

The Japan-U.S. Income Tax Treaty: Signaling New Norms, Inspiring Reforms, or Just Tweaking Anachronisms in International Tax Policy?

PAMELA A. FULLER*

I. Introduction

What form will international tax cooperation take over the twenty-first century? What direction will it take in East Asia and along the Pacific Rim—two of the world's hottest economic zones, where many developing countries are just now beginning to remove tax barriers to trade? What happens in Asia will undoubtedly affect the development of international tax policy (and trade policy) around the world. Of course, precise predictions are elusive, but the long-awaited Japan-United States Tax Treaty (Treaty),¹ which became fully effective on January 1, 2005,² after a decade in the making, sheds new light on these critical questions, especially since Japan has indicated that it will use its new agreement with the United States as its model in negotiating tax treaties with other countries.³

The new Treaty, with its accompanying protocol, replaces an archaic, thirty-three-year-old tax treaty between Japan and the United States that had been in force without amendment since 1972.⁴ Not only does the new Treaty between Japan and the United States represent “a critically important modernization of the economic relationship between the world's

*Pamela A. Fuller, J.D., LL.M. (Tax Law), is a New York-based attorney, specializing in U.S. federal and international taxation, cross-border investments, and tax controversies. She formally served as Attorney Advisor to the Chief Judge of the United States Tax Court in Washington, D.C.

1. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-Japan, Nov. 6, 2003, S. TREATY DOC. NO. 108-14 [hereinafter Japan-U.S. Tax Treaty or the new Treaty].

2. Some of the articles became effective prior to the default effective date of January 1, 2005. See discussion *infra* text accompanying note 7.

3. See, Gary M. Thomas, *Opportunities and Challenges in New International Tax Era in Japan*, 34 TAX NOTES INT'L 1161 (2004) (reporting that a high ranking Japanese tax official clearly indicated, without actually using the term model tax treaty, that Japan views its new tax treaty with the United States as its new model for future tax treaty negotiations).

4. The former tax treaty between Japan and the United States was signed in 1971. Income Tax Convention, U.S.-Japan, Mar. 8, 1971, 23 U.S.T. 967 [hereinafter 1971 Treaty].

two largest economies,⁵ many of its provisions suggest a profound and pivotal change in Japan's international trade and tax policy, which may serve as a catalyst for tax policy reform in other Asian countries looking to remove unnecessary barriers to cross-border trade and investment. Moreover, the new Treaty reflects an evolving international consensus on how best to handle—at least within the confines of the existing normative framework—some key issues, including the allocation of authority to tax cross-border investment income; the treatment of income derived through fiscally transparent entities; and the policing of conduit schemes, non-arm's length transfer pricing, and treaty shopping.

A. NEGOTIATION AND ENTRY INTO FORCE

Formal negotiations to revise the thirty-three-year-old tax treaty between Japan and the United States began in October 2001, when the U.S. Treasury acknowledged in a press release that the 1971 treaty needed to be revised “to take into account significant developments in the tax treaty policies and domestic tax systems of both countries since 1972.”⁶ On November 6, 2003, the two countries signed the proposed Convention and Protocol in Washington. The Convention and Protocol were accompanied by an exchange of diplomatic notes, also dated November 6, 2003. On March 30, 2004, instruments of ratification were exchanged, thereby bringing the proposed Convention into force. Although most of the new Treaty's provisions did not become effective until January 1, 2005, its March 2004 ratification allowed certain key provisions, such as the newly reduced withholding tax rates on dividends, interest, and royalties, to become effective on July 1, 2004—six months prior to the general effective date.⁷ Thus, 2005 became the first full calendar year in which qualifying taxpayers could take advantage of all the provisions in the new Treaty.

B. PURPOSE OF TAX TREATIES

Bilateral tax treaties are a primary means by which unnecessary tax barriers to cross-border trade and investment flows are eliminated between resident individuals and entities of the two signatory countries (Contracting States). A tax treaty is intended to provide greater certainty to taxpayers by knitting together the tax rules of the two Contracting States so “that there is little potential for dispute regarding the amount of tax that should be paid to each country. The goal is to ensure that taxpayers do not end up caught in the middle between two governments, each of which claims taxing jurisdiction over the same income.”⁸ Thus, traditionally, tax treaties have been intended to prevent double taxation.

But in recent years, modern treaties have included an increasing number of provisions aimed at preventing both the improper claim of treaty benefits by third parties engaged in so-called treaty shopping, as well as the complete evasion of income tax in both Contracting States through complex conduit structures lacking any legitimate economic or business purpose other than to obtain treaty benefits. International tax planners have increasingly used fiscally transparent entities and hybrid structures in financing transactions to exploit

5. Press Release, U.S. Dep't. of the Treasury, Testimony of Barbara M. Angus, Int'l Tax Counsel, U.S. Dep't. of the Treasury before the Senate Comm. on Foreign Relations on Pending Income Tax Agreements (Feb. 25, 2004), available at <http://www.ustreas.gov/press/releases/js1191.htm>. [hereinafter 2003 Tax Treaty Hearing].

6. Press Release, U.S. Dep't. of the Treasury, U.S., Japan to Negotiate Revision to Income Tax Treaty (August 10, 2001), available at <http://www.treas.gov/press/releases/po548.htm>.

7. Had the new Treaty been ratified after March 31, 2004, the new lower withholding rates would not have taken effect until January 1, 2005, when the balance of the new Treaty's articles became legally effective.

8. 2003 Tax Treaty Hearing, *supra* note 5.

loopholes created by the myriad of conflicts between various national laws governing: (1) the classification of entities and financial instruments, (2) the identification of entities' tax residence,⁹ and (3) the determination of which persons are subject to tax on a transaction. Arbitrage structures, designed to avoid taxation altogether, have become more common since the United States made entity classification (even in the international context) largely elective through the so-called Check-the-Box Regulations.¹⁰ The 1971 treaty between the United States and Japan did not include modern anti-treaty-shopping provisions. For example, the 1971 treaty included neither a sophisticated definition of "Resident" nor a Limitation-on-Benefits article (LOB) article to counter various treaty-shopping and hybrid-entity techniques. An elaborate Residence article and a modern LOB article are now standard features of tax treaties negotiated by the United States.¹¹ The new tax treaty between Japan and the United States represents the first time Japan has agreed to include a comprehensive LOB article in one of its tax treaties, and its inclusion signals a major policy change for Japan, which is already being reflected in its other newly negotiated treaties.

U.S. Treasury officials have lauded the new Treaty "one of the most important tax treaties in the world,"¹² in large part, because it was agreed to by the world's two most powerful economies. This fact alone merits analysis of the new Treaty since it is bound to be influential outside the explicit bilateral relationship. But while the new Treaty may be important for removing trade barriers in the short term, its long term effect on international tax policy is not as clear. One would expect that an international agreement of this import and magnitude would include provisions that do more than simply refine old concepts to fit new circumstances. One would

9. Except as otherwise provided in the new Japan-U.S. Tax Treaty, only persons who are "residents" of one or both Contracting States are eligible for treaty benefits, including the reduced tax rates. See Japan-U.S. Tax Treaty, art. 1 *supra* note 1. Article 4 contains an elaborate definition of the term "resident of a Contracting State," which generally means "any person, who under the laws of that Contracting State is *liable to tax* by reason of his domicile, residence, citizenship, place of head or main office, place of incorporation, or any other criterion of a similar nature. . . ." *Id.* art. 4(1) (emphasis added). However the term "resident of a Contracting State" does not include any person that is liable to tax in that country only on income from sources in that country or on profits attributable to a permanent establishment in that country. *Id.* This definition puts a great deal of pressure on the meaning of the term "liable to tax," which is not expressly defined in the treaty's text. Article 3(2), however, provides that any undefined term used in the treaty shall, unless the context otherwise requires or the competent authorities agree otherwise, have the meaning that it has under the domestic tax law of the Contracting State at the time it applies the Convention. See *id.* art 3(2). See also Press Releases Dept. of Treasury Technical Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains Signed Nov. 6, 2003, p.16 (2004), available at <http://www.treas.gov/press/releases/report/tejapan04.pdf> (discussing how to determine which persons are liable to tax in a fiscally transparent entity) [hereinafter Technical Explanation of Japan-U.S. Tax Treaty]. The U.S. Treasury Department issues a different Technical Explanation for each tax treaty that the United States enters into. The Technical Explanation is viewed by officials, practitioners, and scholars as an official guide to that particular convention, reflecting the policies behind particular treaty provisions, as well as understandings reached by the Contracting States with respect to the application and interpretation of their treaty. See *id.* at 1.

10. Treas. Reg. §§ 301.7701-1 to -5 (as amended in 2006).

11. See, e.g., Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 4 (Residence), art. 23 (Limitation on Benefits), July 24, 2001, U.S.-U.K., (Protocol signed July 22, 2002), available at <http://www.treas.gov/offices/tax-policy/library/uktreaty.pdf> [hereinafter U.S.-U.K. Convention]; see also Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 4 (Residence), art. 22, Oct. 2, 1996, U.S.-Switz., (Protocol signed Oct. 2, 1996), (Limitation on Benefits), available at <http://www.treas.gov/offices/tax-policy/library/teswiss.pdf>.

12. Tax Analysts, *Japan-U.S. Tax Treaty of Crucial Importance*, U.S. Treasury's Angus Says, 2003 WORLDWIDE TAX DAILY, Dec. 12, 2003, at 239-5.

expect to find some change in approach given how much the world has changed in the thirty-three years since the former treaty between Japan and the United States was signed.

This article reviews the foundational norms upon which most bilateral tax treaties are based. It then examines selected articles of the new Japan-U.S. Tax Treaty with three questions in mind: (1) Does the new Treaty signal new norms? (2) Might the new Treaty inspire reforms? (3) Does the new Treaty merely tweak anachronistic principles or, put another way, does it evince the continued future dominance of the Nation State in a globalizing world?

These questions are not merely academic. Presently, an ongoing debate is raging over whether the informal bilateral tax treaty network, of which the Japan-U.S. Tax Treaty is a part, and which has been spawned and promoted by the Organisation for Economic Cooperation and Development (OECD) through adoption of its Model Income Tax Treaty, is an adequate or outdated institutional structure for allocating international tax authority in a world that is being increasingly transformed by economic integration, electronic commerce, and the greater mobility of taxpayers. Much of this article is devoted to delineating the deficiencies in the OECD bilateral tax treaty network, and evaluating several alternatives to bilateralism that have been offered in the literature, including the formation of: (1) an explicit multilateral tax treaty, (2) a supranational body similar to the World Trade Organization, and (3) regional tax agreements under the umbrellas of existing regional free-trade agreements. My claim is that, despite its flaws and weaknesses, the OECD bilateral tax treaty network, which operates within the informal, multilateral, consensus seeking framework provided by the OECD and its Model Treaty, is still the best institutional approach for allocating international tax authority, given the broad spectrum of domestic tax rules, economies, and diverse political regimes. Fortunately, the conclusion of the new Japan-U.S. Tax Treaty greatly strengthens this informal network, making it much more likely that the competing architectures for international tax policy will be dissuaded. My claims and conclusions are admittedly controversial and not all scholars will agree.

Part II of this article reviews the foundational principles underlying normative international tax systems in order to set the stage for the policy arguments made in this article. Part III provides a structural overview of the domestic tax rules of both Japan and the United States, and briefly explains their trading relationship. Parts IV through XI set forth an analytical description of the Japan-U.S. Tax Treaty, noting the tax policy objectives each provision appears to serve, as well as any new approaches that are being taken in the Treaty. Part XII analyzes the various alternatives to bilateral tax treaties mentioned above, after discussing the flaws in the existing system. Part XIII is divided into four sections. First, it describes how the bilateral tax treaty network is exhibiting certain synergistic attributes, known in economics as network effects, which serve to increase the value and utility of the network to participating Contracting States, especially as it expands. In particular, so-called transgovernmental networks, comprised of Contracting States' national tax administrators, OECD representatives, and academics, appear to be serving a key cooperative function by establishing standards that bolster compliance with explicit treaty rules and principles. Part XIII then defends the bilateral tax treaty network from the sharp criticisms it has received, and argues that the OECD bilateral tax treaty network may prove to be the optimal tax institution for the Information Age. Section C returns to focus on the new Japan-U.S. Tax Treaty, and considers the extent to which it is signaling new norms and inspiring reforms—particularly in Asia, where many developing countries are only now beginning to negotiate modern tax treaties. In this context, the continued viability of the alleged anachronistic principles—*income source and taxpayer residency*, as a means to delineate Nation State tax sovereignty—is finally evaluated. Part XIV concludes.

II. Foundational Principles of Normative International Tax Systems

Before analyzing provisions of the new Japan-U.S. Tax Treaty, it is appropriate to briefly review the foundational principles that inform most countries' international tax regimes—particularly those principles that are routinely given as policy justifications for the domestic tax rules of the United States and Japan concerning foreign-source income.¹³ In general, every country exercises some degree of sovereignty over all the income producing activities of its residents—whether that income is derived domestically or abroad. In fact, the right of a country to tax the global income of its residents has long been recognized in international law.¹⁴ Conceptually, it is possible to divide the various national systems for taxing residents into (1) worldwide systems (also known as residence-based systems) that tax their resident individuals and entities on their global income, regardless of whether that income was derived within the home country's borders or abroad, and (2) territorial systems (also known as source-based systems) that tax only the income that was derived within the nation's borders, irrespective of whether the person deriving the income is a resident or a foreigner. Thus, a country employing a pure territorial system exempts all foreign-source income from its tax base. If all countries in the world employed the territorial system and also had the exact same rules for characterizing income and determining each income category's source, the potential for double juridical taxation would be eliminated, although, in the absence of some supranational institutional tax authority imposing restrictions, there would undoubtedly be fierce competition between countries for attracting capital by offering the lowest effective tax rates.

A. SYSTEMS THAT TAX WORLDWIDE INCOME—RESIDENCE BASED TAXATION

Economists have long believed that worldwide economic welfare is reduced when capital resources cross national borders in response to tax policies and incentives, rather than in response to pure economic fundamentals.¹⁵ A system that taxes residents (or citizens) on their worldwide income is arguably more economically efficient, from a global standpoint, than a territorial system since the decision of where to invest—at home or abroad—is not distorted by tax considerations.¹⁶ Under this system, a resident would choose to invest in the location that provides the best economic opportunity based on pure business considerations,

13. Both the United States and Japan allow domestic taxpayers to elect to either deduct their foreign taxes or to credit them against their domestic income tax, so long as the foreign tax credit does not offset domestic-source income. See discussion *infra* at Part I. D (1)-(2).

14. See Nancy H. Kaufman, *Fairness and the Taxation of International Income*, 29 LAW & POL'Y INT'L BUS. 145, 148 (1988).

15. See PEGGY B. RICHMAN, *TAXATION OF FOREIGN INVESTMENT INCOME: AN ECONOMIC ANALYSIS* (1963); PEGGY B. MUSGRAVE, *UNITED STATES TAXATION OF FOREIGN INVESTMENT INCOME* (1969). Musgrave's theoretical and empirical work on the efficiency aspects of outbound foreign investments is thought to be the seminal analyses on the subject, although recently her conclusions have been questioned. See generally, Michael J. Graetz, Justus S. Hotchkiss Professor of Law, Yale University, The David R. Tillinghast Lecture delivered at New York University School of Law: *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, (Oct. 26, 2000), in 54 TAX. L. REV. 261, 271 (2001) [hereinafter Graetz, *Taxing International Income*]. See also U.S. Treasury Dep't, *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study*, 23-54 (2000), available at <http://www.ustreas.gov/offices/tax-policy/library/subpartf.pdf> [hereinafter Treas. Subpart F Tax Policy Study].

16. See generally, Treas. Subpart F Tax Policy Study, *supra* note 15.

knowing that the domestic tax burden will be the same regardless of whether he locates his investment at home or abroad. Because this kind of system promotes the efficient allocation of capital, it is said to serve the efficiency norm of capital export neutrality (CEN). When the worldwide system also allows domestic taxpayers to credit the foreign taxes they paid on their foreign-source income, the worldwide system (so adjusted by eliminating the penalty for choosing to invest abroad) also serves the norm of equity—specifically horizontal equity—in that it ensures that all domestic taxpayers are treated equally relative to themselves, irrespective of whether they chose to invest abroad or not. The foreign tax liability, via the credit, displaces a part of the domestic tax liability on the foreign-source income so that the marginal domestic tax rates on foreign-source and domestic-source income are the same, and equality between domestic taxpayers is achieved. Moreover, worldwide systems can be easily tailored to also serve the norm of vertical equity—the idea that those with a greater ability to pay for government service should be taxed at higher rates. Progressivity in tax rates is more easily effectuated through a residence-based system, than through a source-based system, because the former can more easily access and substantiate the information about each taxpayer's total income and expenses upon which progressive tax brackets are based.

B. SYSTEMS THAT EXEMPT FOREIGN-SOURCE INCOME—SOURCE-BASED TAXATION

A territorial system, unlike a worldwide system, exempts foreign-source income from its tax base, but subjects all domestic source income to tax regardless of whether the person deriving such income is a resident or a foreign person. Thus, the major prerequisite to income taxation is the income's source. Territorial systems are said to serve the efficiency norm of capital import neutrality (CIN) or competitive neutrality because all investors in a given country are competing on a level playing field; all business activity derived within the same jurisdiction is subject to the same marginal tax rate regardless of whether the investor is a resident or a foreigner, so that those investors who invest both within and without the jurisdiction are not disadvantaged as they are in pure residence-based systems (i.e., those that offer no relief for foreign taxes paid).¹⁷ Because all investors receive the same after-tax returns on investments sourced to the country employing a territorial system, they all encounter the same prices within that country on future versus present consumption.¹⁸

The problem of double juridical taxation is avoided in a territorial tax system since all foreign-source income is exempt from tax. However, CEN is not served by a pure territorial system because investors are likely to be lured to the jurisdictions that offer the lowest tax rates on investments. Huge amounts of capital will cross borders in direct response to divergent tax policies. Thus, while a territorial system avoids double taxation and efficiently allocates savings within a given jurisdiction, these advantages come at the price of losing CEN.¹⁹ The efficiency norm of CEN has been thought of as superior to the efficiency

17. Overview of Present-Law Rules and Economic Issues in International Taxation: Hearing before the Joint Comm'n on Taxation, 106th Cong. (1999) [hereinafter JCT Economic Issues Report]; Graetz, *Taxing International Income*, *supra* note 15 at 262, 271.

18. Graetz, *Taxing International Income*, *supra* note 15, at 271.

19. Factors Affecting the International Competitiveness of the United States: Hearing before the Joint Comm'n on Taxation, 102d Cong. 5 (1991) [hereinafter JCT Competitiveness Report 1991]; Graetz, *Taxing International Income*, *supra* note 15, at 272 and n.36.

norm of CIN by both government analysts and tax scholars, many of whom maintain that distortions in the locations of investments are “more costly than distortions in the allocation of savings.”²⁰

C. HYBRID SYSTEMS

The world’s tax regimes are neither fully harmonized nor standardized. Rather, the world is full of diverse tax systems with overlapping tax bases; a wide spectrum of tax rates; and clashing rules for classifying entities, determining residence, and characterizing income. In today’s world, it is impossible to achieve the policy goals of CEN and CIN simultaneously.²¹ A pure worldwide tax system, which serves the efficiency goal of CEN, fails to deal with the problem of double juridical taxation and thus cannot fully serve CIN. A pure territorial system, on the other hand, which theoretically serves the policy objective of CIN, cannot efficiently allocate capital across borders unless all prospective competitor countries have virtually the same system and the same tax rate, or are subject to the same international tax authority that eliminates the relative tax incentives. Thus, no country has adopted a pure worldwide tax system or a pure territorial system.²² If a country were to adopt a pure worldwide system, it would face the risk that the foreign-source income of its residents or citizens would be subject to double juridical taxation, putting its domestic taxpayers at an economic disadvantage relative to its foreign investors who reside in exemption countries and who are not therefore subject to double taxation. If a country were to adopt a pure territorial system, it would face the risk that its tax base would be depleted by the rush of its domestic taxpayers to invest in a lower tax country. Accordingly, all countries’ tax regimes reflect a compromise between the tax policy goals of CEN and CIN and incorporate at least a few elements of both systems—the worldwide system and the territorial system—although most countries’ tax regimes strongly reflect one choice over the other. None, however, are pure; all tax systems are hybrids to some extent.

In the absence of international treaties and other cooperative agreements, a country has basically four alternative ways to handle, via its domestic law, the foreign tax that their domestic taxpayers encounter: (1) it may provide no allowance, applying its own tax to the domestic person’s domestic-source and foreign-source income; (2) it may allow the foreign tax to be deducted from the taxpayer’s worldwide gross income, effectively treating the foreign tax as a cost of doing business or making the foreign investment; (3) it may allow the foreign tax that was paid or accrued to be either fully or partially credited against the tax imposed on the taxpayer’s worldwide income; or (4) it may, as just discussed, completely exempt foreign-source income from the tax base. In addition, with respect to the first three alternatives, a country may choose to defer taxing the foreign-source income until it is repatriated in the form of actual or deemed dividends.²³ Each of these

20. Graetz, *Taxing International Income*, *supra* note 15, at 272. (“Many economists regard the choice between CEN and CIN as essentially empirical, turning on the relative elasticities of savings and investment.”) (citing Thomas Horst, *A Note on the Optimal Taxation of International Investment Income* 94 Q.J. ECON. 793, 793–98 (1980)).

21. *Id.* at 270–72.

22. *Id.*

23. Peggy B. Musgrave, *Sovereignty, Entitlement, and Cooperation in International Taxation*, 26 BROOK. J. INT’L L. 1335, 1337 (2001) [hereinafter Musgrave, *Sovereignty*].

alternative methods has dramatically different effects on the flow of capital, and each carries with it different incentives for taxpayer behavior.²⁴

The empirical and theoretical literature debating the consequences of these alternatives is extensive and beyond the scope of this article. But it is important to note that economists have long concluded that the application of the first alternative above would impose a serious tax barrier to capital outflow; the application of the second alternative would protect the residence country's tax base by ensuring that its share of tax revenues imposed on foreign investments (net of the foreign tax) will not drop below the gross rate of return on domestic investments; and the application of the third alternative would allow for the efficient international allocation of capital, although its return on foreign investments (net of foreign tax) could easily drop below the national return on domestic investments (gross of the domestic tax).²⁵ In other words, when foreign taxes paid by a domestic taxpayer exceed the amount of domestic tax due, the third alternative requires that the excess foreign tax credits be refunded to the taxpayer if the policy goal of CEN is to be fully served. Otherwise, the domestic taxpayer would suffer an additional burden of making the foreign investment as compared to the purely domestic investment. Thus, a full foreign tax credit, without any limitation, can result in a revenue loss for the residence country.²⁶

As the foregoing summary strongly implies, critical and far reaching consequences hinge on how a residence country chooses to structure its own tax base relative to foreign taxes. Unfortunately, the dialogue among government analysts and tax scholars has long been dominated by a debate over whether the CEN or CIN best serves their ultimate goal of worldwide economic efficiency, and precisely how a compromise between CEN and CIN should be struck. Critics of this rather limited normative framework charge that many important considerations other than worldwide efficiency are too frequently ignored in the international tax policy discourse.²⁷ Given the dramatic and integrative changes in global economics, it is time for resident countries to expand their list of criteria in designing their international tax rules and cooperative agreements. Other worthy criteria that could and should be considered include: (1) whether the policy adequately relates to the way modern foreign investment is now often conducted—that is, through multinational affiliated corporations and often through electronic commerce; (2) whether the policy serves the national welfare; (3) whether the policy treats taxpayers fairly; (4) how the policy will affect the country's own national income, exchange rates, and balance of payments; and (5) whether the policy will increase or decrease compliance burdens and transaction costs in its implementation.²⁸

24. The debate is again being considered by U.S. congressional committees. See Heidi Glenn, *U.S. Taxwriters Told to Switch to Territorial System*, 2006 *WORLDWIDE TAX DAILY* 122-4, June 22, 2006 (witnesses testifying before a U.S. House Ways and Means subcommittee hearing on international tax reform advocated that U.S. switch to territorial system and reduce its corporate rates).

25. See, e.g., Musgrave, *Sovereignty*, *supra* note 23 at 1337-38.

26. *Id.*

27. See, e.g., Graetz, *Taxing International Income*, *supra* note 15, at 284 (“[E]conomists today seldom ask how these rules affect the economic welfare of U.S. citizens or residents. [citation omitted] Instead, they generally accept worldwide economic efficiency as the operative norm, and generally conclude that the United States should follow a policy of capital export neutrality.”).

28. See Musgrave, *Sovereignty*, *supra* note 23, at 1337-38.

D. THE 1920S' COMPROMISE

At this point, the newly initiated might ask how the new Japan-U.S. Income Tax Treaty—essentially a binding contract between two nations—reflects the economic principles that inform normative international tax policy systems. Of course, the framework for the new Japan-U.S. Tax Treaty is not really new. Like virtually all of the world's about 1,800 bilateral income tax treaties, it is based on the OECD Model Tax Treaty,²⁹ which has its genesis in the activities of the League of Nations. In 1921, in the wake of World War I, a number of international organizations including the International Chamber of Commerce sought the help of the League in facilitating a postwar system of international trade, since the old system had disintegrated during the war. Starting on a slate that had been wiped clean by the conflict, the League was able to produce a number of working drafts of model income tax treaties aimed at eliminating double juridical taxation. Although some fairly comprehensive 1928 drafts are recognizable as the progenitors of the present OECD Model, the League's working drafts did not attain their final shape until the 1940s. During these years, the League was debating between two draft models—the Mexico Model (1943), which was thought to favor developing countries through a source-based tax system, and the so-called London Model, which was thought to favor developing countries by imposing a residence-based tax system. The work of the League was later taken up by the predecessor of the OECD, which produced a 1963 draft model treaty that basically reflected a compromise between the Mexico and London models by allocating the taxation of business income to the country of its source and the taxation of portfolio income to the country of the capital supplier's residence.³⁰ This finding of middle ground became known as the 1920s' compromise. The Japan-U.S. Tax Treaty, which became fully effective in 2005—more than forty years after the Mexico and London Models were melded, and more than seventy-five years after the League of Nations drafted its influential model—still reflects this fundamental compromise of splitting the jurisdiction to tax international income between the Residence State and the Source State.

The 1920s' Compromise is based on an economic entitlements theory, which also makes pragmatic sense under common law principles. "There are two universally recognized and widely practiced national entitlements to tax income in an open economy setting."³¹ One entitlement is based on the income's source, and the other is based on the residence of the income recipient. Thus, a country is thought to be naturally and fundamentally entitled to tax all the income that arises within its borders. The rationale for this entitlement is that the source country should be able to benefit from the gains reaped within its borders by the domestic and foreign-owned factors of production since it is providing the profit-enabling

29. See ORGANIZATION OF ECONOMIC CO-OPERATION AND DEVELOPMENT, OECD MODEL CONVENTION WITH RESPECT TO TAXES ON INCOME AND ON CAPITAL (2005) [hereinafter OECD Model Tax Treaty, OECD Model Treaty, or OECD Model].

30. But many scholars believe that the London Model was favored and is reflected in both the present OECD Model Income Treaty, as well as modern treaties which, as a general rule, often limit the Source State's authority to tax in favor of the Residence State's authority. Richard J. Vann, *A Model Tax Treaty for the Asian-Pacific Region?* (pt. 1), 45 BULL. FOR INT'L FISCAL DOCUMENTATION 99, 102 (1991) [hereinafter Vann, *Treaty for the Asian-Pacific?*]. Cf. PHILIP BAKER, DOUBLE TAX CONVENTIONS AND INTERNATIONAL TAX LAW 67 (2d. ed. 1994) ("Neither of these Model Conventions [Mexico Model or London Model], however, was fully and unanimously accepted. Moreover, in respect of several essential questions, they presented considerable dissimilarities and certain gaps.") [hereinafter BAKER, DOUBLE TAX CONVENTIONS].

31. Musgrave, *Sovereignty*, *supra* note 23, at 1336.

environment, whether that environment consists of an educated or low-cost labor force, natural resources, liberal regulations, or natural resources.³² From a common law perspective, this limited *in rem* tax makes sense since the sovereign has jurisdiction over the taxpayer's property, but not his person. Accordingly, the source-based tax is most conveniently implemented through a tax imposed, under origination principles, as a payroll, value-added, or gross withholding tax.

The residence country's legal entitlement to tax, on the other hand, is based on its *in personam* jurisdiction. Thus the residence country is entitled to fully tax its legal residents who are presumed to be enjoying the special rights, privileges, and protections afforded to them by the sovereign—whether they be property rights, public services, or military protection. And, as previously discussed, this theory of entitlement is usually expressed by taxing the residents' worldwide income, including foreign-source income, on a net basis. The residence country's entitlement may also be justified by a benefits or quid pro quo theory. Under this theory, the residence country is viewed as the residual or dominant taxing authority,³³ which view became embedded in the OECD Model Treaty. This is one major reason why the OECD Model has long been generally regarded as being oriented toward the interests of countries that are industrialized or on the fast track to becoming so.³⁴

E. ANACHRONISTIC PRINCIPLES?

The world is now a very different place than it was in the early part of the twentieth century when drafters of the OECD Model Treaty first embraced the framework of assigning income on the basis of its source and the taxpayer's residence. Nonetheless, most countries, especially the industrialized ones, appear wed to this construct—it is at the foundation for all bilateral tax treaties based on the OECD Model.³⁵ A commitment to this course of international tax cooperation, however, is sure to lead to more complexity and confusion because as economies have become increasingly integrated, and transactions increasingly borderless, the concepts of source and residence have become increasingly anachronistic and arbitrary.

Treaties based on the OECD Model, as well as most national tax systems, all require that a distinction be made between domestic-source and foreign-source income. But since the 1920s, the concept of source has become nebulous and no longer relates to the realities of how business is conducted in the twenty-first century. Most cross-border transactions in the 1920s involved tangible goods, and enterprises, even if they were related to each other, operated rather autonomously. Thus, it was much easier to rationally relate a particular item of

32. *Id.*

33. *See id.*

34. Vann, *Treaty for the Asian-Pacific?*, *supra* note 30, at 102.

35. *Id.* Nonindustrialized countries, wanting their own model tax treaty, signed treaties based on the United Nations Model Tax Treaty, which more strongly reflects the Mexico Model (i.e., source based taxation) than the London Model (i.e., residence based taxation). However, because when the U.N. Model was first being drafted in the late 1970s, it relied on the 1977 OECD Model as its starting point, the framework and much of the textual language of the two models is similar. Accordingly, the influence of the OECD Model Treaty is not limited to industrialized countries since developing countries and non-OECD member countries are becoming more involved in a growing bilateral network that is also effectively based on the OECD Model Tax Treaty. *Id.*; see UNITED NATIONS MODEL DOUBLE TAX CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES (2001) [hereinafter U.N. Model Tax Treaty, or U.N. Model]. For an unofficial commentary on the U.N. Model, see U.N. Draft Model Tax Convention (Kluwer, Deventer, 1979).

income to a particular country in which it ostensibly arose. But things have changed. In the last few decades alone, the world has witnessed the invention of the personal computer and software, the tremendous rise of e-commerce, teleconferencing, and telecommuting, and the explosive growth of transactions involving intangible assets and complex financial derivatives. The idea that income is being derived from one particular country is no longer a valid assumption (if it ever was) since more transactions are taking place in cyberspace and the factors of production are often scattered around the world, split into tiny bundles of various ownership rights. Yet, under the present system, income cannot be sourced to cyberspace; it has to be sourced to a country. Thus, in order to implement the distinction between domestic-source and foreign-source income, all kinds of artificial constructs have had to be inserted into the sourcing rules. Taxpayers can now more easily manipulate an item of income's source, and given the divergent tax systems and rate structures offered by various countries, taxpayers have the incentive to change the character and source of their income.³⁶ The result is that economic inefficiencies are now built into the system.

