committee concluded that override was not an appropriate manner in which to modify tax treaty obligations and strongly urged OECD members to avoid legislation that would constitute a treaty override.”


65 Id. at art. 27.
cooperation needed for effective tax harmonization.

It may be beneficial to posit whether it is domestically permissible for a legislature to “override” the effect of international treaty. “Self-regulation” of international affairs can be an important bulwark protecting international cooperation; that is, if a government externally binds itself by treaty, in some circumstances, this treaty has “supremacy” and it may be impermissible for that country to later internally override those provisions by “mere” legislation. However, there is no international consensus on this hierarchy. Just as there are many divergent forms of political systems throughout the world, there are many approaches to the question of how to deal with treaty obligations and what pre-eminence to give them over domestic situations and legislation. Even between political systems that are inherently similar, the approach may be markedly different. A robust body of legal theory has grown up around the relationship between domestic and treaty law, but it too has marked schisms.

A starting point for the analysis of the hierarchy of domestic treaty is to look at a classification of the treaty as self-executing. A self-executing treaty can be executed without special legislation; it is effective immediately upon the compact of the treaty nations without the need for ancillary legislation at the domestic level. Contrast this with non-self-executing treaty, which requires each nation’s domestic legislature to ratify it by corresponding legislation. This distinction is important because a self-executing treaty is effectively binding on national parties from the start. Whether a treaty provision is self-executing is an exceedingly confusing area in U.S. federal law, one that has spurred inconsistent cases and a great deal of academic commentary. Generally, one will need to look at the form and substance of a treaty to determine whether it is self-executing, but generally speaking, a tax treaty qualifies as self-executing. The self-executing form of a treaty creates a rebuttable presumption as to its place in the hierarchy of legal norms between international and domestic law.

There are two general theories as to the hierarchy. First, “monism” regards a treaty as part of a national legal system, and second, “dualism” regards a treaty as a legal system distinguished from the national legal system. According to “dualism,” there is no relationship between

international and domestic laws: international laws are effective only in the international relationship, and domestic laws are effective only in domestic settings. Monism on the other hand presents international laws and domestic laws as a unified order, but it is again divided between the international law priority theory and the domestic law or equal status priority theory.

The late Klaus Vogel,\textsuperscript{68} emeritus professor at the University of Munich, is best known among scholars advocating a monism position that tax treaties are equivalent to "special" legislation,\textsuperscript{69} having a hierarchical position that has priority over general domestic legislation. This theory provides that subsequent general legislation does not override previous special legislation and therefore provides that treaties will remain in force, despite domestic changes. If legislation contradicts an existing international treaty, it is a violation of international law.

Many countries have assumed a priority approach as to treaty law. The French civil system, for example, favors accord with international law. Article 55 of the French Constitution, provides that a treaty has priority over general laws upon its proclamation.\textsuperscript{70} Domestic law in France is subrogated to international treaty obligations. The Japanese civil system, which borrows heavily from the French tradition, also gives a treaty priority over a law.\textsuperscript{71} The Swiss Constitution, Article 5, provides that international law has priority over domestic law.\textsuperscript{72} The 1994 Moldovan Constitution Article 4(2) gives priority to treaty law (but only with respect to the protection of human rights) and Article 7 of the Civil Code expressly provides for the priority of treaty law.\textsuperscript{73} In Australia, tax treaties concluded with other states are enforced domestically according to the International Tax Agreements Act ("ITAA"), which was established in 1953.\textsuperscript{74} According to paragraph 2, Article 4 of ITAA, a tax treaty has priority over a domestic tax law.\textsuperscript{75} Similarly, section 15(3) of the Act on Administrative Procedures of Latvia provides that