The concept of residence also has become increasingly anachronistic and arbitrary. The jet age has permitted individuals to become increasingly mobile and therefore able to live and work in several different jurisdictions within the same year and have more than one home. But the problem of identifying a human's tax residence pales in comparison to the conundrum of identifying a transnational conglomerate's tax residence. Transnational corporations are routinely composed of consortiums of companies that are related either through equity ownership or contractual agreements. These transnational corporate groups have member companies all over the globe that are performing different functions. A corporation may be formally incorporated under the laws of one country, have its management and control center in another country, and perform its business operations through subsidiaries, partnerships, or branches in many other countries. Because different countries impose different tax rates on their resident corporations, and bilateral treaties limit only the maximum rate a Contracting State can impose on a foreign-owned business operating within its borders, companies remain motivated to manipulate their tax residence for tax treaty purposes.³⁷ Indeed, the ease with which tax residence might be manipulated is the primary reason why the United States requires an LOB clause in all of its tax treaties.³⁸ Many provisions of modern treaties are aimed at this abuse, which fact proves how artificial the concept of residence has become.

Technically, treaties based on the OECD Model Treaty do not view the whole corporate conglomerate as a one huge combined entity for residence purposes, but instead treat each member of the group as a separate person with its own tax residence. As will be shown, this separate entity approach is also used by the OECD and the new Japan-U.S. Tax Treaty in policing perceived transfer pricing abuses. In general, treaties based on the OECD Model require that

36. For example, because royalties and business profits have different rules for determining source and different maximum tax rates under most treaties, inefficiency is essentially built into the system by creating incentives for taxpayers to structure their transactions for optimal tax results, rather than in response to pure economic fundamentals. See discussion *infra* Part V.

37. The U.S. Entity Classification rules greatly increase taxpayers' ability to manipulate a company's residence for tax purposes, by allowing certain eligible entities, both foreign and domestic, to elect their U.S. tax classification as an opaque corporation, a tax transparent trust or partnership, or a disregarded entity. See Treas. Reg., §§ 301.7701-1 to -5 (as amended in 2006). For further discussion of the problems created by the ambiguous concept of residency as applied to companies, and how the new Japan-U.S. Tax Treaty attempts to resolve them, see *infra* Part VII.

38. See discussion of LOB clause in the Japan-U.S. Tax Treaty *infra* Part VIII.

arm's length prices be charged between entities that are related. This requirement is aimed at preventing commonly controlled groups of companies from effectively lowering their overall tax burden by shifting their income to subsidiaries located in low-tax jurisdictions and their deductions in high-tax jurisdictions through artificial means such as the setting of intercompany sales prices that bear little relation to economic reality. But as applied on a separate entity basis to intra-firm transactions within a huge affiliated corporate group, the arm's length formula becomes an administrative nightmare that is laden with all kinds of artificial constructs in order to find a comparable transaction so as to determine what might be an arm's length price.³⁹

Ironically, while many domestic tax systems, such as those of the United States and Japan, have been focused on implementing rules aimed at increasing worldwide efficiency or CEN, bilateral tax treaties have in some ways made achieving that tax policy objective more difficult. Of course, the whole purpose of a tax treaty is to eliminate the potential for the double taxation of income and to prevent fiscal evasion. But the concepts of source and residence—so fundamental to today's treaties—have created incentives to misuse them. Moreover, the schedular nature of bilateral tax treaties contains built-in inefficiencies. Taxpayers are motivated to structure transactions so that their income will fall within a particular tax favored category. This problem is exacerbated by the assumption in treaties that the tax rates will be reciprocal. Treaties do not require a *uniform* tax rate be imposed, but only that the rates with respect to particular types of income not exceed a maximum. If the two Contracting States employ different systems of taxing the same kind of income and provide different effective rates—on dividends for example—inefficiencies will result in spite of the treaty rate limitations. These problems are further illustrated below in the discussion of specific provisions of the New Treaty.⁴⁰

III. Tax Systems of the U.S. and Japan—A Structural Overview⁴¹

The Japanese and U.S. international tax systems are broadly similar in that both strongly resemble a worldwide tax system and employ a limited foreign tax credit to eliminate double juridical taxation. But beyond these general similarities, there are numerous differences in the ways Japan and the United States implement the tax policy goal of CEN. Moreover, they have conflicting definitions of residency, different tax rate structures, and assign different weight to the status of tax treaties relative to their own domestic legislation.

A. STRUCTURAL OVERVIEW OF U.S. INCOME TAX RULES

1. *Tax Treatment of U.S. Persons*

The United States taxes the income of all U.S. persons—including its residents, citizens, and domestic entities—on a global basis, meaning the base is determined without regard to

39. See discussion of transfer pricing provisions in the Japan-U.S. Tax Treaty *infra* Part VI.

40. See discussion *infra* Parts IV–VII.

41. The descriptions in this section are intended to serve as general overviews of the U.S. and Japanese tax systems without regard to their bilateral treaty provisions. For purposes of exposition, many of the rules and virtually all of the complex details of these two national tax regimes have been omitted. Pertinent details and exceptions to the rules mentioned will be discussed as they are raised in the discussion of selected articles of the Japan-U.S. Tax Treaty, which follows in Parts IV through IX.

geographic source or character.⁴² All income that is recognized⁴³ is considered gross income⁴⁴ and is potentially subject to tax. Determining gross income is the starting point for determining the U.S. income tax, although some categories such as gifts, bequests, and cancellation of indebtedness, are specifically excluded from the definition.⁴⁵ After various deductions are taken, a tentative tax is computed using progressive rates. Allowable tax credits, such as the foreign tax credit, are then subtracted to determine a U.S. taxpayer's tax liability.⁴⁶

a. Individuals

For purposes of the U.S. federal income tax, an individual is a U.S. person if he or she qualifies as either a citizen or a U.S. resident.⁴⁷ The individual income tax base includes all of a U.S. person's gross income from whatever source derived,⁴⁸ is computed on a net basis under a self-assessment system, and is taxed at progressive rates.⁴⁹ In 2005, the individual rates on ordinary income ranged from 10 to 35 percent. Since 2003, long-term capital gains and qualified dividends have been taxed at a maximum rate of 15 percent.⁵⁰

b. Business Entities

The United States is an example of a jurisdiction that uses a purely formal test for determining whether a business entity is domestic and thus a "U.S. person" for federal tax purposes.⁵¹ Any business entity is considered domestic if it is organized in the United States, or organized

42. I.R.C. § 7701(a)(30) (RIA 2006) (defining "United States person"); *see, e.g.*, I.R.C. § 1 (tax imposed on individuals); I.R.C. § 11 (tax imposed on corporations); I.R.C. § 701 (tax imposed on partners of a partnership); I.R.C. § 1366(a) (determination of S-Corp shareholder's tax liability).

43. Income recognition is a term of art under U.S. tax law. *See* I.R.C. § 1001.

44. *See* I.R.C. § 61 (defining gross income).

45. *See* I.R.C. §§ 101, 112, 115, 117–23, 125–27, 129–39 (Specific exclusions from gross income).

46. Income of U.S. corporations is taxed at graduated rates ranging from 15% to 35% with no preferential rate for capital gains. I.R.C. § 11(a)–(c). However, U.S. corporations may deduct qualified dividends received from their U.S. subsidiaries. *See* I.R.C. §§ 243, 244, 245, 246, 246A, 247. The amount of the dividends-received deduction is dependent on the percentage of equity ownership. For example, 80% of a dividend received from a 20-percent-owned corporation is deductible if certain requirements are met. *See* I.R.C. § 243. In general, inter-company dividends are eliminated if the corporations are eligible to file a consolidated return, meaning they meet the definition of an affiliated group. *See id.*

47. I.R.C. § 7701(a)(30) (RIA 2006). The residency of an individual is important under U.S. law because a resident individual, like a U.S. citizen, is taxed on his or her global income, while a nonresident alien is taxed only on certain U.S.-source income and income that is effectively connected with a U.S. trade or business. Any alien that spends sufficient time in the United States during a single year, or over a three-year period, is generally treated as a resident for federal tax purposes. There are a few other ways an alien can qualify as a U.S. resident. For example, an alien who holds a green card is considered a U.S. resident for federal tax purposes and taxed on his or her worldwide income.

48. I.R.C. § 61(a).

49. The effective rates on ordinary income earned by U.S. individuals for the taxable years 2006 through 2010 are 35%, 33%, 28%, and 25%, respectively. *See* I.R.C. § 1. In 2003, the maximum capital gains rate for individuals was lowered to 15%, although this rate is set to expire at the end of 2008, at which time it could go back to a maximum of 20%. *See* Jobs and Growth Tax Relief and Reconciliation Act of 2003, Pub. L. No. 108–27, 117 Stat. 752, (2003) (JGTRRA). In addition, the 2003 JGTRRA lowered the tax rate on qualified dividends received by individuals to a maximum capital gains rate of 15%, which will also expire at the end of 2008 unless Congress extends it. *See* discussion *infra* Part III.A.1.

50. This preferential 15% rate, however, is set to expire at the end of 2008, at which time it could go back to a maximum of 20%. *See* JGTRRA, *supra* note 49. *See* discussion *infra* Part III.A.1.

51. I.R.C. § 7701(a)(30)(B)–(E) (defining a "U.S. person" as including, *inter alia*, a domestic partnership, domestic corporation, domestic estate, and a domestic trust, respectively).

under the laws of the United States or any of the federal states.⁵² Thus, a business entity formed in the United States will be considered a domestic entity even if all its shareholders are foreign persons and its center of management is located outside the United States.⁵³ The determination of whether a business entity is domestic is made independently from the determination of its classification for tax purposes as a corporation, a partnership, or other non-corporate entity. Under U.S. tax law, if a business entity is incorporated in the United States and also chartered in a foreign country (i.e., a dual chartered company), it will still be treated as a U.S. entity, and thus subject to tax as a U.S. person, in the absence of contrary treaty provisions.⁵⁴

In 1997, the United States made entity classification, even in the international context, largely elective through the promulgation of the so-called Check-the-Box Regulations.⁵⁵ These regulations provide that certain eligible entities that are not per se corporations may elect to be treated as either corporations, partnerships, or disregarded entities for U.S. tax purposes.⁵⁶ The U.S. and international tax consequences of being classified as a corporation as opposed to a partnership, especially in the international context, are huge. All U.S. corporations are taxed on their worldwide income under a two-tier corporate tax regime, regardless of whether they have one shareholder or thousands.⁵⁷ In contrast to corporations, the U.S. tax law treats partnerships, and limited liability companies that elect to be taxed as partnerships, as generally transparent for tax purposes, meaning no tax is imposed at the entity level.⁵⁸ Instead, the undistributed income from these non-corporate entities is treated as passing through on an annual basis in the form of distributive shares, which are then combined with the other income of each partner or member and taxed separately at the rate applicable to each of the different partners or members.⁵⁹ As will be shown, the ability of certain eligible entities—domestic and foreign—to elect their U.S. tax status as either tax transparent partnerships or separate corporate taxpayers has proven advantageous in international tax planning due to their resulting utility as vehicles of tax arbitrage. In recent years, various domestic laws and treaty provisions have attempted to restrict these tax advantages.⁶⁰

U.S. corporations are treated as separate entities with separate legal personalities. In keeping with this principle, the income of a domestic corporation is generally subject to tax both at the corporate level and again at the shareholder level when the income is distributed in the form of dividends or liquidating distributions.⁶¹ Critics of this two-tier tax system have long argued that it is burdensome and inefficient. In May 2003, the United States largely abandoned its classic two-tier tax system by adopting, at least temporarily, a type of

52. Treas. Reg. § 301.7701-5 (as amended in 2006).

53. *Id.* § 301.7701-5.

54. *Id.*

55. Treas. Reg. § 301.7701-1 to -5 (as amended in 2006).

56. *Id.* Publicly traded entities are always taxed as corporations regardless of their form of organization. LLCs with only one member are disregarded for U.S. tax purposes (tax nothings) unless they elect to be taxed as a U.S. corporation. *Id.*

57. See I.R.C. § 301 (RIA 2006).

58. I.R.C. § 701 (partner, not partnership subject to tax); see I.R.C. §§ 1363(a) & 1366(a) (flow-through tax regime applicable to electing S-corporations and shareholders).

59. I.R.C. § 702(b).

60. See discussion of fiscally transparent entities and tax arbitrage *infra* Part V.

61. I.R.C. §§ 311, 301, 336, 331. *But see* I.R.C. § 243 (Corporate Dividends Received Deduction).

partial corporate integration in the form of dividend tax relief. Certain dividends received by U.S. individuals (historically taxed to shareholders at rates as high as 38.6 percent) will be taxed at preferential capital gains rates—the highest rate being 15 percent.⁶² Much like dividend imputation systems, which used to be common in Europe, dividend tax relief is only available to U.S. investors. Moreover, in order to qualify for the 15 percent U.S. tax rate, the dividend must be paid to an individual shareholder, either by a domestic corporation, or a qualified foreign corporation, defined as meeting one of the following requirements: (1) its shares or American depository receipts are traded on a U.S. stock exchange, (2) it resides in a foreign country with which the United States has a tax treaty that contains adequate exchange-of-information provisions, or (3) it is established in a U.S. possession. The 15 percent rate is also extended to actual dividends or deemed dividends received by U.S. shareholders of controlled foreign corporations (CFCs) as defined under section 957.⁶³

Traditionally, income earned indirectly by U.S. shareholders through a foreign corporation is not subject to U.S. tax until it is repatriated to its U.S. shareholders. Deferral of U.S. taxation is considered appropriate on most types of active business income earned by foreign corporations with U.S. shareholders. However, the ability of U.S. taxpayers to accumulate earnings in a foreign corporation, free from U.S. tax, is restricted by several sets of complex rules, known as anti-deferral regimes. The policy underlying these anti-deferral regimes is aimed at taxing a U.S. shareholder's share of the foreign corporation's income that is either (1) passive and situated in low-tax jurisdictions,⁶⁴ or (2) business income that is being routed through conduit foreign corporations so as to artificially isolate the business gains in low-tax jurisdictions outside the country where the manufacturing or service activities are taking place.⁶⁵ The tax is either a current tax on annual deemed distributions, or a tax on actual distributions, which is proportional to the value of the tax deferral that was enjoyed on the foreign accumulated earnings.

The United States removes the potential for double juridical taxation by allowing U.S. taxpayers to annually elect to either deduct their foreign taxes from their global income,⁶⁶ or to credit the foreign taxes paid or accrued against their U.S. tax liability.⁶⁷ Generally, it is more advantageous to elect the foreign tax credit over the deduction since it provides a

62. See § 1(h)(1) (RIA 2006) (dividends taxed as net capital gains). The preferential 15% rate on dividends is not available to nonresident aliens. See JGTRRA, *supra* note 49. In addition, the 2003 JGTRRA lowered the tax rate on qualified dividends received by individuals to a maximum capital gains rate of 15% which, like the 15% rate on dividends, will automatically expire at the end of 2008 unless Congress extends it.

63. I.R.C. § 957(a). The preferential 15% rate is not extended, however, to passive foreign investment companies (PFICs) or personal holding companies (PHCs) since a preferential dividend repatriation rate would defeat the whole purpose of those anti-deferral regimes. The investors in those corporations are already effectively enjoying an interest-free loan from the government in the form of tax-deferred earnings so long as none of the anti-deferral mechanisms are triggered. See I.R.C. § 1297 (defining "passive foreign investment company"), I.R.C. § 542 (defining "Personal Holding Company").

64. See, e.g., I.R.C. §§ 1291–97 (treatment of certain passive foreign investment companies and qualified electing funds); I.R.C. §§ 541–47 (personal holding companies); I.R.C. §§ 531–37 (accumulated earnings tax).

65. See I.R.C. §§ 951–62, 964–65) (Controlled Foreign Corporations). These Code sections, along with their accompanying regulations, are commonly referred to as the "subpart F provisions." Under the same-country exception to certain types of subpart F income, tax deferral is allowed for certain classes of income that are earned in the same jurisdiction where the income-producing activities are taking place. Thus, to the extent the exception applies, the policy objective of CEN is trumped by the policy objective of CIN, which the same-country exception serves. See I.R.C. § 954(c)(3), (d)(1)–(2), (e)(1)(b).

66. I.R.C. § 164(a) (RIA 2006).

67. I.R.C. § 901.

dollar-for-dollar offset from U.S. income tax. However, the foreign tax credit is subject to a general limitation, the purpose of which is to prevent the cross-crediting of foreign taxes against U.S. tax on U.S.-source income.⁶⁸

A U.S. corporation owning at least 10 percent of a foreign corporation, and which is paid a dividend or is required to include a portion of its subsidiary's earnings in income under an anti-deferral regime, is also allowed a foreign tax credit.⁶⁹ The U.S. parent corporation is deemed to have paid a portion of its subsidiary's foreign taxes. The foreign taxes deemed paid by the U.S. parent are included in the computation of its total foreign taxes paid, and its general foreign tax credit limitation for the year in which the actual dividend or deemed dividend is received.

2. Tax Treatment of Nonresident Aliens and Foreign Corporations

There are two alternative U.S. tax regimes that can potentially apply to nonresident aliens (NRAs) and foreign corporations. An NRA or foreign corporation that is engaged in a U.S. business is viewed as directly participating in the economic life of the country and is thus treated like a U.S. taxpayer; the income that is "effectively connected" to the U.S. business is taxed to the NRA or foreign corporation on net basis at regular corporate rates.⁷⁰ Even if the NRA or foreign corporation is not engaged in a U.S. trade or business, or has no effectively connected income, certain U.S.-source investment income, comprised primarily of dividends, interest, and royalties, is subject to a 30 percent gross-basis withholding tax.⁷¹ The 30 percent rate is often reduced by a treaty.⁷²

A foreign corporation is also subject to a 30 percent branch profits tax on its "dividend equivalent amount," which is essentially the earnings that are taken out in any year from its U.S. business.⁷³ Arguably, the intent of this provision is to place the foreign corporation in the same position as a U.S. corporation by subjecting it to a second-level shareholder tax. A foreign corporation may also be subject to a 30 percent branch-level interest tax,⁷⁴ under which interest that is paid by a U.S. branch of the foreign corporation is treated as if the interest were paid by a U.S. corporation. That is, the interest will be treated as U.S.-source income and subject to the 30 percent gross-basis withholding tax unless limited by treaty.

3. Status of Treaties under U.S. Law

Article IV, Clause 2 of the U.S. Constitution provides that: "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." The U.S. Supreme Court has construed this provision to mean that statutory law and treaties are given equal status under the U.S. Constitution.⁷⁵ Accordingly, if domestic legislation conflicts with a treaty provision, the legal authority that became effective later in time

68. I.R.C. § 904 and regulations issued thereunder.

69. I.R.C. § 902 and regulations issued thereunder.

70. I.R.C. §§ 872(a)(2), 882(a). "Effectively connected income" is a term of art that requires that the foreign-source income be attributable to either a U.S. office or other fixed place of business of the NRA or foreign corporation. I.R.C. § 864.

71. I.R.C. §§ 871(a)(1), 881(a) (RIA 2006).

72. See discussion of reduced withholding rates in the Japan-U.S. Tax Treaty *infra* Part IV.A.

73. I.R.C. § 884. See discussion of treatment of branch profits taxes under the Japan-U.S. Tax Treaty *infra* Part IV.C.

74. I.R.C. § 884(f).

75. Reid v. Covert, 354 U.S. 1 (1957).

prevails.⁷⁶ Thus, in principle, U.S. law literally provides that treaty obligations can be overridden by later-enacted U.S. legislation. However, U.S. courts have held that before a treaty can be deemed overridden, specific legislative intent to override existing inconsistent treaty provisions must be shown.⁷⁷

Historically, the U.S. Congress has tended to allow income tax treaties to take precedence over income tax statutes.⁷⁸ But as tax planners began to utilize tax treaties for what Congress perceived were abusive purposes, U.S. lawmakers became less deferential to treaties. In 1988, section 894(a) of the Internal Revenue Code was amended to provide that “[t]he provisions of this title shall be applied to any taxpayer with [only] *due regard* to any treaty obligation of the United States which applies to such taxpayer.”⁷⁹ Amended section 7852(d)(1), sheds light on what “due regard” means: “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.”⁸⁰ The report of the Senate Finance Committee discussing these code amendments shows that Congress did not intend to “blunt in any way the superiority of the latest expression of the sovereign will in cases involving actual conflicts, whether that expression appears in a treaty or statute.”⁸¹ Thus, the judicially created later-in-time doctrine still applies to genuine conflicts between U.S. tax statutes and U.S. tax treaties. However, the legislative history also points out that later-enacted statutes can often be harmonized with a treaty (and vice-versa) by looking to see whether the legislators’ intent underlying the ostensibly conflicting provision was to merely harmonize domestic law with the fundamental purpose of all bilateral tax treaties—that is, to prevent both double taxation and fiscal evasion.⁸²

B. STRUCTURAL OVERVIEW OF JAPAN’S INCOME TAX RULES

1. *Tax Treatment of Japanese Residents*

Under Japanese law, domestic individuals and domestic corporations are subject to national income taxes on both their Japanese source and foreign-source income. However, there is no single income tax code; rather, two separate taxing statutes are applicable to individual income and corporate income, respectively.

a. Resident Individuals

In contrast to the U.S. system, an individual’s Japanese citizenship is not a basis for taxation; instead, residence is dispositive. An individual is considered a legal resident if he has

76. The “later-in-time” rule dates back to an old common law rule, originally formulated for conflicts between statutes. See David Sachs, *Is the 19th Century Doctrine of Treaty Override Good Law for Modern Day Tax Treaties?*, 47 TAX LAW. 867 (1994).

77. *Cook v. U.S.*, 288 U.S. 102, 120 (1933). But see S. REP. NO. 100-445, at 325 (1988) (Cook does not mandate that “Congress must specifically advert to the treaties to have later statutes given effect,” but if the supposed conflict is actually mentioned in the statute or its legislative history, then such mention is “dispositive” in favor of the later-enacted statute, an intentional treaty override.) See also BORIS I. BITTKER & LAWRENCE LOKKEN, *FUNDAMENTALS OF INTERNATIONAL TAXATION*, para. 65.1.6 (3d ed. 2001).

78. BITTKER & LOKKEN, *supra* note 77.

79. I.R.C. § 894(a) (RIA 2006) (as amended in 1988) (emphasis added).

80. I.R.C. § 7852(d) (RIA 2006) (as amended in 1988).

81. See S. Rep. No. 100-445, at 322.

82. See *id.* at 378-79.

resided in Japan continuously for one year or more. Individuals who have lived in Japan for less than one year and who are not domiciled⁸³ in Japan are considered nonresidents and are subject to tax only on certain categories of their Japan-source income, if any. Not all resident individuals are taxed on a worldwide basis under Japanese law—there is a special category of residents. A non-Japanese national who has been residing in Japan for no more than five of the past ten years will qualify as a non-permanent resident. A non-permanent resident is taxed only on Japanese-source income, plus any non-Japan-source income that is paid in or remitted into Japan.⁸⁴ However, if an individual has either resided in Japan for more than five out of the last ten years or intends to return to Japan permanently, both his Japan-source and foreign-source income is subject to tax. Thus, in the absence of a treaty tie-breaking provision, a U.S. citizen living continuously in Japan for more than five out of the last ten years would be subject to both countries' worldwide tax regimes. The Japan-U.S. Tax Treaty resolves the problem of dual residence for individuals through an elaborate series of so-called tie-breaker rules in its Residence article (Article 4).⁸⁵

Although in principle Japan has adopted a self-assessment system for individual tax purposes, approximately 80 percent of the individual income taxes are collected through an elaborate withholding system. Japan's individual income tax also differs from the U.S. tax system in that it is schedular—meaning that income is first characterized and separated into ten different categories and computed according to distinct rules.⁸⁶ Although the policy objective for this system has been said to be vertical equity, or the ability to pay, it also gives taxpayers the incentive to manipulate the character of the income for tax purposes.⁸⁷

Beginning in the year 2000, Japan's individual income tax rates were dramatically flattened and now range from 10 percent to 37 percent. Moreover, all resident individuals are subject to a local income tax. To the extent that an individual's income does not exceed 250,000 yen, individuals are entitled to a special 20 percent reduction of tax which makes the effective individual rates much lower than the marginal rates. As under the U.S. system, individuals are afforded some dividend tax relief. Individuals with income levels below 10 million yen may credit 10 percent of the dividends they receive. For individuals whose income exceeds that level, the credit drops to 5 percent. Individual taxpayers who sell shares of listed corporations enjoy a capital gains tax preference; the preferential rate ranges between 10 and 20 percent.

83. Under Japanese law, one's domicile is that place where one's life is centered and the place to which one intends to return permanently.

84. This rule became effective on Mar. 31, 2006. See Ernst & Young's Foreign Desk, *Proposed 2006 Japanese Tax Reform*, J. INT'L TAX'N (WG&L March 2006), available at <http://checkpoint.riag.com/Checkpoint?usid=ef733423f2&lkn=mainFS&uqp=766293&bhcp=1>.

85. Under the tie-breaker rules, an individual is deemed to be a resident of the country in which he or she has a permanent home. If the individual has a permanent home in both countries, the individual's residence is deemed to be the country with which he or she has the closest personal and economic relations (center of vital interests). If the center of vital interests cannot be determined, then the individual's residence is where he or she has a "habitual abode," and if that cannot be determined, then he or she is a resident for purposes of the Treaty in the country where he or she is a national. If the individual is a national of both countries or neither country then, the competent authorities of Japan and the United States will settle the issue of residency under the Mutual Agreement Procedure (art. 25). Japan-U.S. Tax Treaty, art. 4(2).

86. Minoru Nakazato, Mark Ramseyer & Yasutaka Nishikori, *Japan*, in *COMPARATIVE INCOME TAXATION—A STRUCTURAL ANALYSIS* 73, 78–79 (2d ed. 2004).

87. See *id.*

b. Business Entities

A corporation is considered a resident of Japan if either its headquarters or principal office is located in Japan. These concepts are derived from Japan's Civil Code⁸⁸ and Commercial Code⁸⁹ respectively. Technically, all companies that are incorporated under Japanese law are required to have either a registered headquarters or a registered principal office in Japan.⁹⁰ But a company may be registered in Japan even though it is not incorporated there. This rule leaves room for so-called dual-resident companies. Thus, a company that is incorporated in the United States and that has its head office located in Japan could be subject to both countries' worldwide tax regimes in the absence of a treaty tie-breaking provision. The potential for double juridical taxation presented by dual-resident companies is resolved in Article 4 of the new Japan-U.S. Tax Treaty, which provides that "the competent authorities of the Contracting States shall determine by mutual agreement [which] Contracting State . . . that person shall be deemed to be a resident [of] for the purposes of the Convention."⁹¹

The *kaishiki kaisha* (KK) (i.e. joint stock company)⁹² is the most popular form for doing business in Japan, and its fundamental features are broadly similar to the U.S. publicly traded corporation under Delaware law.⁹³ In June 2005, Japan's Diet passed the 2005 Companies Law,⁹⁴ which broadly amends and integrates old business codes into one streamlined statute. With 979 articles, the new legislation constitutes the most sweeping revision of Japan's Commercial Code since World War II. The Companies Law abolished the old *yugen kaisha* (YK) form⁹⁵ for closely held companies and replaced it with two new business entities—the *godo kaisha* (GK) [i.e., limited liability company] and the *yugen sekinin jigyo kumiai* (LLP) (i.e., limited liability partnership), both of which are patterned on American models. The GK, however, is subject to tax at the entity level, which means that its profits could be subject to a combined national and local income tax rate of up to 42 percent. In addition, GK members could be subject to a combined national and local tax rate of up to 50 percent on distributions from GK net profits.⁹⁶ The LLP is not subject to tax at the

88. See Minpo Law No. 89 (Civil Code), April 27, 1896, as amended.

89. See Shoho Law No. 48, (Commercial Code), Mar. 9, 1899, as amended.

90. Japan does not employ the so-called "managed and controlled" test for determining residency.

91. See Japan-U.S. Tax Treaty, *supra* note 1, art. 4(4); see also discussion of Mutual Agreement Procedure *infra* Part X.

92. Until the new 2005 Companies Law became effective in May 2006, joint stock companies were governed by Part II of the Commercial Code, Law No. 48 of 1899, as amended; see Law No. 48 of Mar. 9, 1899.

93. There are differences however. Until statutory amendments to the Commercial Code in 1999, KK shareholders could only recover their investment by selling their shares; redemptions were not sanctioned. Stock redemptions were made legal in 1999, a key development since stock redemptions are a critical element in many tax-free corporate reorganizations.

94. Kaisha Ho [Companies Law], Law No. 86 of 2005 [hereinafter 2005 Companies Law]. The 2005 Companies Law, along with an accompanying Coordination Law whose purpose it is to implement the 2005 Companies Law, went into effect in May 2006. See Seibi Ho [Law Regarding the Coordination, Etc., of Associated Laws in Connection with the Enforcement of the [New] Companies Law], Law No. 87 of 2005 [hereinafter Coordination Law]. References to the 2005 Companies Law are hereinafter intended to include a reference to its companion Coordination Law.

95. See discussion of U.S. tax consequences of repeal of the Yugen Kaisha form *infra* Part VI, note 207.

96. For U.S. tax purposes, it is likely that the GK will be treated as a default corporation under the U.S. Entity Classification Regulations since none of its members have unlimited liability. See Treas. Reg. § 301.7701-2(b)(8)(vi)(2006). Thus, in the absence of further guidance by the U.S. Treasury Department, a GK's U.S. tax classification may be elected by a U.S. taxpayer.

entity level and is the first business entity Japan has sanctioned that combines all three of the following attributes: "(1) limited liability for all the partners; (2) the ability to make special allocations of gains and losses that are disproportionate to the partners' relative equity interests in the partnership; and (3) pass-through taxation."⁹⁷

As under the U.S. system, Japanese corporations are treated as separate taxable entities with a few features that partially integrate the corporate level and shareholder level taxes. First, domestic corporations are afforded a dividends-received deduction depending on their level of ownership in the given subsidiary. For parent corporations owning at least 25 percent of the subsidiary's equity, the dividend is completely excluded from income. For parent corporations owning a lesser percentage, only half of the dividend is excluded from income.⁹⁸ On ordinary income, the marginal national tax rate for Japanese corporations is 30 percent.⁹⁹ But, Japanese corporations are also subject to a local income tax and an enterprise tax, bringing their top effective income tax rate to 42 percent. In 2006, Japan has the distinction of having the highest effective corporate income tax rate in the world.¹⁰⁰

Japanese shareholders are generally not taxed on the earnings of their foreign corporations until those earnings are repatriated to Japan. A major exception to this general rule is an anti-deferral regime that is quite similar to subpart F under U.S. tax law.¹⁰¹ Japan's foreign tax credit is similar to that of the United States and is available to both resident individuals and domestic corporations.¹⁰² Foreign tax credits are limited in generally the same manner as those available to offset U.S. income. Japanese corporations that own at least 25 percent of a foreign corporation for at least six months may also qualify for an indirect foreign tax credit with respect to foreign taxes attributable to their foreign subsidiaries.

2. Tax Treatment of Nonresidents

Under Japan's tax law, nonresident individuals and foreign corporations are generally taxed only on income that is sourced in Japan. But if the nonresident maintains a place of business in Japan,¹⁰³ then the business income it generates is taxed as though the nonresident

97. See discussion *infra* Part VI, note 189; see also Pamela A. Fuller, *International Legal Developments in Review: 2005, Regional & Comparative Law—Asia and Pacific Law—Japan*, 40 INT'L LAW. 515, 521–23 (2006) [hereinafter Fuller, Japan—2005 Int'l Legal Developments, Asia and Pacific Law—Japan]. In March 2005, Japan's Diet passed a provision, as part of Japan's new Tax Reform Act, which could be a trap for unwary foreign partners in Japanese partnerships, including LLPs. Foreign partners that do not have a permanent establishment in Japan will be liable for a 20% withholding tax on the partnership's actual distributions and deemed distributions. Japan Income Tax Act of 2006, art 212(3). The new provision, which is reminiscent of anti-deferral regimes, is effective for calendar-year partnerships beginning in 2006. *Id.* at supplement, art. 3.

98. In 2002, Japan enacted a corporate consolidated tax system which is largely patterned on the U.S. consolidated system. See *Hojin-zei ho* [Corporate Tax Law], Law No. 34 of 1965, art. 4–2 (2002); cf. I.R.C. §§ 1502–04. As with the U.S. system, consolidated tax relief is only extended to domestic corporations.

99. For nonprofit companies and corporations with stated capital of 8 million yen or less, Japan's national corporate income tax rate is 22%.

100. Japanese corporations also do not enjoy a capital gains preference when they sell shares in their subsidiaries; such gains are generally taxed at their ordinary income rate.

101. See, e.g., I.R.C. §§ 951–64 (RIA 2006). Like the U.S. CFC rules, the Japanese CFC regime is also aimed at taxing Japanese shareholders on the passive, low-taxed earnings of their CFCs. A foreign corporation qualifies as a CFC under Japanese law if more than 50% of its shares are owned, directly or indirectly, by Japanese residents.

102. Japanese shareholders may elect to deduct their foreign taxes in lieu of the credit.

103. The statutory concept of place of business is similar to, but broader than, the treaty concept of permanent establishment.

proprietor was a Japanese resident. Depending on the type of business and the type of income it generates, other non-business income of the foreign proprietor may be required to be aggregated with the business income and subjected to tax on a net basis. Japanese law thus reflects a strong force-of-attraction principle.

In the absence of a place of business in Japan, nonresident individuals and foreign corporations will be taxed only on their Japan-source dividends, interest, and royalties, which are generally subject to a 20 percent gross-basis withholding tax. A lower withholding rate of 15 percent applies to interest from Japanese bonds, domestic corporate debentures, and domestic bank deposits. Japan does not have a branch profits tax.

3. Status of Tax Treaties under Japanese Law

Japanese law does not allow domestic legislation to override existing treaty provisions. Article 98 of the Japan Constitution provides that treaty obligations should be faithfully observed,¹⁰⁴ which has been interpreted as establishing the superiority of international treaty obligations over domestic law, even if the domestic statutes are enacted later in time. The only way domestic legislation may trump a treaty provision is if the treaty itself contains a savings clause that preserves the application of domestic law in situations described in the treaty itself.

IV. Japan-U.S. Tax Treaty—Operative Articles

The scope of the recently effectuated Japan-U.S. Tax Treaty is sweeping, and an exhaustive analysis of its many provisions exceeds the scope of this discussion. Rather, the following discourse focuses on some of the more noteworthy articles contained in the new Treaty, explains how these rules differ from those found in the old 1971 treaty, and attempts to evaluate how well these provisions deal with problems that are innate to the current system for taxing international income, as well as the extent to which the provisions may be serving international tax policy objectives.

A. WITHHOLDING TAXES ON INVESTMENT INCOME

Bilateral tax treaties mitigate double juridical taxation by resolving the potentially conflicting claims of two countries to tax the same item of income. In the case of investment income—especially royalties, interest, and dividends—the standard international tax practice is for the country in which the income arose (i.e., the Source State) to yield most of its tax claim to the country of the income recipient's residence (i.e., the Residence State). Thus, pursuant to a bilateral tax treaty, the Residence State preserves its right to tax the foreign-source investment income of its residents, and the Source State agrees to limit its withholding tax to a relatively low rate or eliminate it entirely.¹⁰⁵

Among the most notable revisions reflected in the new Japan-U.S. Tax Treaty are the reciprocal reductions in gross-basis withholding taxes¹⁰⁶ imposed by the Source State.

104. KENPO, art. 98, para. 2 (1946).

105. This norm is consistent with the 1920s' Compromise previously discussed. See *infra* Part. II.D.

106. See, e.g., I.R.C. § 871(a) (RIA 2006) (imposing a 30% withholding tax on income of nonresident alien individuals not connected with a U.S. business); I.R.C. § 881(a) (imposing a 30% withholding tax on income of foreign corporations not connected with a U.S. business); I.R.C. § 1441 (withholding of tax on nonresident aliens); I.R.C. § 1442 (withholding of tax on foreign corporations).

The 1971 treaty had set maximum withholding tax rates on cross-border investment income that were significantly higher than the rates reflected in most U.S. tax treaties with industrialized countries. The new Treaty reduces these reciprocal withholding rates, in some instances bringing the rates into line with other tax treaties the United States has recently negotiated, but in some instances, reducing the rates below those reflected in the Model Treaty issued by the OECD,¹⁰⁷ and even those set forth in the U.S. Model Tax Treaty.¹⁰⁸ The target withholding rates proposed in the OECD Model Tax Treaty are zero percent on royalties, 10 percent on interest, and 5 percent on dividends.¹⁰⁹ The U.S. Government's objectives for withholding rates, as reflected in the U.S. Model Tax Treaty, are zero percent on royalties and most categories of interest, and 5 percent on dividends received by corporate shareholders holding directly at least 10 percent of the voting stock of the payor.¹¹⁰ As further explained below, the new Japan-U.S. Tax Treaty provides for a zero percent withholding rate on all qualified royalties, a zero percent rate on direct dividends paid by 50-percent-owned subsidiaries, and a zero percent rate on broad categories of interest, although a 10 percent tax rate generally applies to interest.

The elimination of withholding tax on these broad categories of investment income was a key objective of the U.S. Treasury Department when it negotiated the new Tax Treaty with Japan. The final agreement represents a remarkable and "unprecedented departure from historic Japanese tax treaty policy."¹¹¹ For the United States, the zero percent withholding rate on all royalties and intercompany dividends also sets a new standard. Only recently has the United States been able to negotiate a zero percent withholding rate on some intercompany dividends, and even in the three other treaties that reflect that rate—the United Kingdom, Australia, and Mexico—the category of exempt dividends is defined much more narrowly than under the new Japan-U.S. Treaty. In fact, the Japan-U.S. Treaty is the first U.S. income tax treaty in which the imposition of domestic withholding taxes are limited to such a great degree. The magnitude of this policy change is amplified by the fact that the reduced rates were agreed to by two of the world's largest economic giants. It is difficult to predict exactly how this aspect of the Treaty will impact the development of cooperative tax agreements between other sovereign states, but it undoubtedly will have a significant impact. It is very likely that the almost complete elimination of withholding taxes on investment income will serve to motivate other Asian countries to attempt to negotiate the same deal with the United States in order to attract more portfolio investment and to stay economically competitive. Moreover, it may spur small developing countries to enter into cooperative international tax agreements, even if they are not based on the bilateral OECD Model.

1. *Royalty Income—Article 12*

In the last two decades, economies have become increasingly borderless due in part to advances in certain technologies (like fiber optics and digital electronics), which have been nothing short of revolutionary. Today, industrial processes, know-how, and other intangibles

107. See OECD Model Tax Treaty, *supra* note 29.

108. See United States Department of the Treasury, UNITED STATES MODEL INCOME TAX CONVENTION OF NOVEMBER 15, 2006 (Nov. 15, 2006) available at <http://www.irs.gov/pub/irs.trty/usmtech..pdf>. [hereinafter U.S. Model Treaty or U.S. Model Tax Treaty]. The U.S. Model Treaty is an archetype the United States has long held out as its ideal tax treaty. The U.S. Treasury Department routinely uses the U.S. Model Treaty as its starting point in all its tax treaty negotiations.

109. See OECD Model Tax Treaty, *supra* note 29, arts. 12(1) (royalties), 11(2) (interest), 10(2) (dividends).

110. See U.S. Model Tax Treaty, *supra* note 108, arts. 12(1) (royalties), 11(1) (interest), 10 (dividends).

111. See 2003 Tax Treaty Hearing, *supra* note 5.

are often developed in one country, and then utilized all over the world. Recognizing the high volume of transfers of intangibles between the United States and Japan, U.S. treaty negotiators wanted to overhaul the existing rules for the treatment of royalties.¹¹² The 1971 Treaty allowed the Source State to impose a 10 percent withholding tax on cross-border royalties. Ten percent may seem low, but the withholding tax¹ was computed on a gross basis, which frequently led to excessive taxation because the developer of the licensed intangible often incurred substantial research, development, and marketing costs, none of which it was allowed to deduct. Moreover, because the withholding tax on royalties could be imposed even though the taxpayer had no actual presence in the Source State, the withholding tax put considerable pressure on the need to distinguish between royalty income and other types of income not subject to gross withholding tax, including income derived from personal services. In today's world, it has become much more difficult to distinguish between different types of income; the old lines of demarcation have become increasingly nebulous and, in many cases, obsolete.

Article 12 of the new Treaty completely eliminates Source-State taxation of royalty income "beneficially owned by a resident of the other Contracting State."¹¹³ In other words, the new Japan-U.S. Tax Treaty allocates the right to tax royalties solely to the Residence State, which will tax them on a net basis in the same manner as other business profits. Treating royalties in the same manner as business profits removes a source of dispute in tougher cases where it becomes difficult to distinguish royalty income from other types of income. The zero percent withholding rate on royalty income is consistent with the U.S. Model Treaty.

Although beneficial ownership is a critical prerequisite to claiming treaty-reduced withholding rates on royalties, interest, and dividends, the text of the Japan-U.S. Treaty, like other treaties, does not attempt to define what a beneficial owner is. Rather, the U.S. Treasury's Technical Explanation clarifies that one must look to the internal law of the Source State to determine the beneficial owner, which is generally the "person to which royalty income is attributable for tax purposes under the laws of the State of source."¹¹⁴ Identifying the beneficial owner—an undefined treaty term—remains one of the most difficult problems in tax treaty interpretation.

Article 12 of the new Treaty defines "royalties" broadly to include:

... payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films and films or tapes for radio or television broadcasting, any patent, trademark, design or model, plan, or secret formula or process, or for information concerning industrial, commercial or scientific experience.¹¹⁵

112. See *id.*

113. See Japan-U.S. Tax Treaty, *supra* note 1, at art. 12. Only beneficial owners who are residents of the other Contracting State may claim the treaty reduced rates on royalties, interest, and dividends. See *id.* arts. 10(2)-(3), 11(2), and 12(1).

114. Technical Explanation of Japan-U.S. Tax Treaty, *supra* note 9, ¶ 266. But, this definition of beneficial owner, which relies on the Source State's domestic tax law, as directed by Article 3(2) of the Treaty applicable to undefined treaty terms, appears to be in direct conflict with the methodology being adopted in many treaties, including the new Japan-U.S. Tax Treaty, for determining which persons are "liable to tax" on items derived through fiscally transparent entities. That methodology looks to the internal tax law of the Residence State in almost all cases, and ignores the Source State's determination of who is the beneficial owner of the income, presumably liable to tax. See discussion *infra* at Part. IV.

115. Japan-U.S. Tax Treaty, *supra* note 1, art. 12(2).

Unlike the old 1971 Treaty, the new Treaty excludes from the definition of royalties any gains “derived from the alienation of any right or property that would give rise to royalties, [regardless of whether such gains are] contingent on the productivity, use, or further alienation” of the property.¹¹⁶ Instead, those gains are dealt with under Article 13 (Gains), although they are generally treated the same as royalties in that they are exempt from Source-State taxation. Royalties, for Article 12 purposes, also do not include income from the lease of personal property.

Historically, there has been a problem in differentiating royalty income from business profits and income from personal services. These characterization issues frequently arise with respect to computer software, which is universally protected by copyright laws. Under the Treaty, consideration received for the use of, or the right to use, computer software may ultimately be treated as either royalty income or business profits, depending on the circumstances of the transaction. The primary factor in making the determination is the nature of the rights transferred. To be characterized as a royalty under the Treaty, the consideration paid must be for the use of, or right to use, the software. “The fact that the transaction is characterized as a license for copyright purposes is not dispositive.”¹¹⁷ According to the U.S. Treasury’s Technical Explanation, a typical retail sale of shrink wrap software will normally not be viewed as giving rise to royalty income for Article 12 purposes, even though for copyright purposes, it is clearly characterized as a *license*. The means by which the computer software is transferred is also irrelevant for purposes of determining whether the payment is a royalty for treaty purposes. Thus, if software is electronically transferred, but the rights obtained by the transferee are substantially equivalent to rights in a program copy, then the payment will be considered business profits, and taxed accordingly on a net basis in the Source State if the income is attributable to a permanent establishment.¹¹⁸

In general, the zero percent withholding rate for royalty income is not available if the royalties are attributable to a permanent establishment or other fixed place of business of the recipient in the Source State. In that case, the income would be taxable under Article 7 as business profits.¹¹⁹

The new Treaty injects transfer pricing principles into the Royalty article. Paragraph 4 of Article 12 provides that in cases where there is a non-arm’s length relationship between the payor and the beneficial owner of the royalty, then the zero percent withholding rate is available “only to the extent the royalties would have been paid absent such special relationship(s).”¹²⁰ Any excess amount of royalty income may be taxable in the Source State at a rate not to exceed 5 percent.¹²¹

At the request of Japan, the new Treaty contains an additional limit on the availability of treaty benefits when they are claimed in connection with certain conduit schemes involving royalties, interest, and dividends. In the Royalties article, this limitation appears in

116. Technical Explanation of Japan-U.S. Tax Treaty, *supra* note 9, ¶ 266 [emphasis added].

117. *Id.* ¶ 272.

118. *See id.* ¶¶ 272–74.

119. *See* Japan-U.S. Tax Treaty, *supra* note 1, art. 12(3). In general, the profits of an enterprise of one Contracting State may not be taxed by the other Contracting State unless the enterprise carries on business in that other Contracting State that rises to the level of a “permanent establishment” or “PE” as its known for short, a term of art that Article 5 of the Treaty attempts to define. *See* discussion of Business Profits *infra* Part IV.B.

120. Technical Explanation of Japan-U.S. Tax Treaty, *supra* note 9, ¶ 279 (explaining limitation of Article 12(4)). *See* discussion of transfer pricing provisions *supra* Part V.

121. *See* Japan-U.S. Tax Treaty, *supra* note 1, art. 12(4) (last sentence).

Paragraph 5, which states that a resident of a Contracting State shall not be considered to be the beneficial owner of the royalty if the royalty would not have been paid but for the resident's agreement to repay the royalty to a third party that is not a resident of either Contracting State. Because Japan's domestic law does not provide sufficient protection against these conduit schemes, the limiting caveat was included in the new Treaty. But, its inclusion may signal a new trend in tax treaty negotiation; such language is beginning to appear in other recently negotiated U.S. treaties. For example, there is a similar provision in the 2001 tax treaty between the United States and the United Kingdom,¹²² although the breadth of the latter provision is broader than that found in the U.S.-Japan Tax Treaty. The United States already has elaborate rules aimed at conduit financing,¹²³ which are more stringent than the provision included in the new Japan-U.S. Tax Treaty. The U.S. rules policing conduit financing structures shall continue to apply.

2. Interest Income—Article 11

Like the old 1971 treaty, the new Japan-U.S. Tax Treaty allows the Source State to impose a withholding tax on interest payments. This represents a departure from the rule reflected in tax treaties the United States has recently negotiated with other industrialized nations, in which the Residence State was granted the exclusive right to tax qualified cross-border interest income. The maximum allowable withholding rate under the new Treaty is generally 10 percent if paid to a resident of the other Contracting State that beneficially owns the interest, which is the same maximum rate that applied under the 1971 Treaty.

But unlike the 1971 Treaty, Article 11 of the new Treaty eliminates Source-State withholding tax on broad categories of interest.¹²⁴ The most significant of these is the elimination of Source-State withholding tax for interest earned by financial institutions. "Due to the highly-leveraged nature of financial institutions, imposition of a withholding tax on interest received by such enterprises could result in taxation that actually exceeds the net income from the transaction."¹²⁵ Interest falling within this exempt category includes interest beneficially owned by a resident bank, an insurance company, a registered securities dealer, or a qualified deposit-taking entity as defined.¹²⁶ Moreover, interest paid to a resident creditor on debt arising as part of a credit sale of equipment or merchandise is exempt from a withholding tax under the new Treaty. This latter exemption appears to apply not only to the resident seller that originally extended the credit, but also to any beneficial owner of the account receivable that is a resident of the other Contracting State.¹²⁷

Source-State withholding tax is also eliminated on interest received by either of the two governments directly, and on interest received by residents with respect to debt claims that were guaranteed, insured, or directly financed by either of the two governments.¹²⁸

122. See U.S.-U.K. Convention, *supra* note 11.

123. See I.R.C. § 7701(l) (RIA 2006), which authorizes regulations "recharacterizing any multiple-party financing transaction as . . . appropriate to prevent avoidance of any tax imposed by this title." Regulations under I.R.C. § 7701(l) were issued in 1995, and allow the U.S. Internal Revenue Service to "disregard . . . the participation of one or more intermediary entities in a financing arrangement" for purposes of I.R.C. §§ 871, 881, 1441-42 (i.e., the withholding tax). Treas. Reg. § 1.881-3(a)(1) (1995).

124. See Japan-U.S. Tax Treaty, *supra* note 1, art. 11(3).

125. 2003 Tax Treaty Hearing, *supra* note 5.

126. See Japan-U.S. Tax Treaty, *supra*, note 1, art. 11(3)(c).

127. *Id.* art. 11(3)(e).

128. *Id.* art. 11(3)(b).

Moreover, interest earned by pension funds is also exempt from Source-State withholding tax.¹²⁹ Treaty negotiators felt that imposing a withholding tax on interest received by pension funds would be burdensome because there is no mechanism for providing individual pension beneficiaries with foreign-tax-credit relief for any withholding taxes that would otherwise be imposed on investment income years before the retiree actually receives distributions from his pension fund.

The above exemptions from Source-State withholding tax on interest are broader than any similar exemptions Japan has so far negotiated in its other tax treaties. The willingness of Japan to agree to these rates is likely a direct reflection of former Prime Minister Koizumi's announced goal of doubling foreign investment by the year 2008.¹³⁰

Article 11 defines interest fairly broadly to include "income from debt-claims of every kind . . . whether or not carrying a right to participate in the debtor's profits."¹³¹ This definition is broader than the definitions of interest under the either the U.S. Internal Revenue Code or the OECD Model Treaty. And, although the new Treaty is careful to state that income under Article 10 (i.e., dividends) "shall not be regarded as interest for purposes of this Convention,"¹³² the broad definition of interest in the new Treaty, which relies on the Source State's tax treatment of the income and which does not exclude any penalty charges for late payment, represents a departure from the norm.

As with royalty income, if the beneficial owner of the interest carries on business through a permanent establishment in the Contracting State where the interest arises and the interest is attributable to that PE, then the interest is characterized as business profits for purposes of the Treaty and governed by Articles 5 and 7.¹³³

The U.S. Internal Revenue Code exempts a number of categories of interest from its withholding tax. These exemptions include certain bank deposit interest¹³⁴ and portfolio interest.¹³⁵ The new Treaty sets the maximum withholding rates allowable and should not be construed to restrict any tax exemption provided under the internal laws of either Contracting State. Thus, a Japanese lender would still be exempt from U.S. withholding tax if the interest it receives qualifies as exempt portfolio interest under U.S. tax law.¹³⁶

As with the Royalties article, transfer pricing principles are also reflected in the Interest article.¹³⁷ Article 11 provides that in cases involving a "special relationship between the payor and the beneficial owner," where the amount of interest paid exceeds the amount that would otherwise have been agreed upon in the absence of the special relationship, then the reduced treaty rate applies "only to the last-mentioned amount"—that is, the "arm's length interest payment," as it is called in the U.S. Treasury's Technical Explanation.¹³⁸ The Treaty does not define what a special relationship is, but the Technical Explanation states that the

129. *Id.* art. 11(3)(d).

130. See Press Release, U.S. State Dep't., U.S.-Japan Investment Initiative (May 23, 2003), available at <http://www.state.gov/r/pa/prs/ps/2003/20940.htm>.

131. Japan-U.S. Tax Treaty, *supra* note 1, art. 11(5).

132. *Id.*

133. See discussion of treatment of business profits *infra* Part IV.B.

134. See I.R.C. §§ 871(i)(2)(A), (3), 881(d) (RIA 2006).

135. Portfolio interest is defined to include original issue discount (OID), explicit and unstated. See I.R.C. §§ 871(h)(2), 881(c).

136. See I.R.C. § 871(h)(2) (defining "portfolio interest" for purposes of the exemption).

137. See Japan-U.S. Tax Treaty, *supra* note 1, art. 11(8).

138. See Technical Explanation of 2003 Japan-U.S. Tax Treaty, *supra* note 9, ¶ 248.

determination of whether such a relationship exists turns on the definition of control as it is interpreted within the context of Section 482 of the U.S. Internal Revenue Code. This broad construction is consistent with the OECD Commentaries to the Interest article in the OECD Model Treaty.¹³⁹

Benefits under Article 11 are not available with respect to back-to-back loan schemes, where the recipient of the interest payment would not have established the debt-claim but for the establishment of another debt-claim with a person that is not entitled to the same or more favorable treaty benefits. Similar anti-abuse rules appear in both the Royalties and Dividends articles to deny treaty benefits in the context of conduit structures involving those types of income, respectively. The anti-conduit language may represent a new trend in the negotiation of U.S. tax treaties with countries that do not have sufficient protections against conduit schemes.

3. Dividend Income—Article 10

The new Treaty significantly reduces the Source States' maximum withholding taxes with respect to all types of cross-border dividends. Under the 1971 Treaty, the Source State could impose a maximum 10 percent withholding tax on dividends paid to companies resident in the other Contracting State that beneficially owned at least 10 percent of the stock of the payor company. Portfolio dividends (i.e., those paid to resident individuals or companies owning less than 10 percent of the payor) could be taxed at a maximum withholding rate of 15 percent. The new Treaty reduces these rates, imposing three different rate structures, depending on the payee's level of stock ownership in the payor.¹⁴⁰

Under the Treaty, the Source State can impose a gross withholding tax of 10 percent on portfolio dividends received by a resident of the other Contracting State when the resident qualifies as the beneficial owner on the date when entitlement to the dividend is determined. If the beneficial owner of the dividend is a company that owns, directly or indirectly (i.e., through tiers of entities resident in either Contracting State), at least 10 percent of the voting stock of the payor company, then the Source State can impose a gross withholding tax of no more than 5 percent. Notwithstanding these provisions, the Treaty provides for a zero percent withholding rate for dividends paid if the beneficial owner of the dividend is a company that has owned, directly or indirectly, greater than 50 percent of the voting stock of the company paying the dividend during the 12-month period ending on the date on which entitlement to the dividend is determined, and one of three alternative tests is satisfied. Under the additional requirement, the payee company must either: (1) meet the "publicly traded" test set forth in the Limitation-on-Benefits (LOB) article;¹⁴¹ (2) meet both the ownership/base-erosion and active-trade-or-business tests described in the LOB article;¹⁴² or (3) be granted express eligibility by the competent authorities pursuant to the LOB article.¹⁴³

Certain tax-exempt pension funds are also eligible for the zero percent withholding rate on cross-border dividends, provided the dividends are not derived from the carrying on of a business, directly or indirectly, by the pension fund.¹⁴⁴ Special rules apply to dividends paid

139. See OECD Model Tax Treaty, *supra* note 29, Commentary on art. 11 (as updated in 2005); see also discussion of transfer pricing *infra* Part V.

140. See Japan-U.S. Tax Treaty, *supra* note 1, art. 10(2)(a)–(b) and (3).

141. See *id.* art. 22(1)(c).

142. See *id.* art. 22(1)(f), (2).

143. See *id.* art. 22(4).

144. See *id.* art. 10(3)(b).

by a U.S. Regulated Investment Company (RIC) or a U.S. Real Estate Investment Trust (REIT), as well as their Japanese counterparts.¹⁴⁵

The complete elimination of Source-State withholding taxes on dividends from controlled subsidiaries is not the current U.S. Model Treaty position. U.S. Treasury officials have publicly stated that it is not appropriate to agree to such an exemption in every treaty: “Consideration of such a provision in a treaty is appropriate only if the treaty contains anti-treaty-shopping rules that meet the highest standards and the information exchange provision of the treaty is sufficient to allow [confirmation] that the requirements for entitlement to this benefit are satisfied.”¹⁴⁶ Moreover, despite its inclusion in several recently negotiated U.S. tax treaties, the withholding tax exemption on direct dividends is also not reflected in the next version of the U.S. Model Tax Treaty, released in late 2006.¹⁴⁷ Nonetheless, in attempting to discern the direction of international treaty policy, it is worth noting that numerous bilateral tax treaties to which the United States is not a partner do eliminate withholding taxes on intercompany dividends, and that the European Union in its Parent-Subsidiary Directive achieves the same exemption result. Moreover, an increasing number of countries are agreeing to include sophisticated LOB articles and verifiable information exchange procedures in their tax treaties—two U.S. criteria for agreeing to the zero percent withholding rates on intercompany dividends. Thus, over time, it should become easier to verify, through compliance with the LOB and the Exchange-of-Information articles, that the requisite ownership thresholds for qualifying for the withholding tax exemption have been reached and maintained. Accordingly, as the Japan-U.S. Tax Treaty joins a growing list of bilateral tax treaties that completely eliminate the Source State’s jurisdiction to tax intercompany dividends, it is not irrational to postulate that such a limitation on withholding tax will likely evolve into standard treaty practice or, at the very least, become a widespread objective of tax treaty negotiation. It is safe to conclude the Japan-U.S. Treaty sets a new standard in this regard, if not a new precedent.¹⁴⁸

B. BUSINESS PROFITS—ARTICLES 5 AND 7

The 1920s’ Compromise, which first took shape in the OECD’s 1963 draft Model Treaty, held that the taxation of business income should be allocated to the country of its source and the taxation of portfolio income should be allocated to the country of the capital supplier’s residence. The Japan-U.S. Tax Treaty’s treatment of business profits still reflects this compromise. Paragraph 1 of Article 7 states that the profits of an enterprise are taxable only in the Contracting State where the enterprise is situated “unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein,” in which case the other Contracting State may tax the business profits “but only so much of them as [are] attributable to the permanent establishment.”¹⁴⁹ The concept of permanent

145. See *id.* art. 10(4).

146. See 2003 Tax Treaty Hearing, *supra* note 5.

147. See U.S. Model Tax Treaty, *supra* note 108; Kevin Bell, *New U.S. Model Treaty Won’t Provide For Zero Dividend Withholding, Official Says*, *WORLDWIDE TAX DAILY*, Apr. 13, 2005, available in LEXIS, Intlaw library, TNI file, 2005 WTD 70-4 (quoting Patricia A. Brown, U.S. Treasury Deputy International Tax Counsel).

148. U.S. treaty negotiators have staunchly maintained that each tax treaty stands on its own and that treaty benefits are negotiated with other countries on a case-by-case basis. See *id.* However, this unofficial bargaining position seems to contradict the fact that the U.S. requires that a Limitation-on-Benefits clause and a Savings clause be included in all of its new treaties and protocols.

149. Japan-U.S. Tax Treaty, *supra* note 1, art. 7(1).

establishment is a key but elaborate term,¹⁵⁰ the basic function of which, under the new Treaty, is to allocate business profits to a jurisdiction only if and to the extent the enterprise is participating in the economic life of the jurisdiction.¹⁵¹ Article 5 of the Treaty defines permanent establishment as a “fixed place of business”—including a place of management, a branch, an office, a factory, mine, or place of extraction of natural resources—“through which the business of an enterprise is wholly or partly carried on.”¹⁵² Thus, two questions are involved: first, is there a PE as defined under Article 5; and, secondly, what profits are attributable to that PE? Article 7 addresses the second question.

The rule in Article 7 that only profits that are attributable to the PE are taxable by the other Contracting State is roughly analogous to the effectively connected income concept, used in U.S. tax law for determining whether a foreign person operating a U.S. trade or business will be taxed on the net income of that business at graduated rates.¹⁵³ The term profits is not explicitly defined in the Treaty, but the Technical Explanation makes it clear that the term includes income from personal services and income attributable to notional principle contracts and other financial instruments. Profits of a PE also may include income derived by a partner residing in one Contracting State, but which is attributable to the personal services performed by his partnership in the other Contracting State where there is a PE. In other words, all personal services performed by the partnership are viewed in the aggregate and those services attributable to the PE are taxable, including those services of a partner who may be located outside the jurisdiction where the PE's office or site is located.¹⁵⁴

Paragraph 2 of the Diplomatic Notes confirms that the arm's length principle set forth in Article 9 (Associated Enterprises) may apply in determining the profits attributable to a PE.¹⁵⁵ In general, Article 7 is to be applied using a functional analysis, taking into account

150. For the nuances, *see* OECD Model Tax Treaty, *supra* note 29, Commentaries to arts. 5, 7.

151. But some treaties apply a limited force-of-attraction principle whereby a Contracting State may tax *all profits* of the enterprise derived within its territory even if those profits are *not* directly attributable to the enterprise's PE. This so-called “residual force of attraction principle,” which is found in U.S. tax law at I.R.C. § 864(c)(3), is not the rule adopted in Article 7 of the new Japan-U.S. Treaty. *See* Technical Explanation of Japan-U.S. Tax Treaty, *supra* note 9, ¶ 135.

152. Japan-U.S. Tax Treaty, *supra* note 1, art. 5(1), (2). Thus, the rationale for the PE concept is consistent with the ostensible *in rem* entitlement of a source country to benefit from the gains reaped within its borders since it is providing the profit-enabling environment. *See* discussion *infra* Part II.D & E.

153. *See* I.R.C. § 864(c)(1) (RIA 2006) (defining “effectively connected income”).

154. *See* Technical Explanation of Japan-U.S. Tax Treaty, ¶¶ 126–27. The Technical Explanation gives the following example:

[A] legal partnership has five partners (who agree to split profits equally), four of whom are resident and perform personal services only in Japan at Office A, and one of whom performs personal services at Office B, a permanent establishment in the United States. In this case, the four partners of the partnership resident in Japan may be taxed in the United States in respect of their share of the income attributable to the permanent establishment, Office B. The services giving rise to income which may be attributed to the permanent establishment would include not only the services performed by the one resident partner, but also, for example, if one of the four other partners came to the United States and worked on an Office B matter there, the income in respect of those services. Income from the services performed by the visiting partner would be subject to tax in the United States regardless of whether the visiting partner actually visited or used Office B while performing services in the United States.

Id. ¶ 127.

155. *See* Exchange of Diplomatic Notes Accompanying the Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-Jap., Nov. 6, 2003, S. Treaty Doc. No. 108–14, [hereinafter Diplomatic Notes].

the different economics that arise from operating through a single legal entity as opposed to separate legal entities. For example, banks that trade in global securities often use internal swap transactions to shift risk from one branch to a central location where the traders have the expertise to manage that particular risk. The Treaty allows a bank to employ such swap transaction as a means of allocating income between the branches if they use of the transfer pricing method that constitutes the best method within the meaning of the U.S. transfer pricing regulations—specifically section 1.482-1(c). But the income can only be so attributed internally if the “sales and risk management functions that generate the income are performed in” that same location.¹⁵⁶

Determining whether there is a PE is necessary for purposes of applying many articles of the new Treaty. For example, the Treaty’s limitations on withholding rates for cross-border dividends, interest, and royalties (Articles 10, 11, and 12, respectively) are not available if such income is attributable to a permanent establishment that the recipient has in the Source State. The permanent establishment concept is also relevant in determining which Contracting State may tax certain Gains under Article 13 and certain Other Income under Article 21.

C. BRANCH PROFITS TAXES

Since 1986, the United States has imposed special taxes on unincorporated U.S. branches of foreign corporations doing business in the United States, in addition to the regular corporate income tax. The so-called “branch profits tax” is intended to replicate the tax that would be imposed under U.S. tax law if the U.S. branch were a separately incorporated domestic subsidiary. The U.S. branch profits tax rate is generally 30 percent.¹⁵⁷ The United States also imposes a second-level tax on interest paid to foreign recipients by a foreign corporation with substantial amounts of earnings that are “effectively connected” to a U.S. trade or business.¹⁵⁸ These branch taxes are often reduced or eliminated by treaty. Under the 1971 Treaty, Japanese corporations with unincorporated branches in the United States were considered exempt from all U.S. branch taxes. But under the new Treaty, the United States is allowed to impose the branch profits tax, but only at a reduced 5 percent rate. The branch profits tax may only be applied if the Japanese corporation has a PE in the U.S., or is subject to tax on either income from real property or on gains realized from the disposing of interests in real property. The Treaty provides that the branch taxes may not be imposed in cases where a zero percent rate would have applied to any dividends under Article 10 had the U.S. branch business actually been conducted through a U.S. subsidiary of the Japanese parent. The exception is consistent with the policy objective underlying the Branch Profits Tax—to burden the foreign corporation’s U.S. business profits with roughly the same two-tier U.S. corporate income tax regime regardless of whether its U.S. business is conducted through a U.S. subsidiary or an unincorporated branch.