\textsuperscript{68} Klaus Vogel is probably the best known legal theorist on tax treaties, having published some 15 books and approximately 200 articles before his death in 2007.
\textsuperscript{69} It is special in the European sense of having the highest authority, not "special" in the American sense, which refers to specific laws applying only to a particular locality or person.
\textsuperscript{70} 1958 \textit{Const.} art. 55 (Fr.)
\textsuperscript{71} \textit{See Nihonkoku Kenpō [Kenpō] [Constitution],} art. 98, para. 2 (states that both treaties concluded by Japan and established international law must be faithfully observed), \textit{see also} Japan v. Kim Sun-Ki, 92 A.J.I.L. 301 (Matsue Dist. Ct., 1997).
\textsuperscript{72} \textit{See Bundesverfassung [BV] [Constitution] Apr. 18, 1999, SR 101, art. 5 (Switz.).}
\textsuperscript{73} \textit{See Const. of the Republic of Moldova,} July 29, 1994, art. 4(2); \textit{Codul Civil al Republicii Moldova,} art. 7, (2002).
\textsuperscript{74} \textit{See International Tax Agreements Act, 1953, ATS,} art. 4, para.2
\textsuperscript{75} \textit{See id.}
international legislation, regardless of its source, is applicable in accordance with its position in the hierarchy of legal force of external legislation.\textsuperscript{76} Where a discrepancy emerges between an international legislative provision and a Latvian legislative provision with equal legal force, the international legislative provision prevails.\textsuperscript{77} Note that the Australian, Moldovan and Latvian examples of treaty superiority, as it applies to taxes, are merely statutory, unlike the other examples in this paragraph, which are constitutional.

The American approach has generally been one of equal status—that is, treaty law is of equal status to domestic legislation.\textsuperscript{78} Hence, just as with any other domestic law conflict, the “later-in-time” legislation is binding if there is a contradiction.\textsuperscript{79} The Korean approach has been similar. Paragraph 1, Article 1 of the Korean Constitution provides that treaties concluded and promulgated based on the Korean Constitution and generally approved international rules have the same effect as domestic laws. Further, Article 5 of the Supplementary Provision of the Korean Constitution provides that laws and treaties are effective only in the cases where they do not infringe upon the Constitution. Where treaties are in conflict with domestic laws, the priority must be determined by the later-in-time rule.\textsuperscript{80}

This approach falls far short of the concept of “pacta sunt servanda” incorporated in the Vienna Convention, Article 26. It should be noted that although the United States signed this treaty on April 24, 1970, to date, the U.S. Senate has not given its advice and consent to make it legally binding in the United States. The constitutional context of treaty law in the U.S. is found in Article VI, section 1, clause 2, which provides that

This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.

\textsuperscript{76} See Administrative Procedure Law, sec. 15(3), (2003).
\textsuperscript{77} See id.
\textsuperscript{78} See JAMES J. FREELAND ET AL., FUNDAMENTALS OF FEDERAL INCOME TAXATION 24 (1994).
\textsuperscript{80} See SUNG LARK IN, THE KOREAN CONSTITUTION 207 (2003).
This has been interpreted from the earliest cases of the U.S. Supreme Court to mean that statutes and treaties have equal status or, in other words, a treaty “may supersed a prior act of Congress, and an act of Congress may supersed a prior treaty.”\textsuperscript{81} As it relates to tax law, the Internal Revenue Code codifies the doctrine of equal status at § 7852(d)(1), which states, “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.” Further, § 7701(l) provides authority to promulgate regulations necessary to prevent the avoidance of tax through treaty shopping and other “conduit arrangements” of treaty abuses.

Most cases discussing the general issue of equal status were determined in the 1880s\textsuperscript{82}, and the U.S. Supreme Court has not made any further judgments concerning treaty override since the Prohibition era case of \textit{Cook v. United States}.\textsuperscript{83} In that case, a 1924 treaty between the United States and Britain allowed the United States to board and inspect British vessels in international waters if not more than one hour of voyage time from the U.S. territorial zone or three miles from land. Later, § 581 of the Tariff Act of 1930 gave power to stop and board any vessel at any place within four leagues (twelve miles) of the coast of the United States to search the ships, particularly for contraband. In this case, a British ship was boarded on suspicion of carrying alcohol at a point further away than the treaty would allow, but within the distance the later act would allow. The Supreme Court, somewhat in response to the ambiguities of the situation, said in relation to the treaty, that it is not “abrogated or modified by a later statute unless such purpose on the part of Congress has been clearly expressed.”\textsuperscript{84} This confirms two things: (i) the United States may certainly override a treaty, but (ii) the treaty must be relied upon as law unless a later statute clearly expresses the override.

The result of “equal status” is that there is no overriding legal reason why a U.S. tax law cannot override an earlier treaty. One can look at the provisions of § 884 of the U.S. Tax Reform Act of 1986 as an example of treaty override in action. This section created a system of withholding

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\textsuperscript{81} Cherokee Tobacco, 78 U. S. 616, 621 (1870).

\textsuperscript{82} The Cherokee Tobacco case was about a particular tax on tobacco, and a number of cases have followed en suite in relation to other types of powers: Chew Heong v. United States, 112 U.S. 536 (1884) (Immigration); Head Money Cases, 112 U.S. 580 (1884) (Customs Duties); Whitney v. Robertson, 124 U.S. 190 (1888): (Customs Duties); Botiller v. Dominguez, 130 U.S. 238 (1889) (Ejectment).