D. INCOME FROM EMPLOYMENT AND STOCK OPTIONS

Article 14 of the new Treaty apportions taxing jurisdiction over the remuneration derived by a resident employee between Japan and the United States.¹⁵⁹ The general rule under

156. Technical Explanation of Japan-U.S. Tax Treaty, *supra* note 9, ¶ 133.

157. I.R.C. § 884(a).

158. I.R.C. § 884(f).

159. See Japan-U.S. Tax Treaty, *supra* note 1, art. 14.

Article 14 is that the State where the employee services were actually performed has primary jurisdiction to tax the employee's income. For example, if a U.S. citizen earns wages while working as a resident in Japan, Japan may tax the wages, and the United States will grant a foreign tax credit. Employee stock options are a form of employee compensation and are generally governed by Article 14. The Protocol to the new Treaty sets forth special rules regarding employee stock option plans (ESOPs) to deal with situations where the employee changes his work location after the date of the option grant, but before the option is exercised. The annex to the Treaty's Protocol describes four alternative scenarios; the outcome of each scenario is dependant on whether the stock option is treated as qualified under the tax laws of either or both Contracting States. Although the new Treaty rules governing stock options are not simple to apply, they attempt to ensure that income arising from a stock option is taxed only once and is fairly apportioned between the two Contracting States, either through the operation of the Treaty and its Protocol, or through the Mutual Agreement Procedure under Article 25.

E. GAINS FROM THE ALIENATION OF PROPERTY—ARTICLE 13

The new Treaty generally provides for exclusive Residence-State taxation of gains from the alienation of property, with a few exceptions. Pursuant to a major exception, gains from the sale of real property, and gains from the sale of shares or other interests in certain real property holding companies, may be taxed in the country where the real estate is located, even if the owner is not a resident in the country where the real property (or the holding company housing the real property) is located.¹⁶⁰ This rule is consistent with the U.S. Tax Code provision dealing with foreign sellers of real property holding companies as defined.¹⁶¹

Pursuant to a second major exception to the general rule giving the Residence State the primary right to tax gains from the alienation of property, the new Treaty preserves the non-exclusive right of the Source State to tax gains realized on the disposition of shares in certain restructured financial institutions that arise in the Source State. This narrow exception was included at the request of Japan to deal with the problems it has experienced in its banking sector. Under this rule, the Source State may tax gains on stock of resident restructured financial institutions if: (1) the financial institution had earlier received substantial financial assistance from the government to resolve its imminent insolvency; (2) a resident taxpayer had purchased its shares from the government; and (3) the stock is sold within five years of such assistance. A grandfather rule provides that this provision does not apply to any stock held by an investor who made an investment in such a financial institution prior to the Treaty's entry into force, including any after-acquired stock in the financial institution.¹⁶²

F. OTHER INCOME—ARTICLE 21

Under the 1971 treaty, income from financial services was usually subject to a gross basis withholding tax imposed by the Source State. The new Treaty changes the tax treatment of income from financial services with the addition of new Article 21 applicable to "other

160. See *id.* art. 13(2).

161. See I.R.C. § 897(a)(1), (c)(1) and (2) (RIA 2006).

162. Japan-U.S. Tax Treaty, *supra* note 1, art. 13(3).

income.”¹⁶³ This article, which applies to income not otherwise dealt with in Articles 6 through 20, assigns exclusive taxing jurisdiction to the residence of the beneficial owner of the income, so that income falling within this catch-all category is taxed on a net basis similar to the treatment of business profits. Examples of types of income covered by new Article 21 include income from covenants not to compete, punitive damage awards, income from gambling, and income from certain financial instruments to the extent such income is derived by persons not engaged in the trade or business of dealing in such instruments. Article 21 also applies to items of income that do not fit within the other treaty articles because of their source or some other characteristic. The Protocol confirms that securities lending fees, guarantee fees, and commitment fees generally will not be subject to Source-State withholding tax, but instead will be taxable in the Residence State in the same manner as other business profits, unless such fees are attributable to a PE in the Source State.

V. Transfer Pricing

Due to the difference in tax systems and tax rates of different countries, a multinational corporation may have a strong incentive to shift income, deductions, tax credits, and other tax attributes around within its commonly controlled group of companies in order to reduce the group's overall tax burden. Locating sales gains, for example, in a low-tax jurisdiction might be accomplished by setting artificially high prices between a related seller and buyer if the selling corporation is in a low-tax jurisdiction and the related buyer is located in a jurisdiction that will charge a higher rate on resale.

The new Treaty gives greater ammunition to tax authorities attempting to police this type of non-arm's length transfer pricing. The Diplomatic Notes, which the U.S. Secretary of State and the Japan Minister of Foreign Affairs exchanged when the Treaty was signed,¹⁶⁴ expressly incorporate the OECD Transfer Pricing Guidelines as a source of authority in applying the new Treaty. Thus, “[t]he domestic transfer pricing rules, including the transfer pricing methods, of each Contracting State may be applied . . . under the Convention only to the extent that they are consistent with the OECD Transfer Pricing Guidelines,”¹⁶⁵ which reflect the OECD Member States' consensus on application of the arm's length principle. Moreover, the Technical Explanation clarifies that the reference in “the Notes to the OECD Transfer Pricing Guidelines is to that document as it continues to evolve” over time.¹⁶⁶ Thus, the Contracting States' obligations under the Treaty may change as the OECD Guidelines are updated.¹⁶⁷

Article 9 (Associated Enterprises) of the new Treaty allows Japan and the United States to adjust the taxable income (or loss) of associated enterprises if the conditions of the enterprises' transactions differ from what they would have been if the enterprises were

163. See *id.* art. 21.

164. Diplomatic notes typically confirm and clarify the understanding reached by the parties to the treaty. By their terms, the diplomatic notes to the new Japan-U.S. Treaty are “regarded as constituting an agreement between the two Governments [and] enter into force at the same time as the Convention.” Diplomatic Notes, *supra* note 155, ¶ 8.

165. Diplomatic Notes, *supra* note 155, ¶ 3.

166. See Technical Explanation of Japan-U.S. Tax Treaty, *supra* note 9.

167. Technical Explanation of Japan-U.S. Tax Treaty, *supra* note 9, ¶ 165. Because the OECD is a consensus based organization, the OECD Transfer Pricing Guidelines cannot be changed without the acquiescence of all its members, including Japan and the United States. See *id.*

independent from each other. The Treaty's Protocol sets forth five factors that should be taken into account in making the comparison to hypothetical independent enterprises.¹⁶⁸ Associated enterprises are broadly defined to include any enterprise in one Contracting State that "participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State."¹⁶⁹

Enterprises need not be corporations, and two or more may be associated for Article 9 purposes if the same persons (whether or not residents of either Contracting State) wield *effective* control (not necessarily *legal* control) over an enterprise in one Contracting State and an enterprise in the other Contracting State. These principles are consistent with those enunciated in both the OECD Guidelines and the regulations under section 482 of the U.S. Internal Revenue Code.¹⁷⁰

The international norm for policing transfer pricing between different countries' tax jurisdictions has generally been the arm's length standard. The arm's length method was formulated at a time when it was fairly practical to find a genuine arm's length price in a comparable transaction. But with the rise in the volume of transfers of intangible assets and the increase in internal structural linkages between related firms, finding a comparable transaction is often impossible. For example, patents, copyrights, and trademarks are by definition unique. Despite these problems, both the United States and the OECD have expressed their firm commitment to the arm's length standard as being the best theoretical model among alternatives.¹⁷¹ The most often cited alternative is the formulary apportionment or unitary system under which an affiliated group of companies is treated as a single enterprise, and the total worldwide net income of

168. According to Paragraph 5 of the Protocol, five factors that could affect comparability include: (1) characteristics of the property or services transferred; (2) functions of the enterprises, taking into account the assets used and risks assumed; (3) contractual terms between the enterprises; (4) economic circumstances; and (5) business strategies of the enterprises. Japan-U.S. Tax Treaty, *supra* note 1, Protocol, ¶ 5.

169. Japan-U.S. Tax Treaty, *supra* note 1, art. 9(1). Paragraph 3 of Article 9 of the new Treaty appears to extend the domestic time frames within which a Contracting State must initiate an examination of the enterprise in order to make a transfer pricing adjustment. Neither the U.S. Model Treaty nor the OECD Model Treaty contains a comparable provision. According to Article 9(3), a Contracting State may not allocate profits to an enterprise pursuant Article 9 unless an examination is initiated within the seven-year period following the end of the taxable year in which the profits in question should have accrued to the enterprise. *See id.* art. 9(3). The U.S. Treasury's Technical Explanation questions whether the Treaty's longer assessment period will have any real effect given the generally applicable three- and six-year statutes of limitations that apply in the U.S. and Japan, respectively. *See* Technical Explanation of Japan-U.S. Tax Treaty, *supra* note 9, ¶ 178. But Article 1(5) states that the new Treaty's Savings Clause (i.e., Article 1(4)), which normally retains full taxing jurisdiction for a Contracting State over its residents or citizens, does not apply in the case of the limitation. But as the Technical Explanation points out, Article 1(2) (General Scope) of the Treaty provides, *inter alia*, that the Treaty shall not be construed to restrict a statutory allowance. *Id.* ¶ 180. It appears that even though the domestic limitations periods have run, the longer seven-year limitations period under the Treaty will allow a Contracting State to make a refund of tax to an enterprise as the result of a correlative adjustment, since such refund would not be a restriction of a statutory allowance. Under both domestic law and under the new Treaty, all the general limitations periods are extended in the case of the taxpayer's fraud or willful deceit, or when the inability to initiate an exam was due to the actions or inactions of the enterprise.

170. *See* Japan-U.S. Tax Treaty, *supra* note 1, art. 9(1); I.R.C. § 482 (RIA 2006); Treas. Regs. §§ 1.482-1 to -8 (as amended 2003).

171. *See generally* OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (June 18, 2001), available at <http://www.oecd.org> (follow "By Topic" hyperlink, then follow "Taxation" hyperlink, then follow "Transfer Pricing" hyperlink, then follow "Publications & Documents" hyperlink, then follow "Publications" hyperlink).

that aggregated enterprise is determined. The net income is then allocated to each of the relevant taxing jurisdictions on the basis of objective apportionment factors associated with each jurisdiction. The advantage of this approach is that it avoids having to find comparable transactions. The major drawback of formulary apportionment is that all the countries involved would have to agree on the rules for defining the worldwide income of the enterprise.¹⁷² Although the formulary approach has been allowed by the United States in certain limited contexts where it constituted the best method available, it appears that some kind of multilateral framework is necessary to institute the approach on more than a piecemeal basis.

The commensurate-with-income standard, which was added to Section 482 of the U.S. Internal Revenue Code in 1986, is now viewed as consistent with the arm's length standard as it is applied under Article 9 of the Japan-U.S. Tax Treaty.¹⁷³ The standard is normally applied to the transfer of a newly created intangible under the reasoning that an independent enterprise would not sell a new intangible to an unrelated party at a set price until it is known what level of income the intangible will produce. Thus, the standard, employing a fiction of yearly transfer, requires that a new price be determined annually as though an annual royalty was being paid to the transferor. The so-called "super royalty" is required to be commensurate with the income that the intangible actually produced.¹⁷⁴

It is critical to note that although the text of Article 9 refers only to "profits," the Technical Explanation to the Treaty makes it clear that the article authorizes adjustments to any tax attribute that will affect the enterprise's profits, including foreign tax credits, so long as such adjustments reflect the arm's length standard. Moreover, the article also permits the competent authorities to address thin capitalization issues. For example, they may scrutinize the capital structure of an enterprise and, apparently, may also re-characterize interest on a loan as equity. The fact that Article 9 gives the taxing authorities the power to re-characterize income in an international context is representative of the OECD's commitment to add more weapons to the arsenal of anti-abuse provisions in bilateral tax treaties. In cases where the Contracting States disagree on a transfer pricing issue, such as whether a particular adjustment is appropriate, the Treaty authorizes the competent authorities to employ the Treaty's Mutual Agreement Procedure to resolve the dispute.¹⁷⁵

172. Defining an apportionment formula and effective control are issues common to the arm's length standard and so, theoretically, do not pose an additional facilitative burden. Defining a worldwide tax base, however, involves many additional burdens. Professor Richard Vann of Australia explained the problem as follows:

[T]he formulary approach takes as its starting point the worldwide profits of the corporations that fall within the defined relationship. Unless there is agreement among all the countries that have a tax claim in relation to a particular transaction on this matter, the same scope for double taxation will arise as occurs in the bilateral context where the treaty partners cannot agree on the transfer price and in the context of unilateral relief of double taxation where, for example, differing source or residence rules are adopted by the countries involved. As soon as contacts with more than two countries are involved in a particular transaction, agreement of three countries at least is involved.

Vann, *Treaty for the Asian-Pacific?*, *supra* note 30, at 105–06.

173. See Technical Explanation, *supra* note 9, ¶ 68. The OECD did not always view the commensurate with income standard as being consistent with the arm's length approach. See Vann, *Treaty for the Asian-Pacific?*, *supra* note 30, at 106.

174. See Revised OECD Guidelines, *supra* note 171, at ¶¶ 6.28–6.35.

175. Japan-U.S. Tax Treaty, *supra* note 1, art. 25(3).

Transfer pricing principles are also reflected in the texts of several of the Treaty's other articles, including the Royalties article, the Interest article, and Article 21 dealing with Other Income.¹⁷⁶

VI. Fiscally Transparent Entities

One of the most complex problems that countries have begun to seriously deal with in their bilateral tax treaties has been the treatment of fiscally transparent entities. When an item of income is derived through an entity that is classified inconsistently by the Source State and Residence State—for example, as a fiscally transparent partnership by one State, and as a corporate taxpayer by the other State—issues are raised as to which person or persons are liable to tax on the income, and which persons qualify as residents for treaty purposes.¹⁷⁷ Without specific rules in a treaty to address this conflict-of-laws problem, the classification discrepancy can easily result in an item of income being subjected to double juridical taxation or, conversely, no tax at all.

A. MULTIPLE JURIDICAL TAXATION OF SAME INCOME

Assume, as in Diagram 1, that a Japan-sourced royalty is paid to X, an entity organized in Chile, and that X's interest holders (or investors) are U.S. residents. Neither the United States nor Japan has a bilateral income tax treaty with Chile.¹⁷⁸ Assume X is an eligible entity under the U.S. Entity Classification Regulations¹⁷⁹ and elects to be treated as a partnership for U.S. tax purposes. Further assume that under Japanese law, X is viewed as a non-fiscally transparent Chilean corporation. Thus, the company is a so-called hybrid entity, in that it is classified inconsistently by at least two countries with arguable claims to tax jurisdiction over the income it receives.

From Japan's perspective, the royalty is being paid to X Corporation, a resident of Chile, with which Japan has no tax treaty. Thus, Japan would impose its full withholding tax on the royalty income equal to 20 percent of the royalty. But because the United States views X as a fiscally transparent partnership, it would treat the U.S. resident partners as deriving the royalty income, whether or not distributed.¹⁸⁰ Finally, assuming Chile views X as a domestic corporation and does not exempt foreign-source income, Chile would also tax X on its receipt of the royalty income. Thus, in the absence of specific treaty rules addressing how parties to a bilateral tax treaty are to determine who is liable to tax on the income for purposes of identifying who is potentially qualified to claim treaty benefits, the royalty income

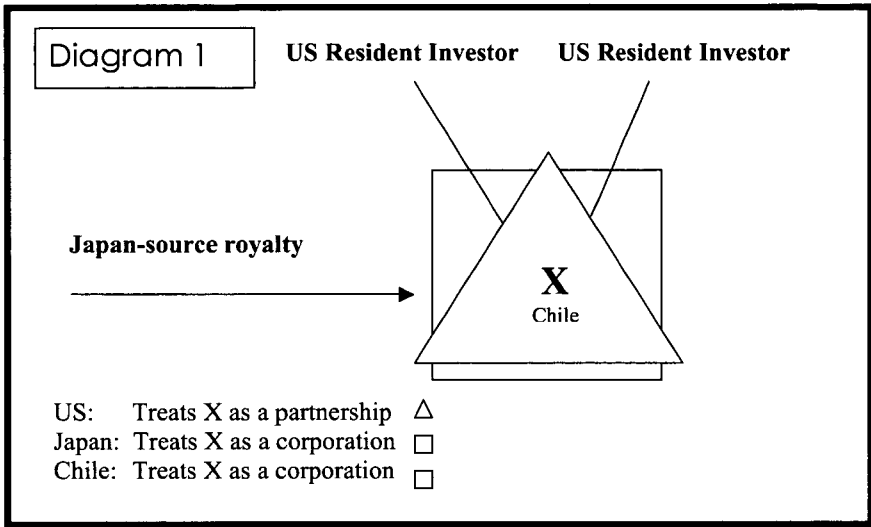
176. See Japan-U.S. Tax Treaty, *supra* note 1, art. 12(4) (Royalties); art. 11(8) (Interest); art. 21(3) (Other Income).

177. Except as otherwise provided in the new Japan-U.S. Tax Treaty, only persons who are residents of one or both Contracting States are eligible for treaty benefits, such as reduced tax rates. See Japan-U.S. Tax Treaty, *supra* note 1, art. 1. See discussion of the residence and liable-to-tax prerequisites, *supra* note 9 and Part III.

178. However, the U.S. is in the preliminary stages of trying to negotiate a bilateral tax treaty with Chile. See Tax Analysts, *Germany-U.S. Tax Treaty Arbitration Process Addresses Sovereignty Issue*, 2006 WORLDWIDE TAX DAILY 133-3 (July 12, 2006), available in LEXIS, Intlaw library, TNI file, Doc 2006-13150 (Treasury official characterizing as "insurmountable" the negotiating obstacles encountered by the U.S. in its efforts to expand its South American tax treaty network).

179. Treas. Reg. §§ 301.7701-1 to -5 (as amended in 2006).

180. I.R.C. §§ 701; 702(a), (b) (RIA 2006).



could easily be taxed three times as in Diagram 1—once by Japan through its withholding tax, once by the United States at the partner level,¹⁸¹ and once again by Chile. This tax result would be a strong disincentive to making the investment in the first place.

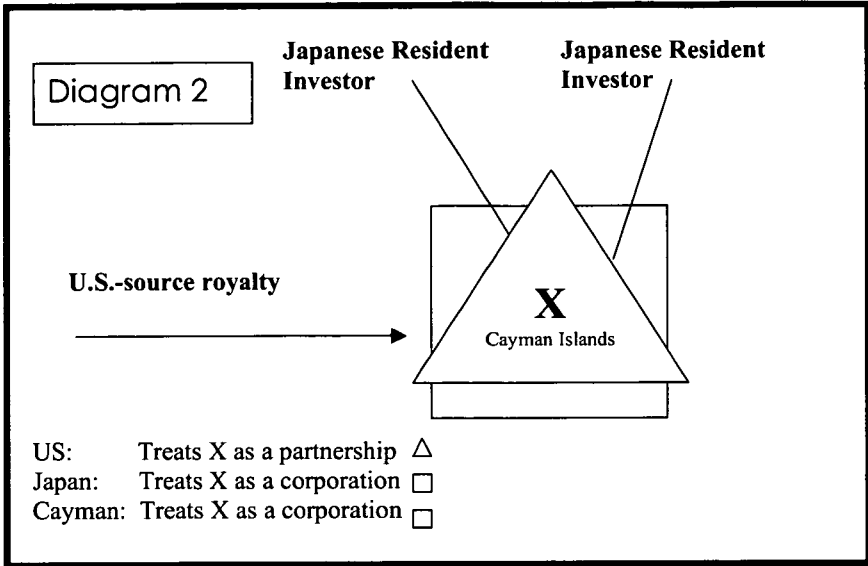
B. DOUBLE NON-TAXATION

Not surprisingly, tax planners have been exploiting conflicts in entity classification laws by deliberately structuring cross-border transactions with hybrid entities to avoid paying tax in any country on items of income.¹⁸² As illustrated in Diagram 2, assume that X is organized in a tax haven, the Cayman Islands, and that X elects under U.S. tax law to be taxed as a fiscally transparent partnership for U.S. tax purposes. Further assume that Japan views the Cayman entity as a non-fiscally transparent corporate taxpayer. X's interest holders are Japanese residents; the United States views them as partners liable to tax, and Japan views them as resident shareholders of a foreign corporation.

Without special rules for determining who is liable to tax on the royalty income for treaty purposes, each Contracting State would be left to apply its own classification rules without regard to the other Contracting State's inconsistent classification and treatment. Thus, when a U.S.-sourced royalty is paid to X as in Diagram 2, the United States, ignoring Japan's characterization, would treat the royalty as income of the Japanese partners of the X partnership and would reduce its withholding tax to zero percent under Article 10 of the treaty. Japan, however, would view the royalty as income of an opaque Cayman corporation and thus would not tax

181. Although the U.S. partners may be eligible to claim a foreign tax credit under I.R.C. § 901 for their shares of the withholding tax paid by the partnership, their individual tax circumstances may prevent them from fully utilizing the credit. See I.R.C. § 904 (foreign tax credit limitation).

182. Arbitrage structures, designed to avoid taxation altogether, became easier to structure in 1997 when the United States made entity classification, even in the international context, largely elective through promulgation of the Check-the-Box Regulations. See Treas. Reg. §§ 301.7701-1 to -5 (as amended in 2006).



the Japanese shareholders, even though the United States—the Source State in this example—reduced its withholding tax on the implicit but erroneous assumption that Japan—the Residence State—also views X as a partnership and would therefore tax the income in the partners' hands. The royalty is subject to only a nominal tax in the Cayman Islands—a tax haven. Thus, in the absence of special treaty rules for determining which persons are considered liable to tax on the income received by a hybrid entity, the royalty income could conceivably cross borders and be subject to no tax in the Source State, no tax in the Residence State, and little or no tax in the country of the entity's incorporation because it is a tax haven. Although this tax result distorts the true economic value of the investment, sophisticated tax planners continue to use myriad variants of this structure to avoid tax on all kinds of cross-border transactions.¹⁸³ Essentially, they structure transactions to take advantage of situations where there is either no tax treaty in place, or an older treaty that fails to clarify which Contracting State's domestic laws are to be used in classifying entities in particular situations, and which Contracting State's laws are to be used in identifying any residents of a treaty partner who are potentially liable to tax on the income in question so that they can properly be accorded treaty benefits.

C. OECD REPORT ON PARTNERSHIPS

In 1993, the OECD Committee on Fiscal Affairs (CFA) formed a working group to study the entity classification problem—specifically, the application of the OECD Model Income Tax Treaty to partnerships, trusts, and other unincorporated entities.¹⁸⁴ On January

183. The opportunities to employ hybrid entities, however, are becoming less abundant as more bilateral tax treaties and domestic laws are being adopted to target this kind of tax arbitrage. See, e.g., Treas. Reg. § 1.894-1(d) (as amended in 2002).

184. See OECD Committee on Fiscal Affairs, *The Application of the OECD Model Tax Convention to Partnerships*, ¶ 1 (1999) [hereinafter the OECD Report on Partnerships].

20, 1999, the working group officially adopted its first report on the subject, entitled "The Application of the OECD Model Tax Convention to Partnerships."¹⁸⁵ In the report, the CFA proposes that where an item of income is derived through an entity that is classified inconsistently in the Source State and Residence State, then:

... the Source state, in applying the Convention where partnerships [or other transparent entities] are involved, should take into account, as part of the factual context in which the Convention is to be applied, the way in which an item of income arising in its jurisdiction is treated in the jurisdiction of the taxpayer claiming the benefits of the treaty as a resident.¹⁸⁶

Under this OECD proposal, if the Residence State treats the income as flowing through to the partner, then the partner is the person who should be considered as being liable to tax and entitled to the benefits of the tax treaty of the State in which he resides (assuming such a treaty exists). On the other hand, if the income, although allocated to certain persons by the Source State, is not similarly allocated for purposes of determining the liability to tax on that item of income in the Residence State of the taxpayers who are claiming the benefits, then the Source State should not grant benefits under the treaty. According to the CFA, "the underlying factual premise on which the allocation of taxing rights is based . . . [is] that the source State is only obliged to reduce its domestic law tax claim where the income in question is potentially liable to tax in the hands of a resident of the treaty partner . . ."¹⁸⁷

D. ARTICLE 4(6)

Like other recently negotiated U.S. tax treaties, the Japan-U.S. Tax Treaty attempts to resolve the problem of fiscally transparent entities with its Residence article (Article 4).¹⁸⁸ The relevant provisions in the new Treaty dealing with fiscally transparent entities are more elaborate than those found in any U.S. tax treaty presently in force. The new Treaty also represents the first time Japan has included such provisions in one of its treaties, perhaps because the concept of flow-through-entity taxation has not been recognized in Japanese tax law until quite recently,¹⁸⁹ and Japan does not have anything on the order of the U.S.

185. *Id.* Although the OECD Report on Partnerships focuses exclusively on partnerships that qualify as such under civil law or commercial law, the CFA acknowledges that many of the principles discussed in its report may also apply to other non-corporate entities like trusts which, according to the report, will be the subject of a "follow-up work." See *id.* at ¶¶ 1, 37.

186. OECD Report on Partnerships, *supra* note 184, ¶ 53.

187. *Id.* To reflect this specific proposal in the OECD's Report on Partnerships, the CFA amended the official Commentary to the Residence article in the OECD Model Treaty, essentially proposing the same methodology for determining who is liable to tax and eligible to claim treaty benefits in the case of a fiscally transparent entity. See OECD Committee on Fiscal Affairs, *Model Tax Convention on Income and on Capital*, art. 1, ¶ 6.3 (2005) [hereinafter OECD Commentary].

188. Japan-U.S. Tax Treaty, *supra* note 1, art. 4(6), (dealing with fiscally transparent entities).

189. Two different kinds of partnerships have long been sanctioned under Japan's Commercial Code—the *gomei kaisha*, or unlimited partnership, and the *goshi kaisha*, or limited partnership. However, neither partnership form has played an important role in Japan due to their various restrictions. Until 2005, Japan had never sanctioned a business entity that combined the following attributes: (1) limited liability for the partners; (2) the ability to make special allocations of gains and losses that are disproportionate to the partners' relative equity interests in the partnership; and (3) pass-through taxation so that the entity itself is not subject to tax. Finally, on May 6, 2005, Japan authorized a new kind of limited liability partnership (LLP) that has this combination of attributes. The new law took effect on August 1, 2005. Yugen Sekinin Jigyō Kumiai [Limited Liability Partnership Act], Law No. 40 of 2005 [hereinafter LLP Act]. The LLP Act amends

Check-the-Box Regulations, which effectively give taxpayers the tools to perform international tax arbitrage.¹⁹⁰

Article 4(6) of the Treaty essentially codifies the basic approach of the OECD Report on Partnerships by establishing the general rule that one must look to the internal tax laws of the Residence State—not the State from which the income is sourced—to determine whether or not an entity is fiscally transparent and who is actually liable to tax. It is the Residence State's characterization that counts, and in almost all cases one is to ignore the Source State's characterization (or a third state's characterization) of the entity if it conflicts.¹⁹¹ The primary operational rule of the Treaty with respect to fiscally transparent entities is that when an item of income is derived from a Contracting State (i.e., the Source State) through an entity organized in a second Contracting State (i.e., the Residence State), and that entity is treated as fiscally transparent under the internal tax laws of the Residence State (e.g., as a partnership or tax transparent trust), the entity will be entitled to treaty benefits only to the extent its beneficiaries, members, partners, or participants are residents of that second Contracting State and otherwise qualify for treaty benefits under other provisions of the Treaty.¹⁹²

The Technical Explanation to the Treaty defines a fiscally transparent entity as one in which the income is normally taxed at the beneficiary, member, or participant level.¹⁹³ U.S.

Part II of Japan's Commercial Code, and is part of the sweeping revisions of Japan's company laws. See 2005 Companies Law, *supra* note 94. Japan's Ministry of Economy, Trade and Industry (METI) has issued an English explanation of the proposed LLP bill, available at <http://www.meti.go.jp/English/information/data/LLPe.html>. For U.S. tax purposes, the LLP is not a per se corporation under the U.S. Entity Classification Regulations. Although its default status is a corporation, it may elect to be treated as a partnership for U.S. tax purposes. For further explanation see Fuller, 2005 Int'l Legal Developments, Asia and Pacific Law—Japan, *supra* note 97, at 521–23.

190. In light of the robust growth in Japan's M&A market in 2005 and the fact that Japan has been incrementally amending its company laws to sanction new types of business entities, holding companies, tax-free spin-offs, and beginning in 2007, triangular cross-border mergers, it is quite foreseeable that Japan will also promulgate more explicit entity classification rules for classifying foreign entities as such rules become necessary. Presently, Japan tends to accept, for purposes of applying its own tax rules, a foreign jurisdiction's classification of a non-Japanese entity. That may be why transactions involving so-called “domestic reverse hybrid entities” (DRHE), and a set of controversial U.S. anti-abuse regulations denying treaty benefits to interest holders in certain DRHE transactions, are not directly addressed in either the Japan-U.S. Tax Treaty or the Technical Explanation; treaty negotiators may have thought that the problem was not likely to arise. See Treas. Reg. § 1.894-1(d) (as amended in 2002). A DRHE entity is defined as a “domestic [U.S.] entity that is treated as not fiscally transparent for U.S. tax purposes and as fiscally transparent under the laws of the interest holder's jurisdiction, with respect to the item of income received by the domestic entity.” *Id.* § 1.894-1(d)(2).

191. *But see* Japan-U.S. Tax Treaty, *supra* note 1, art. 1(4) (Savings Clause), discussed *infra* Part VI.E.

192. See Japan-U.S. Tax Treaty, *supra* note 1, art. 4(6)(a)–(e) (setting forth how the operative rule is applied in various situations); Technical Explanation of Japan-U.S. Tax Treaty, ¶¶ 73–78; see also Technical Explanation of Japan-U.S. Tax Treaty, *supra* note 9, ¶¶ 75–77. The Treaty's text does not use the term fiscally transparent entities, but the term is defined in the Technical Explanation as:

... entities the income of which is taxed at the beneficiary, member, or participant level. Entities that are subject to tax, but with respect to which tax may be relieved under an integrated system, are not considered fiscally transparent entities. Entities falling under this description in the United States include partnerships, common investment trusts under section 584, and business entities such as limited liability companies (LLCs) that are treated as partnerships for U.S. tax purposes.

Id. ¶ 72; see also Japan-U.S. Tax Treaty, *supra* note 1, art. 3(2), (Essentially, any term used but not defined in the Convention will have the meaning that it has at the time under the laws of that Contracting State whose tax is being applied, unless the context requires otherwise and unless competent authorities agree otherwise).

193. Technical Explanation of Japan-U.S. Tax Treaty, *supra* note 9, ¶ 72.

partnerships, limited liability companies (LLCs), and revocable trusts, for example, are all considered fiscally transparent from a U.S. legal perspective because they are not subject to income tax at the entity level. Entities that are subject to tax, but with respect to which the tax may be relieved under an integrated system, are not considered fiscally transparent for purposes of the new Treaty.¹⁹⁴

In applying this general rule of the Japan-U.S. Tax Treaty, assume as in Diagram 3 that an obligor, residing in Japan, pays 100 dollars of interest to Y, an entity that the United States views as an LLC (taxable as a partnership under U.S. law). Further assume that the LLC has ten equal members, each member qualifies as the beneficial owner of 10 percent of the interest, seven members also qualify as U.S. residents, each of the seven U.S. residents also satisfies the Limitation-on-Benefits article of the Treaty, and the interest payments do not violate the conduit rules discussed above.

With respect to the interest payment, Japan is the Source State because the obligor resides in Japan.¹⁹⁵ The United States is the Residence State from the perspective the seven LLC members that are qualified U.S. residents. Thus, under Article 4(6)(a) of the Japan-U.S. Tax Treaty, only 70 percent of the interest paid to Y would potentially be entitled to Japan's treaty-reduced withholding rate, since only seven of the ten LLC members are U.S. residents. But the analysis does not end there. Suppose one of the U.S.-resident members of the LLC is a bank; then its ten-dollar share of the interest would be completely exempt from Japanese withholding tax when it is paid to the LLC.¹⁹⁶ If another LLC member were an insurance company, then its ten-dollar share of the interest payment would be completely exempt from withholding tax as well, pursuant to the Treaty.¹⁹⁷ Fifty dollars would be subject to a maximum 10 percent withholding rate, assuming the other five U.S.-resident LLC members do not fit within another exemption category of the Treaty. The remaining thirty dollars of the interest paid to Y would be subject to the full Japanese withholding tax, without any treaty benefit, unless the non-U.S. resident members could qualify for benefits under a different Japanese tax treaty. This general rule applies, and the same result would obtain, even if Y were organized in the third country—the Cayman Islands, for example—and Y's members decided to elect to have Y taxed as a partnership for purposes of U.S. tax law.¹⁹⁸ Because the United States sees Y as fiscally transparent, the U.S. residence status of Y's beneficiaries, members, and participants suddenly becomes determinative of treaty benefits. Whether Japan views Y as fiscally transparent or not is irrelevant in these two examples since Japan is the Source State, and Y is not organized in Japan.¹⁹⁹ The Cayman Island's characterization of Y is also irrelevant to the U.S. residents' qualifications for benefits under the Japan-U.S. Tax Treaty.

Conversely, if Y were being taxed as a separate corporate taxpayer by the United States as shown in Diagram 4, then it would not be treated as fiscally transparent for treaty purposes. Assume the same facts as in Diagram 3, except that the United States sees Y as a non-fiscally transparent company—either because Y is an LLC and did not elect to be

194. *Id.*

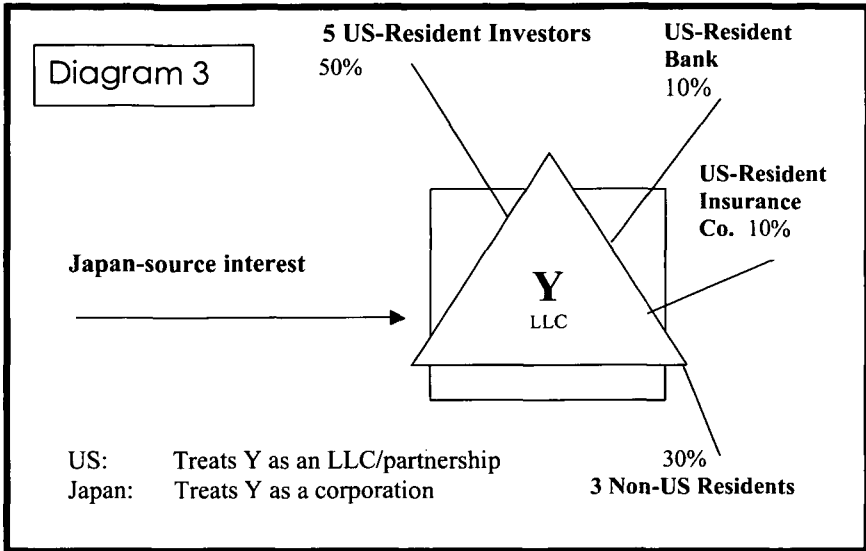
195. See I.R.C. § 862(a)(1) (RIA 2006).

196. Japan-U.S. Tax Treaty, *supra* note 1, art. 11(3)(c)(i); see Technical Explanation of Japan-U.S. Tax Treaty, *supra* note 9, at ¶¶ 75–77.

197. Japan-U.S. Tax Treaty, *supra* note 1, art. 11(3)(c)(ii).

198. *Id.*, art. 4(6)(c).

199. *But see id.* at art. 1(4) (Saving Clause) and discussion of Savings Clause *infra* Part VI.E.



taxed as a flow-through partnership for U.S. tax purposes, or because Y is organized as a Cayman corporation.

In order to be eligible for the treaty-reduced withholding rate under the new Treaty, Y itself would have to qualify as a resident of the United States (i.e., the non-Source State),²⁰⁰ as well as the beneficial owner of the income.²⁰¹ If Y Corporation were organized in the Cayman Islands, it would not qualify as a U.S. resident for treaty purposes. In that situation, Japan would not be obligated to reduce its withholding tax on the interest income pursuant to the Treaty. This is true even if all of Y's shareholders were U.S. citizens. Because Y in Diagram 4 is not treated as fiscally transparent by the Residence State (i.e., the United States in this example), but as a separate corporate taxpayer, its own qualified resident status in the United States is a prerequisite to obtaining treaty benefits.²⁰² Conversely, if Y were organized in the United States, it would qualify as a U.S. resident for treaty purposes assuming, if it is an LLC, it does not elect to be treated as a partnership for U.S. tax purposes. If Y is a resident of the United States, then Japan would reduce its gross withholding tax on the interest income paid to Y, and the United States would tax it on a net basis at Y's regular corporate tax rate.

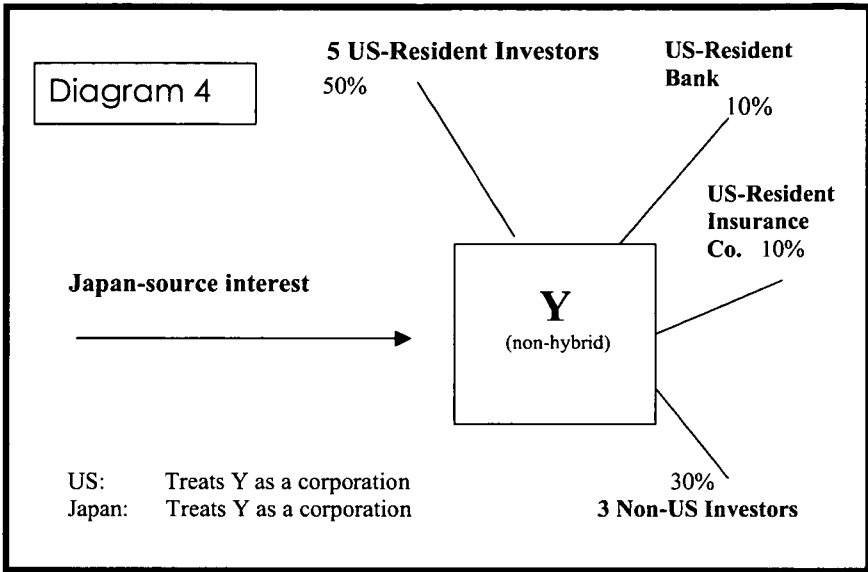
Next assume, as in Diagram 5, that Japanese-resident shareholders incorporate company Z in Chile, which does not have a tax treaty with either the United States or Japan. The Japanese shareholders elect to have the company treated as a partnership for U.S. tax purposes, but their Chilean company is viewed as a taxable corporate entity under Japanese law.

If a U.S. debtor pays interest to the Chilean company, the interest payment would not qualify for a treaty reduced rate under the Japan-U.S. Tax Treaty because Japan (i.e., the

200. See Japan-U.S. Tax Treaty, *supra* note 1, art. 4(6)(b).

201. Entity Y would also have to clear other relevant hurdles to obtaining treaty benefits, such as satisfying the LOB article clause of the treaty. See *id.* See also discussion of the LOB article *infra* Part V.

202. See Technical Explanation of Japan-U.S. Tax Treaty, *supra* note 9, ¶ 77.



non-Source State) sees the entity as a non-resident of Japan.²⁰³ The fact that the United States (i.e., the Source State) sees the entity as fiscally transparent is irrelevant for purposes of applying the Japan-U.S. Tax Treaty, as is Chile’s characterization of the entity. This same result would obtain under the facts presented above in relation to Diagram 2 if the new Japan-U.S. Tax Treaty were applied—that is, the United States would not grant a treaty-reduced withholding rate—because the United States would first look to see whether the royalty income was “treated as the income of the beneficiaries, members or participants of that entity under the tax laws of” Japan before granting treaty benefits.²⁰⁴

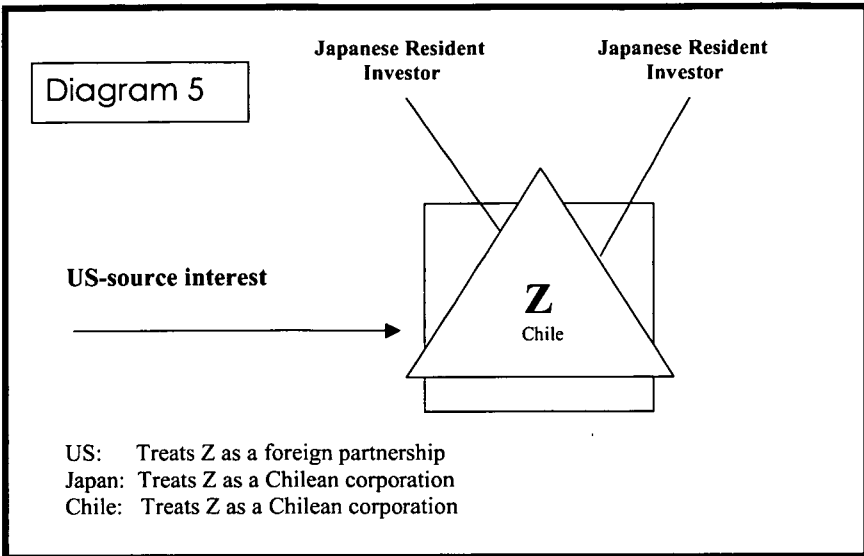
Varying this fact pattern slightly, assume in Diagram 5 that Z is instead organized in the United States (i.e., the State of Source) and Japan views Z as a corporation, while the United States continues to treat Z as a partnership, albeit a domestic partnership. Under the general rule, the Source State is not obligated to cede its tax jurisdiction to the Residence State where the Residence State does not, in fact, treat the income in question as being derived by its residents.²⁰⁵ Neither Z nor its Japanese interest holders would be eligible for a reduced withholding tax rate under the Japan-U.S. Tax Treaty because Japan—the non-Source State—treats the interest income as being that of a foreign, fiscally opaque entity, which income does not flow through to any Japanese residents.²⁰⁶

203. See Japan-U.S. Tax Treaty, *supra* note 1, art. 4(6)(d).

204. See *id.* art. 4(6)(c)(ii).

205. See OECD Report on Partnerships, *supra* Part VI.C. and note 184, ¶ 53; Japan-U.S. Tax Treaty, *supra* note 1, art. 4(6).

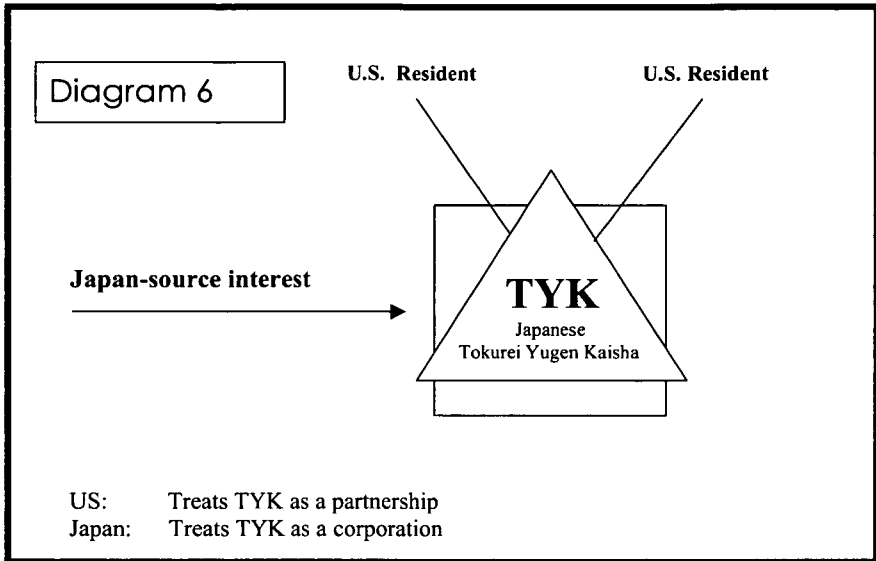
206. See Japan-U.S. Tax Treaty, *supra* note 1, art. 4(6)(e); see also Technical Explanation of Japan-U.S. Tax Treaty, *supra* note 9, ¶ 88.



E. SAVINGS CLAUSE TRUMPS ARTICLE 4(6)

The text of Article 4(6) of the Treaty does not address the sixth fact pattern that commonly arises with respect to fiscally transparent entities. In the sixth case, as illustrated in Diagram 6 as an item of income is derived from Japan or the United States through an entity organized within that State (the Source State) and treated under the tax laws of the other State as income of the beneficiaries, members or participants of that entity. For example, assume, in Diagram 6 the entity is organized in Japan as a *tokurei yugen kaisha* (TYK)—a special kind of *kabushiki kaisha* (KK) or joint stock corporation that is treated as fiscally non-transparent under Japanese law and taxed at the entity level.²⁰⁷ Further assume that the TYK's members are residents of the United States, that the entity receives a Japan-sourced

207. TYK business entities are former Yugen Kaisha limited liability companies (YKs), and were created by operation of law on the May 2006 effective date of Japan's new 2005 Companies Law, which substantially rewrote Japan's company laws and revamped the types of entities available for doing business in Japan. See 2005 Companies Law, *supra* note 94. The 2005 Companies Law abolished the old YK form for doing business, which had been sanctioned by Japanese law since 1938. See Yugen Kaisha Ho [Limited Liability Company Act—Law Relating to Yugen Kaisha], Law No. 74 of 1938, § 8(1). Although the YK form was cumbersome and inflexible, it was nonetheless a popular vehicle for U.S. persons investing in or doing business in Japan because it was listed as an eligible entity under § 301.7701-3 of the U.S. Entity Classification Regulations, meaning that U.S. taxpayers could elect to have the YK treated as either a flow-through partnership or a taxable corporation for U.S. tax purposes. Treas. Reg. § 301.7701-3 (as amended in 2005) Since the 2005 Companies Law would automatically turn all existing YKs into a special type of KK, and in light of the fact that all KKs are “per se corporations” under U.S. Treasury Regulation § 301.7701-2(8)(b), there was an issue as to whether the YKs would lose their ability to elect their U.S. tax status once they became TYKs. In December 2005, the U.S. Internal Revenue Service publicly ruled that any Japanese YK that becomes a Japanese TYK, pursuant to Japan's 2005 Companies Law, will remain an entity eligible to elect its tax classification for U.S. tax purposes pursuant to Regulation § 301.7701-3. Rev. Rul. 2006-3, 2006-2 I.R.B. 276.



interest payment, and that the TYK's members elect to have the TYK entity treated as a fiscally transparent partnership for U.S. tax purposes.

In most cases, Article 4(6) provides that the State applying the Treaty—Japan, in this example—is required to look to the internal tax law of the other Contracting State to see whether any of its residents are liable to tax on the income before granting treaty benefits. Further, if the general principle of the OECD Partnership Report²⁰⁸ discussed above was strictly followed in this example, Japan's ability to impose its 20 percent withholding tax could be limited because TYK is a fiscally transparent entity and the Source State "should take into account, as part of the factual context in which the Convention is to be applied, the way in which an item of income arising in its jurisdiction is treated" by the Residence State.²⁰⁹ Here, the United States will tax the TYK partners on their distributive shares of TYK interest income.²¹⁰ Nonetheless, the Technical Explanation to the Treaty states that Article 4(6) does not apply to this situation and does not prevent the Source State from taxing its domestic corporation or other taxable entity in accordance with its domestic law under the Savings Clause of Article 1.²¹¹ The result in this example turns on the fact that TYKs are liable to tax at the entity level under Japanese law.²¹² According to

208. OECD Report on Partnerships, *supra* Part VI.C., ¶ 53.

209. *Id.*

210. I.R.C. §§ 701, 702(a)–(b) (RIA 2006).

211. See Technical Explanation of Japan-U.S. Treaty, *supra* note 9, ¶ 90.

212. Under Japanese law, the Yugen Kaisha form (YK) was always taxable at the entity level under Japanese law. See Yugen Kaisha Ho [Limited Liability Company Act—Law Relating to Yugen Kaisha], Law No. 74 of 1938. After the 2005 Companies Law converted YKs into a special class of KK, by operation of law, the YKs remain taxable under Japanese law at the entity level, even though the YK may elect to be treated as a partnership for U.S. tax purposes. Rev. Rul. 2006-3, 2006-2 I.R.B. 276. See Fuller, 2005 Int'l Legal Developments, Asia and Pacific Law—Japan, *supra* note 97, at 518–19.

the Technical Explanation, if an item of income is derived from one of the Contracting States (i.e., the Source State) through an entity organized therein, and the Source State's internal law treats that item as income of the domestic entity, then the Source State is not prevented from taxing the entity in accordance with its own domestic law pursuant to the Savings Clause in Paragraph 4 of Article 1 of the Treaty.²¹³ The Treaty's rules for the treatment of fiscally transparent entities are not an exception to the Savings Clause.²¹⁴ Thus, given the facts in Diagram 6, Japan may exercise its full taxing authority over the TYK's receipt of the interest payment without ceding any of that authority to its treaty partner, the United States.

Because the U.S. investors elected to have the TYK taxed as a partnership, they will be subject to tax on their distributive shares of TYK's interest income.²¹⁵ However, they are also treated as paying a share of the taxes that are paid by TYK on the interest.²¹⁶ Thus, the U.S. investors in TYK will be allowed a foreign tax credit in computing their separate income tax liabilities,²¹⁷ but not in excess of the tax they owe on their U.S.-source income.²¹⁸ Although the United States is the country that always insists on the inclusion of the Savings Clause in its bilateral tax treaties, it benefits Japan's treasury in this case.

F. WHAT TAX POLICY NORMS ARE SERVED BY ARTICLE 4(6)?

As evinced in the above examples, Article 4(6), applicable to fiscally transparent entities, is not a simple provision to apply. It is the most detailed provision of its kind ever included in U.S. tax treaty, and the first ever agreed to by Japan. Its inclusion in the new Japan-U.S. Tax Treaty is also significant for a number of other reasons. First, unlike similar provisions found in other treaties and U.S. domestic law,²¹⁹ the purview of Article 4(6) in the Japan-U.S. Tax Treaty is broader; it covers more than just the treaty benefits accorded to dividends, interest, and royalties. For example, it could apply to identify the person who is liable to tax on an item of business profit paid through a fiscally transparent entity. Second, although the concept of flow-through taxation has not been recognized in Japan until recently,²²⁰ the recent amendments to Japan's company and tax laws make it likely that fiscally transparent trusts and partnerships will be used with increasing frequency in domestic

213. The United States has always insisted on including the traditional savings clause in all its tax treaties, which reserves the Contracting States' rights to tax their residents, and in the case of the United States, its citizens, as provided in their internal laws, despite contrary provisions in the treaty. Exceptions to the savings clause are contained in Paragraph 5 of Article 1. See Japan-U.S. Tax Treaty, *supra* note 1, art. 1(4) (savings clause), art. 1(5) (exceptions). See also *id.* art. 23 (Relief from Double Taxation) discussed *infra* Part VIII.; I.R.C. §§ 894(a)(1) (RIA 2006) (as amended in 1988) and 7852(d) (RIA 2006) (as amended in 1988) (discussed *supra* Part III.A.3).

214. Technical Explanation of Japan-U.S. Tax Treaty, *supra* note 9, ¶ 90.

215. I.R.C. §§ 701, 702(a)-(b).

216. I.R.C. § 702(a)(6) ("In determining his income tax, each partner shall take into account separately his distributive share of the partnership's . . . (6) taxes, described in section 901, paid or accrued to foreign countries and to possessions of the United States.")

217. I.R.C. § 903.

218. I.R.C. § 904.

219. See Treas. Reg. § 1.894-1(d) (as amended in 2002) (Denying treaty benefits on certain payments to domestic reverse hybrid entities).

220. Not until 2006 did Japan have a viable business entity—the limited liability partnership—offering pass-through taxation. See discussion of the new Japanese LLP vehicle *supra* note 189.

as well as foreign transactions.²²¹ Thus, Article 4(6) will no doubt become more important as time goes on—both to avoid double taxation on transactions involving U.S. and Japanese entities, and to prevent tax evasion through arbitrage structures. Moreover, the provision codifies the conflict-of-laws tie-breaker mechanism described in Paragraph 53 of the OECD Report on Partnerships, and in doing so, it helps resolve an age-old conundrum of tax treaty interpretation—that is, which person or persons should be considered liable to tax on income derived through a fiscally transparent entity, and which jurisdiction's laws should be used to answer that question. Finally, because the world's two largest economic powers have agreed to this complex but useful provision in their tax treaty, their inclusion of it may signal what some have termed a growing consensus that the OECD's approach to fiscally transparent entities is pragmatic and the best solution to the problem.

The general rule of article 4(6) may seem elegant in theory, but it could prove to be a nightmare in application. The fact that the treaty between Japan and the United States (like all bilateral treaties) even needed a special provision to attempt to more efficiently allocate income between the Source State and the Residence State in transactions involving hybrid entities lends credence to the argument that the Source and Residence concepts no longer work well, if they ever did. The problem would be largely eliminated if every country had the same rules for classifying entities, but that would require that all countries' business entities function the same way in terms of their degree of transparency. Although Article 4(6) may be the best solution to the problem of fiscally transparent entities to date, it no doubt carries with it high compliance burdens and transaction costs, which will reduce efficiency. The State applying the Treaty—the Source State—must look to the peculiarities of a foreign jurisdiction's law to see which persons are “liable to tax.” This could be an expensive and arduous process. The long and labyrinthine U.S. withholding tax regulations issued under Sections 1441 through 1446 of the Internal Revenue Code are a testament to how complex this mechanism could become in practice.²²²

Article 4(6) clearly serves the tax policy objective of CEN to the extent it prevents both double juridical taxation and complete tax evasion.²²³ It may also serve the norm of horizontal equity—the idea that all similarly situated taxpayers should be treated equally—by leveling the international tax planning field. The individuals or companies that regularly employ hybrid entities in their cross-border transactions can afford to pay for sophisticated tax advice, while most taxpayers cannot. Thus, Article 4(6) may be introducing more fairness into bilateral treaties based on the OECD Model, as well as efficiency.

VII. Limitation-on-Benefits Article—Article 22

The 1971 Japan-U.S. Tax Treaty did not contain any Limitation-on-Benefits (LOB) article. The complete absence of this anti-abuse provision meant it was easier for third

221. Moreover, the use of trusts—a few of them tax transparent—is expected to greatly increase in Japan with the enactment of Japan's new Trust Business Law, which, among other things, eases restrictions on trust business licenses. Trust Business Law, No. 154 of 2004. Another statute, Japan's 80-year old Trust Law (Law No. 62 of 1922) is being significantly revised in an effort to introduce new types of trusts, including those used for securitization purposes. Trust Law, Law No. 62 of 1922. The revised Trust Law is expected to be submitted to the Diet in 2006.

222. See, e.g., Treas. Reg. §§ 1.1441-1 to -10 (as amended).

223. See discussion of capital export neutrality and other tax policy objectives *infra* Part II.A.-C.

party residents to take advantage of the treaty. The new Treaty contains a fairly elaborate LOB article,²²⁴ comparable to the rules contained in recent U.S. tax treaties.

It has long been established that the benefits of a bilateral tax treaty are intended only for *bona fide* residents of one of the Contracting States to the treaty. The Commentaries to the OECD Model Treaty, for example, authorize a tax authority to deny treaty benefits, pursuant to substance-over-form principles, to a nominee in one Contracting State deriving income from the other State on behalf of a third-country resident. The LOB article and domestic law complement each other in preventing the misuse of the Treaty. The anti-abuse provisions of internal law (e.g., step transaction doctrine, substance-over-form and conduit principles,) are applied to recast suspect transactions in accordance with their substance and to identify the true beneficial owner of the income. Then the LOB article is applied to determine whether the beneficial owner, which is often an entity, has a sufficient nexus to the Contracting State to be treated as a *bona fide* resident for treaty purposes.

The U.S. Treasury's Technical Explanation to the Treaty describes treaty shopping as "the use, by residents of third states, of legal entities established in a Contracting State with a principal purpose to obtain the benefit of a tax treaty between the United States and the other Contracting State."²²⁵ If the only prerequisite to obtaining treaty benefits was establishing residency in one of the Contracting States, it would be very easy for third-country residents to treaty shop. All someone would have to do is set up a corporation in one of the Contracting States, and then funnel payments through the corporation to the third-party interest holder who, in the absence of the conduit, would not otherwise enjoy the reduced level of taxation.

One way to police treaty shopping would be for the taxing authorities to investigate the taxpayer's *motives* in establishing an entity in a Contracting State. But, of course, this system would be very difficult to administer. To avoid having to investigate a taxpayer's motives, the LOB article sets forth a series of objective tests that are intended to provide useful surrogates for subjective intent:

The assumption underlying each of these tests is that a taxpayer that satisfies the requirements of the test likely has a real business purpose for the structure it has adopted, or has a sufficiently strong nexus to the other Contracting State (e.g., a resident individual) to warrant benefits even in the absence of a business connection, and that this business purpose or connection is sufficient to justify the conclusion that obtaining the benefits of the treaty is not a principal purpose of establishing or maintaining residence in that other Contracting State.²²⁶

Under Paragraph 1 of the new LOB article, a resident is entitled to *all* the benefits of the Treaty only if it can be described as one of the following: an individual resident; certain government entities, including central banks; a company that is publicly traded or has a parent company that is publicly traded, as defined;²²⁷ certain charities and tax exempt organizations; a pension fund provided that more than 50 percent of its beneficiaries are individual residents of either Contracting State; or an entity that satisfies both a resident-owner test and a base-erosion test.²²⁸

224. See Japan-U.S. Tax Treaty, *supra* note 1, art. 22.

225. Technical Explanation of Japan-U.S. Tax Treaty, *supra* note 9, ¶ 383 [emphasis added].

226. *Id.* ¶ 384.

227. See Japan-U.S. Tax Treaty, *supra* note 1, art. 22(1)(c).

228. See *id.* art. 22(1)(f) (two-prong ownership and base-erosion test).

Even if a resident does not meet one of the above descriptions, the resident may be able to claim treaty benefits for some items of income to the extent the resident can establish that the items are sufficiently connected to an active trade or business in the resident's own Contracting State.²²⁹ Residents who do not meet any one of the above tests, including the active-trade-or-business test, may still be able to claim treaty benefits if the Competent Authority of the Contracting State from which the benefits are claimed determines that it is appropriate to grant benefits in that case.²³⁰ While the Competent Authority's analysis will likely differ from that necessitated by the above tests, the objective of the inquiry is the same: to identify investors whose residence in the other Contracting State can be justified by factors other than a purpose to derive treaty benefits.

The U.S. Treasury Department has indicated that a top priority in 2006 and 2007 will be the introduction of more effective LOB articles in newly negotiated and existing treaties within the U.S. tax treaty network.²³¹ While the sophisticated LOB article contained in the Japan-U.S. Tax Treaty helps solidify a new global standard for anti-treaty-shopping mechanisms, each newly negotiated LOB article will necessarily take account of the peculiarities of the Contracting States' domestic laws and is unlikely to be a replica of that contained in the new Treaty or even in the Model Treaties. Nonetheless, the inclusion of a modern LOB article—indeed, any LOB article—in the Japan-U.S. Tax Treaty is a big “first” for Japan, and it appears to be inspiring Japan to include stronger LOB provisions in its own bilateral treaty network, which Japan is presently modernizing through bilateral negotiations with its treaty partners.²³² Moreover, the addition of modern LOB articles in Japanese tax treaties will likely motivate other, less industrialized Asian countries to follow Japan's example. As with Article 4(6) (applicable to income paid to fiscally transparent entities), the LOB article serves the tax policy goals of CEN and horizontal equity, but the mere fact that it is needed evinces the flaws in the present international treaty framework.

VIII. Relief from Double Taxation—Article 23

The new Treaty provides relief from double taxation in a manner consistent with the U.S. Model Treaty. In general, the United States allows taxpayers to credit foreign taxes paid against their U.S. income tax, with a limited carryover mechanism for unused foreign tax credits.²³³ In the Treaty, Japan agrees to allow its residents to credit U.S. taxes paid against Japanese taxes. The amount of the credit, however, cannot exceed the portion of the Japanese tax that corresponds to that income. This provision prevents the use of credits derived from low-taxed income to offset income that is generally subject to higher taxes, and is similar to the basketing mechanism of the U.S. foreign tax credit.²³⁴ The new Treaty includes a re-sourcing rule to ensure that a U.S. resident can obtain a U.S. foreign tax credit

229. See *id.* art. 22(2).

230. See *id.* art. 22(4).

231. See Robert Goulder, *U.S. Treasury Official Spots Trends in Treaty Practice*, *WORLDWIDE TAX DAILY*, Nov. 30, 2005, available in LEXIS, Intlaw library, TNI file, 2005 WTD 229-2 (quoting U.S. Treasury International Tax Counsel Hal Hicks).

232. Japan has recently renegotiated tax treaties with India, France, Indonesia, the Philippines, Switzerland, and the United Kingdom.

233. See I.R.C. §§ 901, 904(a), (c) (RIA 2006); Japan-U.S. Tax Treaty, *supra* note 1, art. 23.

234. See I.R.C. § 904(d) (RIA 2006). This section of the U.S. Internal Revenue Code was amended in 2004 to reduce the number of income categories (known by practitioners as baskets) from nine to two.

for Japanese taxes paid when the Treaty assigns Japan the primary right to tax an item of gross income. A comparable rule applies for purposes of the Japanese foreign tax credit. The first paragraph of the article provides that, if the Treaty allows the United States to tax an item of income beneficially owned by a resident of Japan, that income will be deemed to arise from sources in the United States for Japanese foreign tax credit purposes.

IX. Miscellaneous Provisions

The new Treaty has quite a few other provisions that differ from the old 1971 Treaty. In the case of shipping income, the new Treaty eliminates Source-State taxation, and instead allocates to the Residence State full taxing authority over profits from the operation of ships or aircraft in international traffic.²³⁵ Moreover, the new Treaty exempts from Source-State taxation all income from the use, maintenance, or rental of containers used in international traffic.²³⁶ Other changes found in the new Treaty affect the taxation of entertainers and sportsmen;²³⁷ corporate directors;²³⁸ government employees;²³⁹ and students, scholars, and business apprentices.²⁴⁰ In general, the new Treaty broadens the availability of an exemption from host country taxation for students and teachers with respect to certain classes of income.

X. Nondiscrimination—Article 24

Part IV discussed the ways in which the new Treaty limits source-based taxation for purposes of removing barriers to foreign trade and investment. To recapitulate, Articles 10, 11, and 12 of the Treaty, limit the respective rates at which the Source State can tax nonresident aliens and foreign corporations on the dividends, interest, and royalties they receive in the absence of a PE. Even if the foreigner has a PE in the Source State, Article 7 restricts the Source State's jurisdiction to tax the PE's income to that which is attributable to the PE. Article 24 of the Treaty—the Nondiscrimination article—further prohibits a Contracting State from imposing taxes on nationals of the other Contracting State that are effectively more burdensome than the taxes it imposes on similarly situated domestic taxpayers.²⁴¹ In other words, under Article 24, foreign producers may not be taxed more heavily than domestic producers. Thus, for example, if a Japanese corporation has a PE in the United States, Article 24 prohibits the United States from taxing the profits of the PE more heavily than it taxes its own domestic, *similarly situated* businesses. As another example of Article 24's application, if a U.S. citizen is living in Japan, Japan may not discriminate against him

235. See Japan-U.S. Tax Treaty, *supra* note 1, art. 8 (Profits from Shipping and Air Transport).

236. See *id.* art. 8(4).

237. See *id.* art. 16.

238. See *id.* art. 15.

239. See *id.* art. 18.

240. See *id.* art. 19.

241. Article 24 is not limited to income taxes, but applies to taxes of every kind. A person need not be a resident of a treaty country to claim the protections of Article 24, but the person must be a national as defined in Article 3(1)(j), which term includes U.S. citizens as it pertains to U.S. law, and juridical persons, as the term pertains to Japanese law. U.S.-Japan Tax Treaty, *supra* note 1, art. 3(1)(j). Arguably, the Nondiscrimination article serves the policy objective of capital import neutrality. See discussion *supra* Part II.B. (stating that vertical equity is served where all similarly situated persons are treated similarly; CIN is served when all business activity derived within the same jurisdiction is subject to the same marginal tax rate regardless of whether the investor is a domestic resident or a foreigner, so that those investors who invest both within and without the jurisdiction are not disadvantaged as they are in pure residence-based systems).

or her by imposing taxes that are more burdensome than the taxes Japan imposes on its own residents.²⁴² The Nondiscrimination article in the Treaty is similar to that found in the U.S. Model Treaty and in other recently negotiated U.S. treaties.