\textsuperscript{83} Cook v. U.S., 288 U.S. 102 (1933).

\textsuperscript{84} See id. at 120.
obligations and repatriation rules designed to eliminate the disparity between foreign branch operations of U.S. companies with foreign subsidiaries.\footnote{Under Internal Revenue Code § 884(a), a tax equal to 30\% of the dividend equivalent amount is imposed on any foreign corporation. I.R.C. § 884(e) provides, “No treaty between the United States and a foreign country shall exempt any foreign corporation from the branch profit tax unless (i) such treaty is an income tax treaty and (ii) such foreign corporation is a qualified resident of such foreign country.” I.R.C. § 884(e)(4) provides that the qualified resident means, with respect to any foreign country, any foreign corporation which is a resident of such foreign country unless (i) 50\% or more of the stock of such foreign corporation is owned by individuals who are not residents of such foreign country and who are not United States citizens or resident aliens, or (ii) 50\% or more of its income is used to meet liabilities to persons who are not residents of such foreign country or citizens or residents of the United States.} Known as the “branch profit rule” (BPR), it was enacted in the same vein as other U.S. rules, such as the “earnings stripping rule,” “multiparty financing regulation rule,” and “reverse hybrid rule,” which sought equity between subsidiary-branch level transactions and prevention of fiscal evasion.

Before 1986, a foreign corporation that carried out business through a U.S. branch had an obligation to pay only corporate income tax for profit realized by the U.S. branch but no obligation to pay a dividend tax on funds remitted from foreign branches. However, pursuant to the BPR, the tax burden of these foreign corporations has increased, whereas the taxing rights of a state in which the foreign corporation is situated has decreased.

For example, assume that an Australian corporation does business in the United States through a U.S. branch and realizes $100,000 of profit. Before the BPR, at the U.S. company tax rate of 35\% with no other tax other than income tax, the branch pays $35,000 of income tax to the U.S. government and can remit the remaining $65,000 to Australia. However, if the U.S. government imposes the BPR, the corporation must pay 30\% of branch profit tax on the remaining $65,000 to be remitted in addition to $35,000 of federal income tax. The Australian government will credit against both the corporate income tax and the branch profit tax, so the Australian company is no worse off; however, the taxing right of the Australian government has shrunk. When the BPR was enacted, the United States was party to tax treaties specifically forbidding taxing of distributions from foreign corporations resident in a treaty country to their foreign shareholders even if the distribution came out of earnings of a U.S. branch.\footnote{See GUGLIELMO MAISTO, TAX TREATIES AND DOMESTIC LAW 75-76 (2006)}

Compare the U.S. BPR with the new rules of ITTA. The German approach does not affect the taxing rights of the Irish Government: it merely has an impact on German financial institutions seeking to unfairly
conduit away taxable income from German authorities. Compared to the BPR, which is both contradictory to treaty obligations and repugnant to the mutual protection of tax revenue, the ITTA is not a treaty override as it is consistent with the intent of the treaty with Ireland (or at least not contradictory).

The United States tried to overcome this clear override by announcing that the BPR would not apply to residents of those treaty countries until the treaties were renegotiated to permit it. Most U.S. treaties have been similarly renegotiated. That process does not provide, however, that § 884(e) is consistent with existing treaties. Both on its face and as supported by legislative history, the provision is clearly intended to override pre-existing treaty obligations.87

The United States is not alone in being criticized for treaty override action. Many have argued that section 62 of Britain’s Finance (No. 2) Act, established in 1987, is clear override in relation to the U.K.’s tax treaty with the sovereign state of Jersey.88 The legislation was enacted to reverse the decision of Padmore v. IRC, which dealt with a Jersey-based intellectual property consulting firm known as “CPA.”

Padmore, a U.K. resident, was a partner of the firm, notwithstanding that the business of the firm was carried out from its offices in Jersey and its day-to-day business was dealt with by three managing partners, who were Jersey residents. Padmore claimed that his share of partner profits were exempt from British income tax because they were the profits of a Jersey partnership by reference to paragraph 3(2) of the treaty which states that “[t]he industrial or commercial profits of a Jersey enterprise shall not be subject to United Kingdom tax unless the enterprise is engaged in trade or business in the United Kingdom through a permanent establishment situated therein.”89 Ultimately, the High Court agreed and held that since CPA was a partnership in Jersey and did not carry on its business through a permanent establishment in the United Kingdom, the British Government could not tax Mr. Padmore, a partner of CPA and a British resident. In response, the Crown amended its legislation to specifically say that a U.K. resident who, as a member of a partnership outside of the U.K., receives partner income, which is otherwise not taxable because of a tax treaty, is to be taxed in the U.K.