Not all instances of differing tax treatment or related tax requirements are considered facially discriminatory for purposes of Article 24. Paragraph 2 stipulates that a Contracting State may not tax a PE of an enterprise in the other Contracting State in a manner less favorably than a domestic enterprise "carrying on the same activities."²⁴³ In general, the fact that a PE is taxable in the Source State only on income attributable to the PE pursuant to Article 7, while a domestic corporation is taxable on its worldwide income, is not the kind of different circumstance that would preclude the foreign owners of the PE from claiming protection under Article 24 with respect to some other difference in tax treatment or related requirement.²⁴⁴ But there are situations where protection under Article 24 would be precluded because the claimant is not deemed similarly situated. If the United States required the Japanese owners of a PE to provide information about its enterprise that is much more detailed than the information required of domestic entities carrying on the same activities, that requirement would not necessarily be discriminatory within the meaning of Article 24 because the requisite information concerning a foreign firm may not be as readily available to the Internal Revenue Service as that concerning a domestic firm.²⁴⁵ Similarly, Article 24 is not violated if a partnership with income effectively connected to a U.S. trade or business is required under domestic law to withhold tax on amounts allocable to a foreign partner, even though no similar obligation to withhold tax from the distributive shares of U.S. resident partners is imposed.²⁴⁶ Moreover, a Contracting State is not required to grant "any personal allowances, reliefs and reductions for taxation purposes" to nationals of the other Contracting State.²⁴⁷ Thus, if a Japanese resident has a PE in the United States, the United States is not required to allow him or his family the personal allowances "that he would be permitted to take if the [PE] were a sole proprietorship owned and operated by a U.S. resident."²⁴⁸

There is an ongoing and increasingly controversial issue concerning the extent to which the nondiscrimination principle found in bilateral tax treaties,²⁴⁹ in the U.S. Commerce Clause,²⁵⁰ and in the European Community Treaty²⁵¹ prohibits or should prohibit, under

242. Japan-U.S. Tax Treaty, *supra* note 1, art. 24(1).

243. *Id.* art. 24(2).

244. Technical Explanation of Japan-U.S. Tax Treaty, *supra* note 9, ¶ 469.

245. *Id.*

246. *See id.* ¶ 470; *see also* I.R.C. § 1446 (withholding tax on foreign partners' share of effectively connected income).

247. Japan-U.S. Tax Treaty, *supra* note 1, art. 24(2).

248. Technical Explanation, Japan-U.S. Tax Treaty, *supra* note 9, at 96.

249. Although the United States has argued that its thin capitalization rules do not violate the nondiscrimination clauses in tax its treaties, some scholars have argued otherwise. *See, e.g.,* Richard L. Doernberg, *The Enhancement of the Earnings Stripping Provision*, 7 TAX NOTES INT'L 985, 986-87 (Oct. 18, 1993); Federal Income Tax Project, American Law Institute, *International Aspects of United States Income Taxation* (pt. 2) 258-59, 280-82 (1992) (challenging U.S. congressional arguments that thin capitalization rules do not violate U.S. tax treaty obligations under the typical nondiscrimination article).

250. U.S. CONST. art. I, § 8, cl. 3 ([Congress shall have the power] "[t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes.").

251. In 1986, the then twelve Member States of the European Community agreed to the Single European Act, defining a common market and committing themselves to the so-called four freedoms: "the free movement of goods, persons, services and capital." Single European Act, art. 13, Feb. 17, 1986, 1987 O.J. (L 169) 1.

coherent tax policy principles, the operation of countries' thin capitalization rules and other anti-abuse measures.²⁵² One of the ways multinational corporations shift taxable income from one jurisdiction to another is through strategic debt financing. Thus, if a parent corporation (situated in a low-tax country) capitalizes its subsidiary (located in a high-tax country) with debt, the subsidiary's interest deductions will reduce its taxable income while the payments of interest will increase the parent's income. This mechanism, if not restricted, effectively allows multinational corporations to move the group's income from high-tax to low-tax countries just by positioning its subsidiaries and parent corporations in the right jurisdictions.

To prevent the erosion of their corporate tax bases, both Japan and the United States, like many countries around the world, have enacted so-called thin capitalization rules, often called interest stripping rules, that essentially deny thinly capitalized corporations a deduction for interest paid to related parties on excessive debt.²⁵³ In recent years, scholars have argued that the operation of these thin-capitalization rules can unfairly discriminate against foreign producers as prohibited by the standard nondiscrimination article in bilateral tax treaties. For example, assume a country had a law under which domestic subsidiaries of foreign parent companies will be denied deductions for interest paid to their foreign parents whenever the paying subsidiary has a high debt-to-equity ratio, although such deductions are not denied if the interest is being paid to domestic parent companies.²⁵⁴ The underlying rationale of the law is that if the interest is being paid to another domestic corporation, the income is still within the tax base of the residence country and so there is less reason for the residence country to prohibit the interest deduction as compared to the situation where the interest deduction is actually reducing the corporate tax base of the country. But such a provision discriminates against a similarly situated foreign parent company. The Japan-U.S. Tax Treaty does not nullify the thin-capitalization rules of Japan or the United States. However, Paragraph 3 of Article 24 of the Treaty does expressly prohibit

The Treaty Establishing the European Community, Nov. 10, 1997, 1997 O.J. (C 340) 3, incorporated the four freedoms and other guarantees of the Single European Act of 1986: freedom of movement for workers, *id.* art. 39; freedom of establishment, *id.* arts. 43, 48; freedom to provide services, *id.* art. 49; and freedom of movement of capital, *id.* arts. 56, 58.

252. Although an extensive analysis of the jurisprudence of the U.S. Supreme Court and the European Court of Justice (ECJ) on this issue is beyond the scope of this article, it is further addressed below in the context of alternatives to bilateral tax treaties. See discussion *infra* Part XII.D.3.b (analyzing several decisions of the ECJ, including one in which the court struck down Germany's thin capitalization rules under its expansive view of nondiscrimination). Other jurisdictions' analyses of the nondiscrimination principle in domestic contexts may impact the interpretation of the Nondiscrimination article contained in bilateral tax treaties. For an insightful analysis of the recent nondiscrimination jurisprudence of the ECJ and its possible impact, see Michael J. Graetz & Alvin C. Warren, *Income Tax Discrimination and the Political and Economic Integration of Europe*, 115 YALE L. J. 1186 (2006) (arguing that the developing jurisprudence of the ECJ threatens the ability of Member States of the European Union to use tax incentives to stimulate their domestic economies and to resolve problems of international double taxation)[hereinafter Graetz & Warren, *Income Tax Discrimination*].

253. See I.R.C. § 163(j) (RIA 2006) (Limitation of deduction for interest on certain indebtedness); see also Ernst & Young's Foreign Desk, *Proposed 2006 Japanese Tax Reform*, 17 J. INT'L TAX. No. 3 (March 2006) (discussing proposed amendments to Japan's thin capitalization rules).

254. These are essentially the facts considered in a case before the ECJ in 2002. In *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt*, the ECJ held that Germany's thin capitalization rules, which denied deductions of interest paid to a foreign parent company, but not to interest paid to parent companies with their seats in Germany, violated the freedom of establishment in the EC Treaty. Case C-324/00, *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt*, 2002 E.C.R. I-11779. See further discussion *infra* Part XII.D.3.b.

this type of discrimination. Paragraph 3 provides that when a resident of a Contracting State pays interest (or royalties or other disbursements) to a resident of the other Contracting State, the first mentioned State must allow a deduction for those payments as if the payment had been made under the same conditions to a domestic person.²⁵⁵ Paragraph 3 carves out a big exception to current deductibility where application of the arm's length standard imposed on related persons pursuant to Article 9 (associated enterprises), Article 11 (interest), Article 12 (royalties), and Article 21 (other income) would require a different result. Thus, the Japan-U.S. Tax Treaty employs the arm's length standard as a backup mechanism to ameliorate the effects of the nondiscrimination article,²⁵⁶ leaving a lot of room for argument and making it more likely that such issues will be decided under the Mutual Agreement Procedure.

XI. Mutual Agreement and Exchange-of-Information Procedures

A. MUTUAL AGREEMENT PROCEDURE

In recent years, the volume of cross-border trade and investments has risen dramatically. At the same time, cross-border transactions have become massive and overwhelmingly complex. These developments have not only put pressure on the treaty provisions that allocate substantive tax authority, they have also strained the procedural mechanisms for resolving international tax disputes. In particular, the volume and complexity of cross-border transfer pricing issues has increased, causing the conciliatory dispute resolution mechanism set forth in bilateral tax treaties to assume greater importance. Many transfer pricing issues are resolved using this procedure, particularly in combination with an advanced pricing agreement (APA).

Article 25 of the new Treaty—the so-called Mutual Agreement Procedure—closely follows the OECD Model Treaty. The OECD Committee on Fiscal Affairs, in its 1984 Mutual Agreement Report, characterized the Mutual Agreement Procedure as follows:

The mutual agreement procedure envisaged by Article 25 and adopted in many bilateral agreements on the OECD pattern *is not, however, a process of litigation* between the taxpayer and the competent authorities: for such disputes the domestic courts are the appropriate forum. The mutual agreement procedure is (unless there is specific provision to the contrary in the relevant law of the countries concerned) *simply a process of discussion between the competent authorities in which they seek to explore the possibility of a solution to the relevant problem which can be accepted by all concerned.*²⁵⁷

255. Japan-U.S. Tax Treaty, *supra* note 1, art. 24 (3); see Technical Explanation of the Japan-U.S. Tax Treaty, *supra* note 9, at 97. Thus, the Japan-U.S. Tax Treaty's resolution of the thin-capitalization issue is consistent with the 2002 decision of the European Court of Justice in *Lankhorst-Hobort GmbH v. Finanzamt Steinfurt*, Case C-324/00, 2002 E.C.R. I-11779. See *infra* Part XII.D.3.b.

256. For one thing, the arm's length standard provides no guidance as to when a debt financing is excessive. See, Vann, *Treaty for the Asian-Pacific?*, *supra* note 30, at 108 (arguing that "the OECD has effectively rendered inapplicable one article of its Model treaty that seems to be applicable (the Nondiscrimination article) and rendered applicable another article that seems inapplicable (the associated enterprises article)").

257. Committee on Fiscal Affairs, Organisation for Economic Co-operation and Development, *Report on Mutual Agreement Procedure*, ¶ 98 (1984) (emphasis added)[hereinafter OECD Mutual Agreement Report of 1984].

The history of the Mutual Agreement Procedure is as long and twisted as the history of the OECD Model Treaty itself. Historically, such procedural mechanisms were included in bilateral treaties because drafters thought some kind of on-going channel of negotiation was needed to iron out fiscal authorities' differences as to the proper implementation of any given tax treaty after the agreement actually became effective.²⁵⁸ Today, the Mutual Agreement Procedure, as it appears in the new Japan-U.S. Tax Treaty, looks like a product of its past: the mechanism reflects a trial-and-error, ad hoc process of dispute resolution that is non-binding, non-legalistic, and conciliatory. Currently, a debate is swirling as to whether the process still works as well as it did when cross-border transactions were a lot simpler.²⁵⁹

Structurally, Article 25 of the new Treaty attempts to resolve three different types of problems. The first, which is covered by the first two paragraphs of the article, arises "[w]here a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention."²⁶⁰ The second set of difficulties—those arising from the interpretation or application of the Treaty—is addressed in the first sentence of Paragraph 3. The third set of problems—cases of double taxation not provided for in the Convention—are addressed in the second sentence of Paragraph 3 of the article.²⁶¹

Paragraph 1 thus authorizes a person to bring to the attention of the competent authority of the Contracting State where he is a resident²⁶² any action by either Contracting State that has resulted, or which will result, in taxation contrary to the provisions of the Treaty.²⁶³ Although it is not necessary for the complainant to have exhausted remedies available under domestic law before initiating the Mutual Agreement Procedure, "[t]he case must

258. See, GUSTAF LINDENCRONA & NILS MATTSO, *ARBITRATION IN TAXATION* 24 (Deventer: Kluwer 1981).

259. The debate is evinced in the fact that the OECD's Committee on Fiscal Affairs is studying ways to improve the Mutual Agreement Procedure. See Committee on Fiscal Affairs, Organisation for Economic Co-operation and Development, *Improving the Process for Resolving International Tax Disputes*, (July 24, 2004) available at <http://www.oecd.org/dataoecd/58/0/36079589.pdf> [hereinafter OECD Proposals for Improving Resolution of Tax Treaty Disputes].

260. Japan-US. Tax Treaty, *supra* note 1, art. 25(1). Thus, taxpayers are allowed to initiate the Mutual Agreement Procedure to resolve disputes regarding the application of the Treaty. Historically, this was not the case. The U.S. Internal Revenue Service takes the view that specific tax disputes may also be raised *sua sponte* by the competent authorities, but most authorities take the view that only the taxpayer may initiate the Mutual Agreement Procedure under Paragraph 1. See Rev. Proc. 2002-52, 2002-2 C.B. 242, § 2.04 ("The U.S. competent authority also may initiate competent authority negotiations in any situation deemed necessary to protect U.S. interests."); John Avery Jones et al., *The Legal Nature of the Mutual Agreement Procedure under the OECD Model Convention—I*, 1979 BRIT. TAX REV. 333, 335 at n.5 (1979).

261. The competent authorities are given the power to raise the second and third sets of problems under the Mutual Agreement Procedure. See OECD Committee on Fiscal Affairs, *Commentary on Article 25 Concerning the Mutual Agreement Procedure*, ¶¶ 3, 35, 37 (2005).

262. If the case comes under Paragraph 1 of the Nondiscrimination article (Article 24), then the person need only be a national, not a resident of the Contracting State to which he complains. Technical Explanation of Japan-U.S. Tax Treaty, *supra* note 9, at 95. With respect to Japan, the competent authority is the "Minister of Finance or his authorized representative." With respect to the U.S., the competent authority is "the Secretary of the Treasury, or his delegate." Japan-U.S. Tax Treaty, *supra* note 1, art. 3 (1)(k)(i)-(ii).

263. Japan-U.S. Tax Treaty, *supra* note 1, art. 25(1). Revenue Procedure 2002-52 sets forth the details of how a taxpayer may invoke the Mutual Agreement Procedure with respect to a U.S. Tax Treaty. In general, a request for relief of double taxation, pursuant to the Revenue Procedure, may be filed only when there is at least a probability, and not a mere possibility, of double taxation. See Rev. Proc. 2002-52, 2002-2 C.B. 242, § 4.01 ("Procedures for Requesting Competent Authority Assistance").

be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.”²⁶⁴ If the competent authority of the State to which the case has been brought judges the case to have merit but cannot resolve the problem unilaterally, Paragraph 2 provides that the competent authorities of both Japan and the U.S. “shall endeavor . . . to resolve the case by mutual agreement. . . .”²⁶⁵ This textual language highlights what many have characterized as a major deficiency in the OECD’s Mutual Agreement Procedure: that the competent authorities are only under a duty to try or “endeavor” to resolve the case, rather than under an obligation to definitely resolve it.²⁶⁶ The official OECD Commentaries point out that the Contracting States are free to negotiate a more substantial and exacting commitment on the part of the competent authorities to resolve the case beyond the mere duty to employ best efforts.²⁶⁷ Although some countries, including the United States, have begun to negotiate and add new treaty clauses providing for arbitration as a fallback to the Mutual Agreement Procedure,²⁶⁸ Japan

The Revenue Procedure specifically provides that transfer pricing disputes are within the purview of the competent authorities’ power to negotiate. *Id.* § 2.01 (General Scope). Since the U.S. introduced its Advanced Pricing Agreement (APA) program for transfer pricing in 1991, competent authorities are often called upon to negotiate these APAs on a multilateral basis between the U.S., the foreign tax authority, and the taxpayer. In general, an APA is an agreement between the taxpayer and the relevant tax administrations that specifies the criteria or method(s) to be used for determining arm’s length transfer prices for future transactions between related enterprises. An APA is tantamount to a contract that covers often numerous transactions over a fixed number of years. If domestic legislation does not provide for such APAs, then they may be concluded under the Mutual Agreement Procedure of an applicable tax treaty.

In 1987, Japan issued a directive introducing an APA procedure—making Japan the first country in the world to institute such a program. See Japan National Tax Agency, Guidance on Calculation of Arm’s Length Prices (April 24, 1987) [hereinafter 1987 APA Directive]. The 1987 APA Directive was revised in 1999 and 2001, and was eventually superseded in June 2001 by the Directive on Methods of Calculating Arm’s Length Prices, which combines transfer pricing guidelines, APA procedures, and procedures for resolving transfer pricing dispute through the Mutual Agreement Procedure provided by tax treaties. See Japan National Tax Agency, APA Program Report 2005 1 (Sept. 2005).

264. Japan-U.S. Tax Treaty, *supra* note 1, art. 25(1).

265. *Id.* art. 25(2).

266. See, e.g., OECD Committee on Fiscal Affairs, *Commentary on Article 25 Concerning the Mutual Agreement Procedure*, *supra* note 262, ¶ 26 (Paragraph 2 of Article 25 entails a duty on the part of the competent authorities to negotiate and a duty to use their best endeavors, but no obligation to achieve a result); Robert A. Green, *Antilegalistic Approaches to Resolving Disputes Between Governments: A Comparison of the International Tax and Trade Regimes*, 23 YALE J. INT’L L. 79, 99 (1998) (“The treaty countries promise merely to ‘endeavor’ to resolve disputes; there is no guarantee that they will succeed.”)[hereinafter Green, *Comparison of International Tax and Trade Regimes*].

267. OECD Committee on Fiscal Affairs, *Commentary on Article 25 Concerning the Mutual Agreement Procedure*, *supra* note 261, ¶ 26 (2005).

268. On June 1, 2006, the United States and Germany signed a protocol to their existing tax treaty which will, when it becomes effective, provide for mandatory baseball-style arbitration of disputes when the competent authorities are unable to reach a complete agreement in a case regarding the application of the Residence, Permanent Establishment, Business Profits, Associated Enterprises, or Royalties articles. Under the pending protocol, which is expected to be ratified in 2007, the competent authorities may also agree to arbitrate other subject matter. A determination of the arbitration board would constitute a resolution by mutual agreement under Article 25 of the Germany-U.S. Tax Treaty, which was signed on August 29, 1998. When the protocol becomes effective, it will make the U.S. tax treaty with Germany the first U.S. income tax treaty to provide for mandatory arbitration of competent authority disputes. See Tax Analysts, *U.S. Agrees to Mandatory Arbitration in German Tax Treaty*, 2006 WORLDWIDE TAX DAILY 107-1 (June 5, 2006), available in LEXIS, Inlaw library, TNI file, Doc 2006-10664. Clauses providing for non-mandatory arbitration have been included in some of the tax treaties the U.S. has recently negotiated, including those with Canada, France, Ireland, Italy, Kazakhstan, Mexico, the Netherlands, and Switzerland.

and the United States have not included a supplementary dispute resolution mechanism like arbitration or mediation in their Treaty.²⁶⁹

Any agreement reached by the competent authorities of Japan and the United States as to a specific case is to be carried out “even if such implementation otherwise would be barred by the statute of limitations or by some other procedural limitation, such as a closing agreement.”²⁷⁰ However, the Technical Explanation notes that Paragraph 2 does not preclude the efficacy of a domestic procedural limitation that gives effect to the decision reached by the competent authorities—for example “a domestic-law requirement that the taxpayer file a return reflecting the agreement within one year of the date of the agreement.”²⁷¹ The United States and Japan have explicit rules that coordinate the decisions of the competent authorities and the domestic limitations periods.²⁷² Under U.S. law, the time limits and procedural limitations periods cannot be extended if a request for competent authority assistance is denied or if the competent authorities fail to reach an agreement.²⁷³

There is a longstanding issue as to whether an agreement on a specific case reached by the competent authorities pursuant to Paragraphs 1 and 2 of Article 25 overrides a domestic court decision. In Japan, the decision reached by the mutual agreement procedure may be enforced despite a contrary court decision.²⁷⁴ In the United States the issue is less clear, although U.S. Revenue Procedure 2002-52 explicitly states that “[t]here is no authority for the U.S. competent authority to provide relief from U.S. tax or to provide other assistance due to taxation arising under the tax laws of the foreign country or the United States, unless such authority is granted by a treaty.”²⁷⁵ Thus, if the issue arises, it is likely to be framed as a situation in which the U.S. competent authority agreed to relief that was not authorized under the given tax treaty, as previously interpreted by a prior U.S. court. Because there is a concerted effort to ensure that the agreements reached by the U.S. competent authority are consistent with U.S. law—for example, by explicitly requiring the U.S. competent authorities to be guided

In 1990, twelve Member States of the European Communities signed a multilateral agreement providing for mandatory arbitration of certain issues that were not able to be resolved through the standard mutual agreement procedure set forth in tax treaties. See Convention on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises, July 23, 1990, 90/463/EEC, reprinted Aug. 20, 1990 O. J. European Communities, (L 225). In addition a few bilateral European treaties contain arbitration clauses. See, e.g., Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Austria-F.R.G., art. 25(5), Aug. 24, 2000, reprinted in *Tax Analyst, Worldwide Tax Treaties*, 2001 WORLDWIDE TAX DAILY 36-16, available at LEXIS, TNI file, 2001 WTD 36-16, Doc 2001-5225.

269. As expected, the new U.S. Model Tax Treaty, which was released on November 15, 2006, does not contain a model provision providing for mandatory arbitration. See U.S. Model Tax Treaty, *supra* note 108; Tax Analysts, *Germany-U.S. Tax Treaty Arbitration Process Addresses Sovereignty Issue*, *supra* note 178.

270. Technical Explanation of Japan-U.S. Tax Treaty, *supra* note 9, at 100; cf. Japan-U.S. Tax Treaty, *supra* note 1, art. 9(3) (Contracting State may allocate profits to an associated enterprise pursuant Article 9 unless an examination is initiated within the seven-year period following the end of the taxable year in which the profits in question should have accrued to the enterprise); see discussion *supra* Part V, note 169.

271. Technical Explanation of Japan-U.S. Tax Treaty, *supra* note 9, at 100.

272. See Rev. Proc. 2002-52, 2002-2 C.B. 242, § 7 (Coordination with Other Administrative or Judicial Proceedings), § 8 (Simultaneous Appeals Procedure), § 9 (Protective Measures).

273. *Id.* § 9.01 (“In addition, the particular treaty or the posture of the particular case may indicate that the taxpayer or a related person must take protective measures with the U.S. and foreign tax authorities so that the implementation of the any agreement reached by the competent authorities . . . [is] not barred.”).

274. See Jones et al., *supra* note 260, at 346, n.62; see also discussion *supra* Part III.B.3.

275. Rev. Proc. 2002-52, 2002-2 C.B. 242, § 3.02.

by the arm's length standard within the meaning of the transfer pricing regulations under Section 482 of the Internal Revenue Code²⁷⁶—few mutual agreements are likely to be challenged on this basis, especially since the mutual agreement can be likened to a settlement.²⁷⁷ However, if a U.S. taxpayer does not accept the mutual agreement reached by the competent authorities, U.S. law permits the taxpayer to refer the issue to IRS Appeals for further consideration.²⁷⁸ Except in cases where the Treaty specifically delegates authority to the competent authorities to resolve a particular issue—for example, the residence of a person under Article 4(3)(d) of the Treaty—a taxpayer may generally appeal the results of the Mutual Agreement Procedure to the domestic revenue authorities or to the courts.²⁷⁹ The taxpayer's right to reject the mutual agreement of the competent authorities, combined with the fact that such agreements have no value as legal precedents, imparts a transient quality to the whole dispute resolution process under Article 25, which some have likened to an on-going political negotiation.²⁸⁰ However, the potency of the Mutual Agreement Procedure as a dispute resolution mechanism is bolstered by the fact that it is expressly excepted from the Savings Clause of Article 1,²⁸¹ which otherwise preserves the rights of Japan and the U.S. to tax their own residents (and citizens) in accordance with their domestic laws.

Paragraph 3 authorizes the competent authorities of Japan and the United States “to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of” the Treaty.²⁸² Paragraph 3 sets forth a nonexclusive list of treaty interpretation and application issues that are within its purview, including *inter alia* the proper attribution or allocation of income, deductions, credits, or allowances between persons, or between an enterprise in one Contracting State and a PE in the other Contracting State; the settlement of conflicts regarding the characterization of persons, entities, and income; the application of income source rules; advance pricing agreements; and the meaning of any term used in the Treaty.²⁸³ Because the list is not exhaustive, there is an issue as to the scope of the competent authorities' discretion under this paragraph. For example, can the competent authorities devise an interpretation of the Treaty that is entirely of their own making? The better view is that the scope of their authority under Paragraph 3 is limited to clarifying and

276. *Id.* § 3.03.

277. This issue is related to, but distinguishable from, the issue discussed *supra* Part III.A.3, which focused on the status accorded by U.S. law to U.S. treaty obligations in the face of an ostensibly conflicting domestic statute.

278. Rev. Proc. 2002-52, 2002-2 C.B. 242, § 8.01 (“A taxpayer filing a request for competent authority assistance under this revenue procedure may, at the same time or at a later date, request [IRS] Appeals' consideration of the competent authority issue under the procedures and conditions provided in this section.”).

279. *Id.* §§ 7, 8; see, BAKER, DOUBLE TAX CONVENTIONS, *supra* note 30, ¶¶ 25–13.

280. See, e.g., LINDENCRONA & MATTSOON, *supra* note 258; Green, *Comparison of International Tax and Trade Regimes*, *supra* note 266, at 79, 99.

281. See Japan-U.S. Tax Treaty, *supra* note 1, art. 1(5) (listing exceptions to application of the Savings Clause of art. 1(4)).

282. Japan-U.S. Tax Treaty, *supra* note 1, art. 25(3).

283. Japan-U.S. Tax Treaty, *supra* note 1, art. 25(3)(a)-(d). Because the list is not exclusive, the competent authorities' agreements under Paragraph 3 may also include agreements regarding such things as the proper methodology for determining something like a transfer price, a cost sharing agreement, or an acceptable range of results using a particular methodology. Technical Explanation of the Japan-U.S. Tax Treaty, *supra* note 9, at 100.

completing definitions in the Treaty that are ambiguous or incomplete.²⁸⁴ Moreover, the Technical Explanation broadens the discretion of the competent authorities in this regard by stating that “[a]greements reached by the competent authorities under Paragraph 3 need not conform to the internal law provisions of either Contracting State.”²⁸⁵

Another longstanding issue is whether the competent authorities’ agreements regarding an issue of treaty interpretation are binding. The general view, according to the OECD Commentaries, is that “[m]utual agreements resolving general difficulties of interpretation or application are binding on administrations as long as the competent authorities do not agree to modify or rescind the mutual agreement.”²⁸⁶ However, it is very doubtful that such interpretive agreements would be viewed by domestic courts as legal precedents binding their authority to arrive at a different interpretation.²⁸⁷ But if the competent authorities’ interpretations of the Treaty’s text are given no weight, then Paragraph 3 is superfluous. That view does not likely comport with the intention of the Contracting States. Giving no weight to such interpretive agreements would also be inconsistent with the Vienna Convention of the Law of Treaties—specifically Article 31 which provides, in its pertinent part, that in interpreting a treaty, there shall be taken into account: “(a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions; and (b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation.”²⁸⁸

Thus, the Vienna Convention supports the view that while the interpretive agreements reached by the competent authorities are not binding, they should at least be taken into account by the courts when interpreting a treaty.²⁸⁹ The Japan-U.S. Tax Treaty, consistent with the U.S. Model Treaty, has taken a rather unique approach to resolving this issue. Article 3(2) of the Treaty seems to augment the capacity of the competent authorities to interpret the Treaty by providing in its text that undefined terms used in the Treaty “shall, unless the context otherwise requires, or *the competent authorities* agree otherwise on the

284. See BAKER, DOUBLE TAX CONVENTIONS, *supra* note 30, ¶¶ 25–14.

285. *Id.* ¶ 495.

286. OECD Committee on Fiscal Affairs, *Commentary on Article 25 Concerning the Mutual Agreement Procedure*, *supra* note 261, at 36; *but cf.*, Rev. Proc. 2002-52, 2002-2 C.B. 242, ¶ 7.05, which provides in its pertinent part:

Once a taxpayer’s tax liability for the taxable periods in issue has been determined by a U.S. court (including settlement of the proceedings before or during trial), the U.S. competent authority similarly will endeavor only to obtain correlative relief from the treaty country and will not undertake any action that would otherwise reduce the taxpayer’s federal tax liability for the taxable periods in issue as determined by a U.S. court.

287. See BAKER, DOUBLE TAX CONVENTIONS, *supra* note 30, ¶¶ 25–16 (“The general view seems to be that mutual agreements do not bind the courts of the respective countries, who are free to adopt a different interpretation from that of the revenue authorities.”)(citing Jones et al., *supra* note 260, 348–49).

288. Vienna Convention on the Law of Treaties, art. 31(3)(a)-(b), May 23, 1969, 1155 U.N.T.S. 331, 8 I.L.M. 679 (1969). The text of the Vienna Convention is available at http://untreaty.un.org/ilc/texts/instruments/english/conventions/1_1_1969.pdf.

289. The United States has signed but not ratified the Vienna Convention on the Law of Treaties. While the principles of construction employed by the U.S. federal courts often seem consistent with the approach of the Vienna Convention, the U.S. federal courts are more likely to look beyond the ordinary meaning of a treaty’s text to its underlying purpose, as well as to the particular purpose and context of the article in question. See, HUGH J. AULT & BRIAN J. ARNOLD, COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS 430 (Kluwer Laws Int’l, 2d ed. 2004). Japan is a signatory to the Vienna Convention. Although the national courts do not refer to the Vienna Convention in their opinions involving tax treaties, “the actual results of what sparse case law there is can be said to be consistent with the result that would have occurred under the Convention.” *Id.* at 431.

meaning of a term for the purposes of applying the Convention pursuant to *Article 25*, have the meaning which it has at that time under the” domestic law of the Contracting State applying the Treaty.²⁹⁰ Article 3(2) of the OECD Model Treaty neither includes the reference to the States’ competent authorities, nor infers that their agreement will be determinative of the meaning of an undefined term.²⁹¹

The second sentence of paragraph 3 of article 25 authorizes the competent authorities of Japan and the United States to consult each other regarding instances of double taxation that are not covered by the Treaty. This provision, which is almost identical to the second sentence of Article 25(3) of the OECD Model Treaty, is most commonly used to resolve the double taxation that can occur in triangular cases where a resident of a third country has PEs in both Contracting States.²⁹² A person may seek relief under Article 25 even if he is not entitled to benefits of the Treaty under the LOB article (Article 22). The Technical Explanation provides that, “[a]s in all cases, the competent authority is vested with the discretion to decide whether the claim for relief is justified.”²⁹³ Paragraph 4 of Article 25 enables the competent authorities of Japan and the United States to “communicate with each other directly . . . for the purpose of reaching an agreement” without having to go through diplomatic channels.²⁹⁴ Again, this power reflects the historic purpose of the Mutual Agreement Procedure—to maintain an ongoing conciliatory conversation between the two Contracting States’ fiscal authorities so as to provide a means to iron out differences in their tax systems and the resulting problems those differences can create.

The official OECD Commentary to Article 25 notes that “[o]n the whole, the mutual agreement procedure has proved satisfactory.”²⁹⁵ Perhaps the strongest indication of that satisfactory assessment is the remarkable proliferation of bilateral tax treaties based on the OECD Model, which today number in the thousands.²⁹⁶ The OECD Commentary goes on to observe that “Treaty practice shows that Article 25 has generally represented the maximum that Contracting States were prepared to accept,” but the Commentary is not explicit as to the nature of the maximum thing that the Mutual Agreement Procedure has caused Contracting States to confront.²⁹⁷ Nonetheless, it is clear that the Commentary is referring to the *level of sovereignty* that Contracting States are willing to cede. One of the biggest advantages of the present Mutual Agreement Procedure, from the States’ perspective, is

290. Japan-U.S. Tax Treaty, *supra* note 1, art. 3(2).

291. See OECD Model Treaty, *supra* note 29, art. 3(2).

292. OECD Committee on Fiscal Affairs, *Commentary on Article 25 Concerning the Mutual Agreement Procedure*, *supra* note 261, ¶ 37.

293. Technical Explanation of the Japan-U.S. Tax Treaty, *supra* note 9, at ¶ 102.

294. *Id.* art. 25.

295. OECD Committee on Fiscal Affairs, *Commentary on Article 25 Concerning the Mutual Agreement Procedure*, *supra* note 261, ¶ 45 (2005).

296. See Graetz & Warren, *Income Tax Discrimination*, *supra* note 252, at n.30 (stating that as of 2006, there were over 2500 bilateral tax treaties, most of them among developed countries and having structural features similar to the OECD Model) (citing KEES VAN RAAD, *NONDISCRIMINATION IN INTERNATIONAL TAX LAW* (1986); Mary Bennett, Director of Tax Treaty & Transfer Pricing, OECD Centre for Tax Policy and Admin., The David R. Tillinghast Lecture delivered at New York University School of Law: *Non-discrimination in International Tax Law: A Concept in Search of a Principle*, in 59 *TAX L. REV.* (forthcoming 2007); see also Victor Thuronyi, *International Tax Cooperation and a Multilateral Treaty*, 26:4 *BROOK. J. INT’L L.* 1640 (2001) (noting that in 1998, OECD publications indicated there were over 1500 bilateral tax treaties in effect, with approximately seventy-five new ones being added each year)(citing OECD, *Tax Sparing: A Reconsideration* 14 (1998))[hereinafter Thuronyi, Proposal for a Multilateral Treaty].

297. OECD Committee on Fiscal Affairs, *Commentary on Article 25 Concerning the Mutual Agreement Procedure*, *supra* note 261.

reflected in the new Japan-U.S. Tax Treaty, with neither country ceding its sovereignty to a supranational court or institution to resolve its international tax disputes. The whole procedure is instead an on-going, somewhat consensus-based, process of negotiation.²⁹⁸ This characterization points out a second advantage of the Mutual Agreement Procedure—its flexibility. The competent authorities are free to work out creative solutions to international tax issues which, especially in the transfer pricing area, can be unusual due to the unique interface between the two countries' tax systems.²⁹⁹

A third advantage of the Mutual Agreement Procedure as a means of resolving international tax disputes is that the competent authorities are experts in the field. This is not necessarily the case when tax disputes are decided by domestic courts. Presently, there is no guarantee that if these disputes were decided by an international court (for example, the European Court of Justice) or a supranational body (for example, the World Trade Organization), the international court or institution would be as well versed as the Contracting States' competent authorities are on the Japan and U.S. tax systems.

A fourth advantage of the present Mutual Agreement Procedure is that it is relatively easy for a taxpayer to institute the process; the taxpayer need not prove such technical requirements as constitutional standing or the justiciability or ripeness of the tax issue. Indeed, under the Treaty's text, the tax liability need only be a probability—but not necessarily a reality.³⁰⁰ Under U.S. and Japanese law, failure to satisfy extreme technical regulations such as personal standing, ripeness, and justifiability, will often preclude judicial review. The Mutual Agreement Procedure does not impose these prerequisites.

The flaws in the Mutual Agreement Procedure are obvious, especially to taxpayers. First, the competent authorities are under no legal obligation to resolve a dispute; they need only try or endeavor to resolve it with no guarantee they will. Second, because there are no set time frames and no legal precedents, the process is often long and drawn-out and can lead to unpredictable results. Third, because the Mutual Agreement Procedure was originally devised as a method to continue negotiating the proper purview and application of a tax treaty, the process can take on the spirit of a political compromise wherein all kinds of extraneous factors may enter the deal, much different from a well-reasoned judicial decision where the law is applied to facts that have been formally admitted as evidence. Also, because the competent authorities are handling many tax disputes at once, there is a perception that the competent authorities are making trade-offs or package deals in order to settle a large number of unrelated tax disputes as quickly as possible. It is not always clear to the taxpayer that horse trading is going on since the competent authorities are under no duty to publish the rational (if any) of the agreements they reach. This suggests a fourth disadvantage of the Mutual Agreement Procedure—its lack of transparency. A taxpayer can feel alienated from the whole process since it is handled by the competent authorities—often in seeming secrecy—and often without the taxpayer's full input. Arguably, a fifth flaw in the Procedure

298. There is a fear that mandatory arbitration, as an alternative to the Mutual Agreement Procedure, will cause Contracting States to cede their sovereignty to a panel of experts who could interpret U.S. tax law differently than U.S. courts. See Tax Analysts, *Germany-U.S. Tax Treaty Arbitration Process Addresses Sovereignty Issue*, *supra* note 178.

299. Note, however, that the competent authorities are not allowed to get too creative, as they are bound to the provisions and general purpose of the treaty to avoid double taxation. See, e.g., Rev. Proc. 2002-52, 2002-2 C.B. 242, § 3.03 (Applicable Standards in Allocation Cases).

300. See *id* § 4.01 (requiring that double taxation be a probability, not a mere possibility, before the Mutual Agreement Procedure is invoked).

is that the competent authorities' compromise or interpretation of the Treaty is not binding on the taxpayers. They can most often seek redress through the domestic revenue authorities' administrative procedures or in the courts if they don't like the deal that was struck by the competent authorities.³⁰¹ This feature, which can delay a case's resolution by years, has prompted many observers to call for the adoption of alternatives to the Mutual Agreement Procedure, like mediation and mandatory binding arbitration.

The OECD Committee on Fiscal Affairs has expressed concern that the increasing volume of cross-border tax disputes will pose a serious barrier to trade if the Mutual Agreement Procedure is not revised and revamped. Accordingly, the Committee has convened a working group to study ways to improve the effectiveness of the Mutual Agreement Procedure, including the possibility of adopting supplementary methods of dispute resolution like binding arbitration. In July 2004, the OECD Committee on Fiscal Affairs released a progress report on its efforts entitled "Improving the Process for Resolving International Tax Disputes."³⁰² The report includes various draft amendments to Article 25 and the official OECD Commentaries. Included among the working group's ideas to improve the Mutual Agreement Procedure are proposals aimed at increasing the transparency of the system, proposals to add optional and mandatory arbitration clauses to Article 25, proposals to clarify the time frames for instituting the Procedure, and a tentative list of best practices. One best practice promulgated by the working group advocates that competent authorities take a principled approach to their decision making, much like a judicial proceeding, with decisions resting on the legal merits of the case, rather than on arbitrary trade-offs, as is sometimes done in transfer pricing disputes. The goal of satisfying standards that smack of judicial due process may potentially conflict with Contracting States' concerns about not ceding more of their sovereignty and judicial powers to a decision-making body that might be applying standards fashioned by the OECD, and not by its own courts. The working group is scheduled to conclude its study and present its findings and proposals by January 2007, at which time the Committee on Fiscal Affairs is expected to endorse many of them.

B. EXCHANGE OF INFORMATION—ARTICLE 26

A provision to facilitate information sharing is typically included in bilateral tax treaties for two reasons: (1) to ensure that each country will have enough quality information to know which rules of a particular tax treaty are implicated and how they should be applied, and (2) to provide reciprocal information enabling each country to better apply their own domestic tax laws even if there is no question about a particular provision of their tax treaty. The Exchange-of-Information article—Article 26—in the Japan-U.S. Tax Treaty is based on the U.S. Model Treaty, and is of the highest quality according to U.S. Treasury officials.³⁰³ The scope of authority granted to the competent authorities by Article 26 of the new Treaty is very broad. The information that the competent authorities are required to exchange is not limited to the taxes covered by the Treaty. Rather, it covers all information about any kind of tax that is relevant either to carrying out the Treaty or to the domestic tax laws of

301. Consequently, many in the private sector have urged adoption of supplementary dispute resolution procedures like mandatory binding arbitration. See discussion *supra* notes 264, 268, 273–74 and accompanying text.

302. OECD Committee on Fiscal Affairs, *Improving the Process for Resolving International Tax Disputes* (July 27, 2004), available at <http://www.oecd.org/dataoecd/44/6/336294447.pdf>.

303. Tax Analysts, *Japan-U.S. Tax Treaty of Crucial Importance*, U.S. Treasury's Angus Says, *supra* note 12.

Japan or the United States. Moreover, the sharing of information is authorized even if it relates to a purely domestic transaction. For example, if a U.S. corporation does business with a Japanese company through a company residing in a third country, either the United States or Japanese competent authorities may request information about the transactions that occurred between the third-country-resident company and the company residing in the other Contracting State, respectively. Article 26 is not limited by Article 1; thus, the information requested or provided may concern persons who are not residents of either the United States or Japan. For example, if a third-country resident maintains a bank account in Japan and the U.S. Internal Revenue Service reasonably suspects that the funds in that account should have been reported as income for U.S. tax purposes, the U.S. competent authorities may request information about that account holder from Japan's competent authorities even though the person is not a resident of either Japan or the United States and the putative taxpayer is not under examination. The information requested or provided may relate to civil or criminal tax matters, regardless of whether those matters are under investigation, being prosecuted, being litigated, in collection, or on appeal.

Article 26 also authorizes the competent authorities to request that the information be presented in a form that could be admissible as evidence in a court of law—for example, authenticated copies of original documents, including books, records, statements, and accounts. Unlike the U.S. Model Treaty, Article 26 does not explicitly authorize the competent authorities to depose witnesses to obtain the desired information. The information contemplated by Article 26 may be exchanged by the competent authorities on a routine basis, spontaneously, or in response to a specific request.

Paragraphs 2 and 3 of Article 26 impose restrictions on competent authorities' powers to handle the information. Thus, Paragraph 2 requires that the information exchanged be treated as secret, and disclosed only to those persons, authorities, or supervisory bodies involved in the tax matter at issue, and only to the extent necessary to allow them to discharge their responsibilities. The information exchanged may, however, be disclosed in public court proceedings and judicial decisions.³⁰⁴

Paragraph 3 provides that the obligation to exchange information does not require a Contracting State to take measures that vary from either Contracting State's laws or administrative practices. The obligation also does not require the Contracting States to supply information that would effectively disclose a commercial, business, or professional trade secret, or be contrary to public policy. Thus, the competent authorities of one Contracting State may refuse to provide information that is illegal to disclose, or to take measures that would be overly broad, in the requesting State. However, Paragraph 4 requires both Japan and the United States to take the necessary measures, including possible legislation, to ensure that its competent authorities have sufficient powers under domestic law to exchange the information contemplated by Article 26.³⁰⁵ Such information may include private "information held by financial institutions, nominees, or persons acting in an agency or fiduciary capacity,"³⁰⁶ but it does not include information protected by the attorney-client privilege under U.S. law.³⁰⁷

304. Japan-U.S. Tax Treaty, *supra* note 1, art. 26(2).

305. U.S. law already allows its competent authorities to obtain the information contemplated by Article 26, and a 2003 change in Japan's laws ensures that Japan's competent authorities also have the legal capability to obtain the requisite information. Technical Explanation of Japan-U.S. Tax Treaty, *supra* note 9, at 105.

306. *Id.* ¶ 512.

307. *Id.*

XII. Alternatives to Bilateral Tax Treaties

Parts I through III discussed the foundational norms underlying the international tax policies of Japan, the United States, and their new income tax treaty. Parts IV through XI then analyzed selected provisions of the Treaty in light of various tax policy objectives, including economic efficiency, fairness, inter-nation equity, and national concerns such as the need to raise revenue through tax incentives, the need to maintain tax sovereignty, and the need to maintain a healthy balance of payments. In addition, various articles were evaluated in terms of their transparency, their concomitant compliance burdens and transaction costs, and the degree to which the given provision relates (or fails to relate) to the way modern cross-border transactions are often conducted that is, through multinational corporations and electronic commerce. Despite the many improvements to the Japan-U.S. Tax Treaty and its more innovative solutions to longstanding problems such as fiscally transparent entities,³⁰⁸ a constant theme running throughout the discussion has been that the entire international tax system—encompassing both national tax laws and the growing network of OECD tax treaties—is founded on the iconic but anachronistic principles of source and residency, as well as the erroneous and outdated assumption that international trade is still dominated by physical transfers of tangible goods between unrelated parties dealing at arm's length.³⁰⁹ These may have been reasonable assumptions fifty or sixty years ago, but the reality today is that international trade is dominated by electronic and digital transfers of intangible assets between affiliated corporations that are often vertically or horizontally integrated and not dealing at arm's length. The new high-tech world has created many opportunities for exploiting the old normative rules for taxing international income and, in effect, diminishing countries' tax sovereignty.³¹⁰

Whenever source and residency are compromised as methods of allocating tax jurisdiction between countries, that degree of compromise will always be accompanied by, and indeed proportional to, the decline of the Nation State as an actor on the world stage. That is because income source and residency—as anachronistic as they may seem in the world of electronic commerce and integrated multinational corporations—go to the heart of territorial jurisdiction.³¹¹ Thus, unless one is willing to see the Nation State decline, these fundamental concepts of territorial jurisdiction should not be tossed out lightly, and certainly not without seriously considering the alternative models for allocating tax jurisdiction and the accompanying rules such models and forums would likely impose.

Critics of the bilateral tax treaty system have long argued that there is a better way to tax cross-border transactions. Some argue that a binding *multilateral* treaty based on the

308. See e.g., discussions *supra* Parts IV-VII.

309. See discussion *supra* Part II.D.-E.

310. In recognition of the deleterious effects electronic commerce and globalization has had on international taxation, the OECD launched two initiatives aimed at: (1) combating so-called harmful tax rate competition, and (2) establishing new rules for the taxation of electronic commerce. For an overview of the initiative on harmful tax competition see, OECD Committee on Fiscal Affairs, *Harmful Tax Competition: An Emerging Global Issue* (1998), available at <http://www.oecd.org/dataoecd/33/1/1904184.pdf>; OECD Committee on Fiscal Affairs, *The OECD's Project on Harmful Tax Practices* (A 2004 Progress Report to the Ministerial Council Meeting) (Paris: OECD, 2004) available at <http://www.oecd.org/dataoecd/60/33/30901115.pdf>. For an overview of the issues raised by electronic commerce, see OECD Conference Report, *Dismantling the Barriers to Global Electronic Commerce* (Finland, 1997), available at <http://www.oecd.org/dataoecd/37/55/2751237.pdf>; OECD Committee on Fiscal Affairs, *Implementation of the Ottawa Taxation Framework Conditions—The 2003 Report* (Paris: OECD, 2003), available at <http://www.oecd.org/dataoecd/45/19/20499630.pdf> [hereinafter OECD Ottawa Taxation Framework].

311. See discussion *supra* Part III.D.-E.

OECD Model would resolve many of the problems plaguing the current system.³¹² Others argue that *regional trade blocks* provide useful models to design better ways to integrate diverse national corporate tax regimes.³¹³ Still others argue that a new supranational institution is needed for direct taxes³¹⁴—something similar to the World Trade Organization (WTO)—to introduce meaningful reforms at the global level, such as replacing the arm's length method of allocating income with formulary apportionment.³¹⁵ This Part XII briefly assesses each of these suggested alternatives to the bilateral tax treaty network in terms of their substantive desirability, as well as the political and transaction costs each could pose. Transaction costs and external frictions can greatly alter the efficiency equation of a theoretical model, creating barriers to the implementation of a model not only on a global scale, and also on a more limited regional one.³¹⁶ At this juncture, it may be helpful to first summarize the alleged deficiencies of the bilateral treaty network which, like the OECD Model Tax Treaty itself, have prompted calls to adopt a whole new approach. Since these deficiencies have been discussed in prior Parts in relation to the Japan-U.S. Tax Treaty, the following section is a recapitulation of arguments posed by strong critics of the OECD bilateral tax treaty network—in some instances by scholars who seemingly would prefer it be completely scrapped and replaced.³¹⁷

312. See, e.g., Thuronyi, Proposal for a Multilateral Treaty, *supra* note 296, at 1667 (“The first part [of the proposed multilateral treaty] would be . . . initially based on the OECD Model.”).

313. See, e.g., Arthur J. Cockfield, *Developing an International Tax Policy Strategy for NAFTA Countries*, 42 Tax Notes Int'l, No. 11, 975 (June 12, 2006) (arguing that North Americans can draw useful lessons from the European experience with cross-border tax reform efforts, and that NAFTA countries should create a centralized body to grant approval of tax-free mergers and acquisitions between NAFTA countries on a case-by-case basis); *but cf.*, ADOLFO J. MARTIN JIMENEZ, TOWARDS CORPORATE TAX HARMONIZATION IN THE EUROPEAN COMMUNITY—AN INSTITUTIONAL AND PROCEDURAL ANALYSIS, preface at p. xv (1999) (noting that “the corporate tax policy of the European Commission has proved to be one of the major failures in the EC’s history, despite the constant demand for harmonization throughout the business community . . .”) [hereinafter Jimenez, Corporate Tax Harmonization in the European Community].

314. There is a lot of confusion over the terms direct tax and indirect tax. Black’s Law Dictionary defines direct tax as one that is imposed directly upon property, according to its value. It is generally spoken of as a property tax or an ad valorem tax. BLACK’S LAW DICTIONARY 1496 (8th ed. 2004). On the other hand, Black’s Law Dictionary defines an indirect tax as a tax upon some right or privilege or corporation franchise, a tax laid upon the happening of an event as distinguished from its tangible fruits. *Id.* at 1497. However, international tax scholars routinely refer to value added taxes (VATs) and sales taxes as indirect taxes, which seems to clearly contradict Black’s Law Dictionary’s definition. Moreover, scholars refer to taxes on capital and income as direct taxes. For purposes of this article, taxes that are not routinely or easily shifted to another person or company in the absence of special planning structures will be included under the rubric of direct taxes, and this term thus includes company income taxes and gross withholding taxes. Because VATs can be imposed on either on an origination or destination basis, and thus easily shifted to another person, they will be included under the rubric of indirect taxes for purposes of this article.

315. See, e.g., Vann, *Treaty for the Asian-Pacific?*, *supra* note 30 at 156 (suggesting that an international tax institution structured like the GATT would offer flexibility and could be adopted by countries on a graduated basis, beginning with minimal but binding general rules, leading to greater tax law reforms and a convergence of systems by bestowing the GATT-like institution with a more powerful interpretive role than that now possessed by the OECD); Reuven S. Avi-Yonah, *Treating Tax Issues Through Trade Regimes*, BROOK. J. INT’L L. 1683, 1692 (2001) (suggesting that the WTO may be the “most promising forum for” resolving problems like harmful tax competition) [hereinafter Avi-Yonah, *Treating Tax Issues Through Trade Regimes*].

316. See Ronald H. Coase, *The Problem of Social Cost*, J.L. & ECON. 1, 37 (1960).

317. Although each of these arguments has some credence, Part XII and the one that follows it should make it clear that the author believes the existing OECD bilateral tax treaty network is the most pragmatic alternative for allocating international tax jurisdiction in the Information Age, and will continue to evolve and be strengthened through its transgovernmental networks of tax authorities from countries around the world.

A. FLAWS IN THE OECD BILATERAL TAX TREATY SYSTEM

Although the foundational norms of source and residency are pervasive and will probably never disappear as long as the Nation State exists, a bilateral treaty is not an ideal vehicle for allocating tax authority in transnational business environments where these principles have become increasingly vulnerable to manipulation. The OECD Model Treaty is inefficient in large part because it relies so heavily on these concepts in its schedular layout. Each type of income is categorized and subject to different allocation rules and tax rates. Because countries' tax bases and rates are not uniform, taxpayers are inevitably motivated to manipulate the residence of their companies,³¹⁸ as well as the source and character of their investments, depending on their tax objectives. For example, they may try to convert nondeductible dividends to deductible interest, or business income to royalties—categories of income carrying dramatically different tax treatment under most bilateral tax treaties and national tax rules. With the help of tax planners, taxpayers may defer recognition of their income in a foreign tax haven or create hybrid entities and instruments to reduce or escape income tax entirely.

The manipulable character of the OECD Model raises both fairness and economic efficiency concerns. Taxpayers who can pay for sophisticated tax planning advice can more easily exploit the differences in countries' rules for determining income source, company residence, entity class, and income character. This advantage infringes upon the tax policy objective of horizontal equity, which requires that persons who are similarly situated receive equal treatment.³¹⁹ Moreover, as previously noted, economists have long believed that worldwide economic welfare is reduced when capital resources cross national borders in response to tax policies and incentives, rather than in response to pure economic fundamentals.³²⁰ The efficiency problem is exacerbated by the OECD Model Treaty's requirement of tax rate reciprocity. Due to differences in each Contracting State's level of corporate integration,³²¹ a formal requirement of rate reciprocity does not mean that the effective rates of each Contracting State are identical once a bilateral tax treaty is applied. Most often, taxpayers' behavior will still be biased by the differences in the effective tax rates despite the nominal rate caps. Bilateral tax treaties can mitigate huge disparities by imposing limits on tax rates, but rarely if ever will the treaties have the effect of equalizing the effective rates since they depend on other aspects of the jurisdictions' tax systems, such as the degree and method of corporate integration.

318. As shown in Part VI, this is often fairly easy to do especially with the U.S. Check-the-Box regulations. See Treas. Reg. §§ 301.7701-1 to -5 (as amended in 2006).

319. See discussion *supra* Parts II.A, and VI.F.

320. See RICHMAN, *supra* note 15; MUSGRAVE, *supra* note 15; see also Treas. Subpart F Tax Policy Study, *supra* note 15 at 23-54; *but cf.*, KLAUS VOGEL, JOHAN BRANDS, KEES VAN RAAD, TAXATION OF CROSS-BORDER INCOME, HARMONISATION, AND TAX NEUTRALITY UNDER EUROPEAN COMMUNITY LAW—AN INSTITUTIONAL APPROACH 27-29 (1994) (Vogel argues that if the right to tax is allocated solely to the state of source, inefficiencies would be mitigated because states would compete to provide provisions and services to firms at the lowest (tax) prices. In other words, Vogel seems to think tax subsidy competition is a good thing.) [hereinafter Vogel et al., Taxation of Cross-Border Income].

321. If corporate- and shareholder-level taxes are perfectly integrated, there is effectively only one layer of tax imposed on the income earned by a corporation. For many years, the U.S. corporate tax system has not been integrated since corporate income was fully taxed at both the entity level and the shareholder level when corporate earnings were distributed. When the tax rate on qualified dividends was lowered to 15% in 2003, the U.S. corporate tax system became partially integrated. See Discussion of the Jobs Growth Tax Relief and Reconciliation Act of 2003 (Pub. L. 108-27) (May 28, 2003) *supra* Part III.A.1.b. and note 48.

A major issue that pervades international tax regimes at all levels is whether groups of affiliated corporations should be taxed on a single entity basis (where intra-firm transactions are essentially ignored and the group's total income is consolidated and tallied as one huge, unified entity) or on a separate entity basis (where the relationships between the affiliated corporations are acknowledged but not ignored). Rules policing the pricing of transactions between related corporations strive to create fair methods that will arrive at prices that clearly reflect the income that was actually earned.³²² Treaties based on the OECD Model Treaty are drafted on the assumption that all entities, even related entities, should be treated as separate persons. But staunch adherence to this separate entity accounting convention has invited all manner of tax planning and treaty exploitation, including the use of conduit corporations whose whole *raison d'être* is treaty shopping and other tax saving schemes devoid of economic substance. As corporate groups have become increasingly transnational and their activities more vertically and horizontally integrated and interdependent, the OECD Model's unwavering imposition of the arm's length standard in setting transfer prices has necessitated the creation of artificial constructs and complex rules in an attempt to find a comparable transaction (or to create one hypothetically).

The Japan-U.S. Tax Treaty expressly incorporates the OECD Transfer Pricing Guidelines as they evolve over time, which at least identifies the body of rules that will govern.³²³ But, the costs of complying with and administering those rules are high, and the numerous disputes that they generate make up a vast portion of the issues that competent authorities and courts are called upon to handle. Even with the advent of advanced pricing agreements (APAs), the OECD's steadfast adherence to the arm's length standard as a way to conceptually cram group transactions into the deficient separate-entity principle—which, in turn, is drawn from the fundamental principles of source and residence—has impaired the overall efficiency of these business structures.³²⁴ Hypothetical transactions—sometimes seemingly absurd and contorted must be artificially constructed to find a comparable transaction to which the arm's length standard can be applied. Often, a bevy of tax experts must be employed to apply and enforce the standard. A formulary method of apportioning income based on the single entity principle would eliminate the need for these hypothetical transactions and artificial constructs, but the consensus is that such an apportionment formula as applied in a multi-jurisdictional setting can only work where there is a high degree of economic integration between the subscribing jurisdictions and that, in any scenario, either a binding multilateral treaty or supranational institution would need to be firmly in place to administer the formula since it would raise political issues.

The OECD Model Treaty has traditionally ignored a number of other tax planning strategies that raise efficiency concerns, including finance leases, thinly capitalized companies,

322. See, e.g., I.R.C. § 482 (RIA 2006) (granting the Secretary of the Treasury the authority to “distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among” commonly controlled organizations, trades, or businesses “in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.”).

323. See discussion *infra* Part V (Transfer Pricing).

324. See, Musgrave, *Sovereignty*, *supra* note 23, at 1342-43 (“The current international practice of assigning the profits of a multi-national company to separate business entities operating in source countries by means of unilateral separate accounting is proving to be increasingly arbitrary as international business operations become more intertwined and integrated with shared costs and overheads, and other interdependencies.”) (citing Charles E. McLure, Jr., *Defining a Unitary Business: An Economist's View*, in *THE STATE CORPORATION INCOME TAX: ISSUES IN WORLDWIDE UNITARY COMBINATION* 89 (Charles E. McLure, Jr. ed., Hoover Institution Press 1984)).

and foreign currency conversions.³²⁵ Although OECD reports have examined these problems, many of their recommendations have failed to substantively alter the actual text of the Model Treaty upon which most bilateral tax treaties are based. For example, although Article 4(6) of the Japan-U.S. Tax Treaty, dealing with fiscally transparent entities, is aimed at ending abusive finance leases, recent U.S. tax legislation has arguably done a better job of policing these tax planning schemes.³²⁶

Historically, the OECD Model Treaty has not been very effective at serving national welfare concerns. For example, if a party to a bilateral tax treaty wants to raise its tax rates on inbound portfolio investments, it may be reluctant to do so for fear that other third-party countries will not do the same, resulting in the outbound flow of portfolio investments to the country with the most competitive tax rates. This raises the classic prisoner's dilemma in game theory, where countries strongly suspect they will all be better off if they all resist offering radical tax incentives, but each is compelled to maintain revenue losing tax rates in order to stay competitive. The country that wants to raise its tax rates has no assurance that a third country, or even its own tax treaty partners, will follow suit.³²⁷ In the absence of a system that harmonizes countries' tax systems and eliminates large discrepancies in their corporate tax rates, the whole international tax system is vulnerable to harmful tax competition and a classic race to the bottom where countries are compelled to set their tax rates so low that they lose revenues and incur huge deficits.³²⁸ Although the OECD has made a great deal of headway in fighting harmful tax competition practices through its recent multilateral initiatives,³²⁹ there is a real risk that unbridled tax subsidy competition could spell the demise of the income tax, forcing both developed and developing countries to rely on other types of taxes that are less progressive than the income tax, posing greater proportional burdens on the poor, and thus diminishing equity between individuals, possibly also between developed and developing nations.³³⁰

Another factor bearing on inter-nation equity is the fact that the coverage of the OECD bilateral treaty network is incomplete, leaving poorer nations out of the loop. Although

325. See Vann, *Treaty for the Asian-Pacific?*, *supra* note 30, at 108–09. However, the OECD has assumed a leadership role in addressing a number of these problems. See, e.g., OECD Committee on Fiscal Affairs, *Report on Thin Capitalisation* (1986), reproduced in volume II of the loose-leaf version of the OECD Model Tax Convention on Income and Capital, at p. R(4)-1.

326. See, e.g., Treas. Reg. § 1.894-1(d)(2) (as amended in 2002) (Application to domestic reverse hybrid entities).

327. For a discussion of game theory aspects of tax competition, see generally Green, *Comparison of International Tax and Trade Regimes*, *supra* note 266.

328. However, this problem would not necessarily be relieved by a multinational treaty that fails to equalize effective tax rates. No tax treaty has heretofore forced a country to impose a minimum tax rate; tax treaties only limit tax rates by setting the maximum rate allowable.

329. In 1998, the OECD began a multilateral program aimed at combating harmful tax competition. For an overview of this initiative see OECD Committee on Fiscal Affairs, *Harmful Tax Competition: An Emerging Global Issue*, *supra* note 310 (Paris: OECD, 1998), and OECD Forum on Harmful Tax Practices, Committee on Fiscal Affairs, *The OECD's Project on Harmful Tax Practices* (A 2004 Progress Report to the Ministerial Council Meeting) (Paris: OECD, 2004) available at <http://www.oecd.org/dataoecd/60/33/30901115.pdf>. See further discussion *supra* Part XII.E.2.

330. See Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573 (2000) (arguing that both economic efficiency and equity among individuals and between nations support limits on international tax competition, and proposing that all portfolio income be taxed solely in the state of the investor's residence, and income earned by multinational corporations be taxed primarily in the states where the products or services are consumed)[hereinafter Avi-Yonah, *Fiscal Crisis of the Welfare State*].

there are now over 2500 bilateral tax treaties largely based on the OECD Model Treaty,³³¹ small developing countries do not always have the requisite resources to negotiate a set of advantageous bilateral tax treaties and are effectively excluded from the network, leaving them at a critical disadvantage in terms of attracting desirable investments. Moreover, the OECD Model Treaty's coverage of taxes is incomplete, focusing mostly on taxes levied on income and capital.

Although the coverage of the OECD bilateral treaty network is far from universal, some scholars have argued that its reach is sufficiently extensive and its Model Treaty is sufficiently institutionalized so as to impair the network's flexibility and ability to invoke major substantive changes to its text. In other words, as more bilateral treaties are negotiated and added to the network, the more individual treaties there are to amend in order to fully implement any one OECD initiative.³³² For example, if n number of countries wanted to achieve the equivalent effect of a multilateral treaty with a set of bilateral agreements running between all the countries, the number of treaties that would be needed in order to achieve full connectivity is equal to the combination of n things taken as a function³³³ of n :

$$\frac{n(n-1)}{2} \text{ OR } \frac{n^2-n}{2}$$

Thus, in order to fully institute an amendment to the Model's text via a network of 100 bilateral tax treaties, 4950 separate bilateral treaties would need to be amended (i.e., $100(100-99)$ divided by $2 = 4950$), as opposed to just one multilateral treaty.³³⁴ Critics argue that the most the OECD can do is tweak the Model through small textual amendments and revisions to the Commentaries, and once these revisions are made, it still can take decades for the hundreds of tax treaty partners to institute such suggested amendments through renegotiations of their bilateral agreements. Although the OECD has attempted to circumvent this problem by pushing new interpretations of its Commentaries, national courts are not that receptive to such changes, particularly when another common law court has ruled to the contrary on a given issue.³³⁵ The OECD can make recommendations as soft law, but it has no way of enforcing these recommendations or sanctioning offenders.