In Korea, there have been some rules to prevent certain abuses, for

88 See Double Taxation Arrangement, U.K.-Jersey, June 24, 1952, SI1952 No1216 as amended
89 See id. para. 3(2).
example, a “thin capitalization rule,” which fits within the general rubric of anti-abuse and anti-shopping measures consistent with OECD models and commentary. Contrast this however, with Article 98-5 of the Corporate Tax Law, which provides that a Korean tax agent must withhold taxes on interest, dividends, royalties, etc. at the domestic rate going to a foreign country if the Korean Ministry of Finance and Economy designates the income holder’s beneficial country as an “Article 98-5 country.” This is in spite of a limited tax rate stipulated in a tax treaty with that country. Further, if that “designation” is made, only when a foreign company gets advance approval from the Commissioner of the National Tax Service can a Korean withholding agent withhold taxes according to a tax treaty with that country. This is essentially a “carte blanche” law that allows the Korean Executive branch to overturn the treaty on a country-by-country basis, and if it does, the presumption in respect to treaty compliance is reversed. This is clearly a treaty override.

As discussed, in both U.S. and Korean domestic law, both nations have the right to override pre-existing treaties (a right that it does not have at international law). However, the “right” to override does not make treaty override desirable as a matter of policy. In this vein, treaty override action has come under heavy criticism in the United States and abroad for a number of reasons. For example, the international customary law violation of override damages a country’s reputation as a member of the global community, the international legal order itself, and erodes the trust among treaty partners that the powerful countries will remain faithful to their treaty obligations.

Legislative overrides harm domestic interests because an increasing number of treaty partners have insisted upon the right to renegotiate or retaliate in the event of a legislative override. The U.S. Department of the Treasury, for example, has indicated that “it is also becoming increasingly difficult to negotiate reciprocal concessions when the foreign government fears that the United States may unilaterally reverse the bargain by legislative action.” This department, which has the

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90 See Law for Coordination of International Tax Affairs, art. 14, para. 1. Korea (providing that when the amount of a loan borrowed from an overseas controlling shareholder and a third party by the payment guarantee of an overseas controlling shareholder exceeds three times the amount of paid-in capital by an overseas controlling shareholder, the interest related to the excessive loan shall not be deductible and treated as dividend or other disposition).

91 See OECD, supra note 7, art. 4, para. 3; OECD MODEL TAX CONVENTION ON INCOME AND ON CAPITAL, art. 1 cmt. 23 (2005).

92 See Doernberg supra note 87, at 201.

93 See id.

94 Id.
principal responsibility for tax treaty negotiation, has been opposed to the statutory override of such treaties.\textsuperscript{95}

IV. CONCLUSION

This paper has provided salient examples of how individual states act in self-interested ways to protect their revenue base, sometimes to the detriment of international treaties. While this paper reveals that this action is sometimes sanctioned or countenanced by supranational norms, the approach is neither consistent with the principle of pacta sunt servanda, nor is it immune from criticism as to its circular logic and vain precedential value.

Treaty override is an obvious impediment to the stability of international tax treaties. This paper has discussed acceptable allowances to domestic sovereignty over tax treaty, such as interpretation and anti-avoidance measures. However, inequalities arise because nations deal with conflicts between domestic and international law in different ways. Because of these differences, individual states should not be left to determine for themselves through domestic legislation which international treaties they will comply with.

Therefore, an apparent first step to unlocking the full potential of international tax law is to develop an international consensus of how conflicts between domestic and international laws will be handled by the global community. As the global community develops an international consensus built upon a robust basis of law, cooperation, and anti-exceptionalism, the strength and vitality of international law will in turn fortify the global community and facilitate greater global interaction.

\textsuperscript{95} See David Sachs, \textit{Is the 19th Century Doctrine of Treaty Overriding Good Law for Modern Day Tax Treaties}, 47 \textit{TAX LAW}. 867, 874 (1994) (noting that when the 1986 overrides were under consideration by Congress, then Secretary of the Treasury Baker wrote to the Chairman of the Senate Finance Committee urging Congress to give the Treasury time to renegotiate treaties rather than to override them. His request was not heeded).