331. See *supra* note 296 and sources cited therein.

332. See, e.g., Vann, *Treaty for the Asian-Pacific?*, *supra* note 30, at 110–11 (arguing that the OECD Model is increasingly inflexible because “[a]s more treaties are negotiated, the more treaties there are to change if any new initiative is adopted in relation to terms of the actual Model”).

333. See RICHARD STEVENS BURINGTON & DONALD CURTIS MAY, JR., *HANDBOOK OF PROBABILITY AND STATISTICS WITH TABLES 26–27* (1953) (1910) (showing the arithmetic development of the combination of n things, taken r at a time).

334. This formula has also been used to estimate the value of adding connections to various business models, such as computer operating systems, software packages, or social networking websites. In these contexts, the formula is often loosely referred to as “Metcalfe’s Law” (although Metcalfe certainly did not invent the algorithmic function), in that it ostensibly has some ability to predict whether a particular vendor, interface standard, or connection method will tend to dominate competitors. See George Gilder, *Metcalfe’s Law and Legacy*, *FORBES ASAP*, Sept. 13, 1993, at S158; Mark A. Lemley & David McGowan, *Legal Implications of Network Economic Effects*, 86 CAL. L. REV. 479, 483 n.9 (1998) (finding it “highly unlikely that Metcalfe’s Law in fact holds strictly true,” but that “there is clearly something to the idea that social value increases with adoption from some goods”) [hereinafter Lemley & McGowan, *Legal Implications of Networks*].

335. See Vann, *Treaty for the Asian-Pacific?*, *supra* note 30, at 110.

Critics charge that because the OECD has no power to legally bind its member countries, its leadership role in reforming the normative international tax system is arguably attenuated. Amendments are sometimes initiated in the bilateral context well before the point at which the OECD Model's text is actually changed. This is the case with the LOB article (Article 22) that the United States has long required in all of its tax treaties; such clauses are not part of the text of OECD Model Treaty even though they are designed to prevent treaty shopping. Mandatory arbitration clauses are now being incorporated into bilateral tax treaties,³³⁶ while at the same time the OECD is still just studying the prospect of including supplementary dispute resolution mechanisms in the Model's text and Commentaries.³³⁷

It has long been established that if all countries' international tax systems were fundamentally the same, with uniform tax rates, substantially similar tax bases, and uniform rules to classify entities and characterize income, virtually all the current difficulties in taxing international income would not exist.³³⁸ Problems of double taxation and fiscal evasion arise because of the diversity of tax systems and tax rates, and these problems have been exacerbated by the growth of electronic commerce, the rise in international transactions between related corporations, and the globalization of economies where vast amounts of capital and labor resources easily cross borders, often with the click of a computer mouse. Thus, a major underlying debate is focused on the best way to bring about a convergence of the world's various tax systems and tax rates. Some scholars have argued that a new international institution, with more clout and power than the OECD, is needed to forge a convergence. Of these proponents, many have argued that a multilateral treaty based on the OECD Model is the answer.³³⁹ Others maintain that regional trade blocks, like the one forged by the European Community, might serve as good models to enhance multilateral cooperation,³⁴⁰ while still others propose models based on the General Agreement on Tariffs and Trade (GATT) and its successor agreements, which the WTO is charged with enforcing.³⁴¹ Some scholars, including this author, continue to believe, however, that given

336. See Japan-U.S. Tax Treaty, *supra* note 1, art. 13(3); see also Tax Analysts, *U.S. Agrees to Mandatory Arbitration in German Tax Treaty*, *supra* note 268.

337. See OECD COMMITTEE ON FISCAL AFFAIRS, *Improving the Process for Resolving International Tax Disputes*, *supra* note 302.

338. See generally Musgrave, *Sovereignty*, *supra* note 23; see also Vann, *Treaty for the Asian-Pacific?*, *supra* note 30, at 153 ("[T]he desire on the part of drafters of model treaties to move to multilateralism is really a (disguised) call for more uniformity in tax systems.")

339. See, e.g., Thuronyi, *Proposal for a Multilateral Treaty*, *supra* note 296, at 1667 ("The first part [of the proposed multilateral treaty] would be . . . initially based on the OECD Model.")

340. See, e.g., Cockfield, *supra* note 313 (arguing that North Americans can draw useful lessons from the European experience with cross-border tax reform efforts, and that NAFTA countries should create a centralized body to grant approval of tax-free mergers and acquisitions between NAFTA countries on a case-by-case basis); *but cf.*, Jimenez, *Corporate Tax Harmonization in the European Community*, *supra* note 313, at xv (noting that "the corporate tax policy of the European Commission has proved [to be] one of the major failures in the [EC's] history . . ." despite the constant demand for harmonization throughout the business community.")

341. See, e.g., Vann, *Treaty for the Asian-Pacific?*, *supra* note 30, at 156 (suggesting that an international tax institution structured like the GATT would offer flexibility and could be adopted by countries on a graduated basis, beginning with minimal but binding general rules, leading to greater tax law reforms and a convergence of systems by bestowing on the GATT-like institution a more powerful interpretive role than that now possessed by the OECD); Avi-Yonah, *Treating Tax Issues Through Trade Regimes*, *supra* note 315 (suggesting that the WTO may be the most promising forum for resolving problems like harmful tax competition).

the present level of diversity between the world's economies and legal systems, it would be most wise to stay with the present system of bilateral tax treaties based on the Model Treaty and Commentaries issued by the OECD, and to augment the influence, if not the authority, of that consensus seeking organization, which uses soft law at the multilateral level to encourage reforms of tax practices, and which also allows countries to maintain a high degree of sovereignty over their power to tax. The following sections explore and evaluate these alternatives to the existing OECD Model Tax Treaty network, of which the new Japan-U.S. Tax Treaty is a big element, both economically and symbolically.

B. OECD-BASED-MULTILATERAL TREATY ALTERNATIVE

1. Background

A multilateral treaty based on the OECD Model's text is not a new idea. Rather, it has been around since the infancies of the models advanced by the OECD and United Nations. Although those who drafted the 1963 version of the OECD Model Tax Treaty decided that a formal multilateral convention "would meet with great difficulties,"³⁴² they also recognized that the Model could be used for both bilateral and multilateral treaty negotiations.³⁴³ Moreover, the Committee on Fiscal Affairs' resolution adopting the 1977 Model invited countries to use it as a basis for drafting regional multilateral treaties.³⁴⁴ Since 1992, however, Paragraph 40 of the Model's official Introduction has expressed the deep reservations OECD countries have concerning the feasibility of a multilateral tax convention:

... [T]here are no reasons to believe that the conclusion of a multilateral tax convention involving all Member countries could now be considered practicable. The Committee [on Fiscal Affairs] therefore considers that *bilateral conventions are still a more appropriate way to ensure the elimination of double taxation at the international level.*³⁴⁵

Despite the OECD's dim forecast for a formal multilateral agreement based on the Model, it is clear that its hope for some form of multilateralism continues. The Introduction to the Model Treaty still implicitly encourages countries to rely on the Model's text to harmonize their disparate tax systems,³⁴⁶ and many scholars believe that a multilateral agreement, although perhaps not inevitable, can and should be forged out of the bilateral model at some point.³⁴⁷ The founders of the OECD Model Tax Treaty clearly recognized the deficiencies inherent in a diverse network of bilateral tax treaties, and that is no doubt why they expressed hopes that multilateral agreements would evolve.

Theoretically, if all countries had agreed to all the details contained in the 1963 OECD Model Treaty, obligating them to use fundamentally the same tax rules and tax rate limitations, most of the problems noted in the previous section would have been resolved.

342. Introduction to OECD Model Tax Treaty, *supra* note 29, ¶ 37.

343. *Id.*

344. See *id.* Vann, *Treaty for the Asian-Pacific?*, *supra* note 30, at 151.

345. OECD Model Tax Treaty, *supra* note 29, ¶ 40 (emphasis added).

346. *Id.* ¶¶ 12-15.

347. See, e.g., Thuronyi, Proposal for a Multilateral Treaty, *supra* note 296, at 1662-67 ("Currently, a number of favorable factors help set the scene for a multilateral agreement, making it more likely than in earlier periods."); cf. PASQUALE PISTONE, THE IMPACT OF COMMUNITY LAW ON TAX TREATIES: ISSUES AND SOLUTIONS 235-323 (2002) (advocating a multilateral tax treaty for the European Community largely based on the OECD Model Treaty).

Tax harmonization obviates practices like treaty shopping, unfair tax rate competition, and arbitrage structures that exploit conflicts of law and reduce economic efficiency. But while a multilateral treaty based on the OECD Model may resemble a cure-all to the ills of the bilateral treaty network, the prognosis for moving into a multilateral mode is not as bright.

At the outset, two fundamental issues emerge: (1) what are the substantive and long-term advantages of a multilateral decision-making institution, and (2), assuming a formal multilateral institution would be an improvement from the current OECD bilateral network, what procedural mechanisms would be needed to implement the new system. A multilateral tax treaty's substantive appeal cannot be isolated from the practical obstacles and institutional costs that would inevitably be encountered in implementing it. Those challenges could impair or destroy the perceived benefits of moving to a multilateral tax treaty system.³⁴⁸

2. *Substantive Desirability*

Many scholars agree that some form of intensified multilateral cooperation is needed to overcome the challenges the bilateral treaty network is current facing—in particular, problems posed by electronic commerce; harmful tax rate competition, which threatens to impair countries' abilities to raise adequate national revenues; inconsistent entity classifications, income characterizations, and treaty interpretations, all of which exacerbate the opportunities for tax arbitrage through the use of hybrid entities and instruments; and complexities associated with the imposition of the arm's length standard on multinational corporations whose cross-border operations are becoming increasingly integrated. But tax scholars do not agree on what kind of multilateral cooperation would be most desirable. By far, the biggest drawback to a formal multilateral tax treaty is that it would require countries to cede a greater degree of their tax sovereignty to an international institution, regardless of what form this decision making body might take. If the decision making body is one that employs a majoritarian voting mechanism, the European experience has shown that countries will likely be wary of sacrificing control over their ability to raise national revenues to an international decision making body in the absence of the right to veto objectionable policies.³⁴⁹ On the other hand, if the decision making body is one that requires a consensus of Member States, there is a risk that deadlock will result. Although a multilateral treaty is often characterized as being more flexible than a bilateral treaty in terms of instituting new rules and dealing with changes in technology and business practices, there is a strong possibility that a binding multilateral agreement could serve as a barrier to change. The bilateral system offers the advantage of being able to try out new methods and rules on less than a worldwide basis by introducing the new rule or procedure in a few treaties.³⁵⁰ If the rule or procedure proves successful, it is likely more treaties will adopt the changes. Indeed, this phenomenon of reforming harmful tax practices one at a time, or at least one treaty at

348. See Coase, *supra* note 316 (In this paper, Coase sets forth the essence of his seminal theorem that in the absence of transaction costs—he did not actually use this term until later—all government allocations of property are equally efficient, because interested parties will bargain privately to correct any externality. High transaction costs, on the other hand, can exceed the perceived benefits, discouraging bargained-for exchanges.)

349. See Diane M. Ring, *Prospects for a Multilateral Tax Treaty*, 26:4 BROOK. J. INT'L L. 1699, 1705 (2001); see discussion *infra* Part XII. D.3.b.

350. *Id.* at 1703–06.

a time, occurs within the present system, although change sometimes seems to move at a glacial pace.

Apart from questions of sovereignty, deadlock, and the optimal level of power to be accorded to any institution chosen to administer a multilateral treaty, there is also the primary concern that a formal agreement may not be more effective than an informal one at resolving substantive tax problems. A multilateral treaty, certainly one based on the OECD Model, is not a panacea. For example, a multilateral treaty would not necessarily solve the problem of harmful tax rate competition. Even if a worldwide treaty were adopted that imposed uniform caps on tax rates, no treaty to date has ever required a sovereign state to impose a tax or a certain level of tax.³⁵¹ Thus, one Member State that offered lower tax rates could still potentially attract more foreign investment than another State imposing the highest allowable rate. The game of inadequate assurances would still be in play. If the underlying purpose of a multilateral convention is to bring about an eventual convergence of tax systems and rates, it is questionable that it would prove to be an effective harmonizing vehicle.³⁵²

3. *Pragmatic and Procedural Problems*

Paradoxically, the robust and ongoing expansion of the bilateral tax treaty network has served as a deterrent to serious efforts to shift to a formal, explicitly binding, multilateral tax treaty. The prevailing attitude seems to be that if the present system, albeit flawed, is functioning fairly well and getting better all the time, why change course?³⁵³ Even if there were more widespread enthusiasm for a move to multilateralism, the difficulties associated with negotiating a bilateral agreement between two sovereign states only hints at the hurdles that would have to be cleared in getting numerous sovereign states to agree to one set of rules. Given the great diversity of tax systems, the obstacles to achieving a binding worldwide tax treaty could be insurmountable—especially since some of them are probably unforeseen. Nobody seems to believe that a sudden shift to multilateralism is possible in the absence of a major catalyst or, as Professor Richard Vann puts it, “a convenient world war that wipes the slate clean.”³⁵⁴

351. In 1992, a mandatory 30% withholding tax was *proposed* by the Ruding Committee, but never adopted. In 1990, the European Commission appointed a Committee of Independent Experts, chaired by former Dutch Finance Minister, Onno Ruding (the Ruding Committee) to study the economic effects of company taxation in Europe and to make recommendations. For a description of the Committee's findings, see REPORT OF THE COMMITTEE OF INDEPENDENT EXPERTS ON COMPANY TAXATION, COMMISSION OF THE EUROPEAN COMMUNITIES (March 1992). For further discussion of the Ruding Report, see *infra* Part XII.D.3.b.

352. Tax harmonization implies action at the level beyond what is necessary to achieve the goal of removing tax distortions. Tax coordination, on the other hand, may be accomplished without a supranational institution. This distinction was noted by the Ruding Committee in 1992. See REPORT OF THE COMMITTEE OF INDEPENDENT EXPERTS, *supra* note 351.

353. See OECD Model Tax Treaty, *supra* note 29, ¶ 40 (stating that the OECD Committee on Fiscal Affairs believes “that bilateral conventions are still a more appropriate way to ensure the elimination of double taxation at the international level.”); Hugh J. Ault, *The Importance of International Cooperation in Forging Tax Policy*, 26 BROOK. J. INT'L L. 1693, 1694–97 (2001) (questioning the wisdom of making the OECD Model Tax [T]reaty more explicitly multilateral when international cooperation, without binding commitments has accomplished so much to date) [hereinafter Ault, *International Cooperation in Forging Tax Policy*]; but cf., Graetz, *Taxing International Income*, *supra* note 15, at 269 (admitting that “the international income tax system has served reasonably well” and “may even have facilitated” international flows of goods, services, and capital, but that now is still a propitious time for making major improvements).

354. Vann, *Treaty for the Asian-Pacific?*, *supra* note 30, at 101.

Typically, proposals for a formal multilateral tax treaty advocate that the new system be introduced on an incremental basis, either temporally, regionally, or topically.³⁵⁵ But history suggests that the coexistence of a multilateral tax agreement with bilateral tax treaties can lead to problems if they cover the same subject matter. For example, if a multilateral tax treaty is entered into by countries in a certain region, it is reasonable to assume that the treaty will adopt methods of allocating income that differ in some way from traditional norms, otherwise there would be little reason to enter into the new agreement. Scholars often contend that a main benefit of a multilateral tax treaty would be the ability to replace the arm's length standard of apportioning income between related companies with a formulary apportionment method more in keeping with those enterprises' integrated substance. However, the experience of the United States³⁵⁶ shows that when some jurisdictions adopt unitary methods of tallying a multi-jurisdictional enterprise's income, and then apply a formulary apportionment method to allocate that income, double juridical taxation can easily result when surrounding jurisdictions do not employ the same accounting method. This conflict-of-laws problem, which commonly arises in federal systems where the constituent jurisdictions have their own tax regimes, could create huge new problems of double juridical taxation if formulary methods of assigning income were adopted on a regional scale. Indeed, this is why the European Commission's Ruding Committee,³⁵⁷ after studying the problem, recommended in 1992 that, if the European Community adopted a formulary apportionment method for its resident companies, such method should not be applied on a global scale, but rather be limited to the "water's edge," meaning that the arm's length standard should continue to be used to allocate income in transactions involving residents of jurisdictions outside the European Community.³⁵⁸

355. See, e.g., Thuronyi, Proposal for a Multilateral Treaty, *supra* note 296 (proposing a gradual transition to a multilateral tax treaty during which period bilateral treaties would remain in force); PISTONE, *supra* note 347, at 235–323 (proposing a multilateral tax treaty, but limited to the Member States of the European Union); Ring, *Prospects for a Multilateral Tax Treaty*, *supra* note 349, at 1701, 1703–06 (tentatively suggesting that the best way to shift to a multilateral tax treaty might be to start with multilateral agreements limited to prominent topics or specific treaty abuses like treaty shopping).

356. Early in the 20th century, several of the United States recognized that as the activities of their business enterprises became more integrated, calculating the income of a multistate company as if it were a single unit would be more efficient and in keeping with the transactions' substance since intercompany transactions could be ignored and the separate pricing of those transactions could be obviated. In 1957, a group of state legislators drafted the Uniform Division of Income for Tax Purposes Act (UDITPA), the principles of which were later incorporated in the Multistate Tax Compact I 1967. In general terms, under this type of formula apportionment system, once a group's combined income is calculated, excluding intercompany transactions, a formula is applied to allocate the income of the multistate enterprise to various locations on the basis of where its activities are conducted. Typically, these activities are measured on the basis of a company's property, payroll, and gross sales. Thus, if a multistate enterprise conducts 65% of its activities in California, 10% of its activities in Wisconsin, and 25% of its activities in North Carolina, such formula would attribute the income of the enterprise accordingly, disregarding any arm's length price. For a discussion of the history of formulary apportionment in the United States, see Joann M. Weiner, *Using the Experience in the U.S. States to Evaluate Issues in Implementing Formula Apportionment at the International Level*, 13 TAX NOTES INT'L 2113 (1996), available in LEXIS, Intlaw Library, TNI file, Doc 96-32691 [hereinafter Weiner, *Using U.S. States' Formulary Apportionment Experience*].

357. See REPORT OF THE COMMITTEE OF INDEPENDENT EXPERTS, *supra* note 351. In 1990, the European Commission appointed the Committee of Independent Experts on Company Taxation, chaired by former Dutch Finance Minister Onno Ruding, to study the propriety of tax harmonization (involving secondary rules at the Community level beyond what is necessary to remove distortions) as opposed to mere tax coordination of the various tax rules of the Member States of the European Community. For a description of the Committee's findings, see *id.*

358. *Id.*

Of course, if an explicit multilateral tax treaty were adopted by a large region such as the EU, rules could be fashioned to eliminate the conflicts at the interface; however, the added costs and complexities associated with eliminating the new potential for double taxation could outweigh the hoped-for benefits of switching to an explicit multilateral tax treaty. Scholars have warned that success in implementing formulary apportionment by constituent members of federations, like those of the United States, should not lead to a quick conclusion that similar success would occur if formulary apportionment were adopted at the national or international level. Economic conditions of the state jurisdictions within the United States that adopted formulary apportionment were relatively similar, and their tax systems and legal cultures were far less diverse than what currently exists around the world today.³⁵⁹ Until there is a greater level of convergence economically and legally, it may be more cost-efficient to maintain an international consensus as to the best income allocation method for multinational corporations, rather than to attempt to incrementally introduce a totally inconsistent one.³⁶⁰

There are presently a small number of regional multilateral tax treaties in force, most of which are based on the OECD Model Treaty. But there is little about these multilateral treaties' experience to suggest that their agreements will expand to include major economic powers like the United States or Japan. The Nordic Treaty, which was initially entered into by five countries (Denmark, Finland, Iceland, Norway, and Sweden) in 1983, relies heavily on the OECD Model's text although it does depart from formal tax rate reciprocity by taking account of the different corporate tax systems of the five contracting countries.³⁶¹ Negotiating the Nordic Tax Treaty was made easier by the fact that the Nordic countries' tax systems were quite similar to begin with. As previously noted, the main advantage of a regional treaty is that it can supply uniform definitions, take a singular approach to assigning income and, as in the case of the Nordic Tax Treaty, make special exceptions tailored to a signatory country's legal peculiarities. But negotiating such a treaty between five *similar* tax jurisdictions cannot begin to approximate the difficulties that would arise in attempting to negotiate a binding commitment with twenty-five, fifty, or two hundred countries with diverse tax systems.³⁶² The complexities and challenges that would inevitably be encountered at a worldwide level could prove insurmountable and not worth the effort.

359. See Weiner, *Using U.S. States' Formulary Apportionment Experience*, *supra* note 356, at 175–76.

360. The European Commission has recently proposed creating a common corporate tax base for the European Community, with the idea of instituting a system of formulary apportionment similar to that used within the United States. See, COMMISSION OF THE EUROPEAN COMMUNITIES, COMMUNICATION FROM THE COMMISSION TO THE COUNCIL, THE EUROPEAN PARLIAMENT AND THE ECONOMIC AND SOCIAL COMMITTEE: TOWARDS AN INTERNAL MARKET WITHOUT TAX OBSTACLES—A STRATEGY FOR PROVIDING COMPANIES WITH A CONSOLIDATED CORPORATE TAX BASE FOR THEIR EU-WIDE ACTIVITIES (2001); see discussion *infra* Part XII.D.3.b.

361. Convention Between the Nordic Countries for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital, 98 T.N.I 9-25, Doc. 98-1713 (replacing 1989 Nordic Convention). Signatories to the Nordic Convention on Income and Capital include Denmark, Finland, Iceland, Norway, and Sweden. The Faroe Islands is also a signatory of the 1989 and 1996 Conventions.

362. Moreover, bilateral norms seep into the multilateral arrangement since the multilateral group is compelled to negotiate with third countries on a bilateral basis. Professor Richard Vann of Australia notes that the drafters of the 1971 multilateral Andean Tax Treaty also produced a model tax treaty that could be used by the signatories in dealing with third countries, although this external model was never used in actual negotiations, which have tended to conform to bilateral norms. Moreover, Chile has left the group. See Vann, *Treaty for the Asian-Pacific?*, *supra* note 30, at 151–52 (citing A. ATCHABAHIAN, FISCAL HARMONIZATION IN THE ANDEAN COUNTRIES (1975), which contains a translation of the Andean Treaty).

Some scholars have suggested that the most expedient way to transform the bilateral tax treaty network into an explicit multilateral agreement might be to *topically* circumscribe the multilateral proposal, seeking binding agreements only with respect to more important issues like treaty shopping or unfair tax competition. The implicit hope is that once binding agreements are reached on a few topics, multilateral norms will evolve, take root, and lead to a broader multilateral tax treaty.³⁶³ Proponents of this theory often point to the multilateral Convention on Mutual Administrative Assistance in Tax Matters (MAAT), which evolved from a bilateral OECD Model.³⁶⁴ The MAAT enables governments to fight tax evasion by sharing tax information on a multilateral basis. It calls for signatory countries to provide assistance in three forms: the exchange of information; assistance in the collection of taxes; and the delivery of documents. In the eighteen years since the MAAT has been open for signature, a dozen or so countries have signed it including developed countries like the United States and Canada.³⁶⁵

It is noteworthy that the MAAT is a multilateral convention that developed from a bilateral OECD Model. How can its ostensible success as a multilateral tax treaty be explained? Professor Richard Vann of Australia notes that the OECD Model Tax Treaty was silent on many of the administrative details covered by the MAAT, so the extensive bilateral treaty network has not served as an obstacle to the MAAT's development.³⁶⁶ Second, the MAAT's purpose of fighting tax evasion is an objective common to most sovereign countries. Third, domestic laws policing tax fraud are far more consistent than the various tax systems themselves. Fourth, although elements of domestic law may deter some countries from agreeing to the MAAT—their bank secrecy laws, for example—such deterrents are far less numerous and complex than those that would be encountered in negotiating a broad substantive multilateral treaty where competing tax interests are at stake.³⁶⁷

During the eighteen years that the MAAT has been open for signing, literally hundreds tax treaty partners have successfully negotiated binding Mutual Agreement Procedures (Article 25) and Exchange-of-Information (Article 26) articles on a *bilateral* basis. But when similar matters are made the subject of an explicitly binding multilateral treaty, only a small handful of countries have agreed to those seemingly innocuous multilateral exchange-of-information provisions. It is difficult to believe that the subject matter of the MAAT is the only factor preventing more countries from agreeing to it since so many countries are making similar promises on a *bilateral* basis.

363. See, e.g., Ring, *Prospects for a Multilateral Tax Treaty*, *supra* note 349, at 1699 (2001) (suggesting that the best way to shift to a multilateral tax treaty might be to start with multilateral agreements limited to prominent topics or specific treaty abuses); *but cf.*, Thuronyi, *Proposal for a Multilateral Treaty*, *supra* note 296 (proposing a multilateral tax treaty, consisting of common textual templates for the overall treaty, followed with optional topics for agreement—"general undertakings for cooperation"—covering specific topics such as nondiscrimination, unfair tax competition, and information sharing).

364. Convention on Mutual Administrative Assistance in Tax Matters, U.S.-Azer.-Belg.-Can.-Den.-Fin.-Ice.-Italy-Neth.-Nor.-Pol.-Swed. Jan. 25, 1988, S. TREATY DOC. 101-6, 27 I.L.M. 1160 (1988). Some of the countries have made reservations. The United States and Canada agreed only to the Exchange of Information articles of the Convention.

365. However, both the United States and Canada agreed only to exchange information and reserved on the other portions. *Id.*; Tax Analysts, *Canada Signs OECD/CE Administrative Assistance Treaty*, 2004 WORLDWIDE TAX DAILY 106-21, June 2, 2004 (noting that Canada agreed only to exchange tax information).

366. See Vann, *Treaty for the Asian-Pacific?*, *supra* note 30, at 152-53.

367. See *id.*

Those who would propose introducing explicit multilateralism one tax topic at time should consider the recent practice of including arbitration clauses in bilateral tax treaties.³⁶⁸ The issues that are frequently identified as potential candidates for arbitration are among the most fundamental issues in tax treaty practice. For example, the new protocol to the U.S.-German Tax Treaty provides for mandatory arbitration of disputes when the competent authorities are unable to reach a complete agreement in a case regarding the application of the Residence, Permanent Establishment, Business Profits, Associated Enterprises, or Royalties articles.³⁶⁹ If the competent authorities of two countries are having trouble resolving disputes on fundamental issues, like delineating the meaning of associated enterprise within the context of a particular country's unique and perhaps insular corporate culture, or the meaning of "PE" or "royalty"—concepts that have been part and parcel of the OECD Model Treaty since its inception—how realistic is it to assume that numerous countries will find it appealing to sign a *binding multilateral agreement* comprised of untested rules governing such uncharted and sensitive areas as harmful tax competition, hybrid instruments, thin capitalization, floating interest rates, and currency fluctuations?

Another disadvantage of attempting to develop a substantive multilateral tax treaty by making certain topics the subject of binding agreements is that countries would be sacrificing their opportunity to test the predetermined solution to any given problem, one treaty at a time. Obtaining the agreement of many countries could be an extremely slow process³⁷⁰ if all of them are being called to adopt *ex ante* a particular approach that was developed largely in the abstract by a group of experts. Although countries might recognize the benefits of a multilateral agreement to address a perceived threat, many might decide to forego signing the proffered accord, opting instead for a wait-and-see strategy out of concern that being bound to a largely untested approach may not serve their best interests over time.³⁷¹

Although the founders of the OECD Model Tax Treaty initially expressed hopes that multilateral tax treaties would evolve out of the Model, such development, at least in terms of explicit, binding agreements, has been more of an anomaly than the norm. The impact of formal multilateral tax treaties on normative international tax policy has been negligible as compared to the robust growth of the OECD bilateral tax treaty network. Moreover, the OECD arguably has been the most successful of any international

368. See Ring, *Prospects for a Multilateral Tax Treaty*, *supra* note 349.

369. See *id.*

370. See Ring, *Prospects for a Multilateral Tax Treaty*, *supra* note 349, at 1703 (noting that agreement could take a long time if the agreement of a large group of nations was necessary to adopt a particular provision).

371. This scenario is another example of how the implementation of a multilateral treaty is likely to generate behavioral games—the classic prisoner's dilemma and the game of inadequate assurances where a player is called upon to make decisions without knowing what choices the other players will make that will affect him. Professor Diane Ring notes that an example of this phenomenon occurred in the early 1990s when the United States introduced its Advanced Pricing Agreement (APA) program (see *supra* note 264, defining an APA), to resolve cross-border transfer pricing disputes with other countries.

[M]any countries were quite suspicious of the United States' motives and of the likely results of such agreements. Nevertheless, the United States initiated the process and pursued agreements involving one or two other countries. Over time, many more countries began participating in the APA program and developed programs of their own. If the United States had needed to obtain up-front support of a large number of countries before starting the APA process, it seems unlikely that such support could have been garnered.

Ring, *Prospects for a Multilateral Tax Treaty*, *supra* note 349, at 1703–04 (citing Diane M. Ring, *On the Frontier of Procedural Innovation: Advance Pricing Agreements and the Struggle to Allocate Income for Cross Border Taxation*, 21 MICH. J. INT'L L. 143, 157–58, 174. n.127, 175 nn.130–31).

institution in forging informal multilateral agreements on highly controversial topics through the use of soft law recommendations, monitoring, and amendments to the OECD Commentaries, which are often incorporated into the texts of the treaties. The disadvantage of this method of gaining international tax cooperation is that it seems slow and there is no guarantee of success because the OECD does not have the power to bind sovereign states.

C. THE WTO-FOR-TAXES ALTERNATIVE

In 1995, Vito Tanzi, former head of the Fiscal Affairs Department of the International Monetary Fund (IMF), wrote that “[t]here is no world institution with the responsibility to establish desirable rules for taxation and with enough clout to induce countries to follow those rules. Perhaps the time has come to establish one.”³⁷² Many scholars believe that neither the current bilateral system of tax treaties nor a new multilateral treaty based on the OECD Model Tax Treaty, as suggested above, are adequate to deal with the tax avoidance problems that have stemmed from increased capital mobility and electronic commerce. More specifically, they point out that the ability of nations to protect their corporate tax bases is being greatly impaired by the advent of e-money and other electronic transactions that leave no paper trail; more intra-firm trade that is often unaccounted for tax purposes; the growing use of off-shore financial centers, tax havens, and exotic financial instruments used to shelter or obfuscate true income and evade taxes; and competition between countries to attract investment by lowering their tax rates to revenue-losing levels.³⁷³ They argue that in order to develop new approaches and rules to effectively police practices like harmful tax rate competition,³⁷⁴ some kind of supranational institution is needed that has the power to bind participating countries and to act more independently to encourage policies, like inter-nation equity, that have often been overlooked.³⁷⁵ This section briefly explores whether a new supranational tax institution, with powers analogous to that of the WTO or the IMF, is substantively desirable, and whether it would be procedurally practical to

372. VITO TANZI, *TAXATION IN AN INTEGRATING WORLD* 140 (1995).

373. See, e.g., Vito Tanzi, *Globalization, Technological Developments, and the Work of Fiscal Termites*, 26 *BROOK. J. INT'L L.* 1261 (2001) (detailing the ways that globalization and electronic commerce are reducing industrialized countries' abilities to sustain high levels of taxation); Jack M. Mintz, *National Tax Policy and Global Competition*, 26 *BROOK. J. INT'L L.* 1285, 1298-99 (2001) (noting that “[t]he shrinkage of corporate income taxes, and perhaps, their eventual demise will have a profound impact on tax structures” perhaps causing governments to rely more on consumption, payroll, property taxes to fund public expenditures).

374. See Avi-Yonah, *Fiscal Crisis of the Welfare State*, *supra* note 330 (observing that tax competition is linked to mobility of capital, and that together, these factors threaten corporate income taxes, which have been the main source of funding for countries that provide social safety nets for their citizens).

375. See Graetz, *Taxing International Income*, *supra* note 15 (arguing that economists and governments, blinded by pure efficiency concerns, too often ignore how a tax policy affects the economic welfare of its own citizens and residents, as well as how a policy affects the distribution of wealth between nations); Vann, *Treaty for the Asian-Pacific?*, *supra* note 30, at 156 (suggesting that an international tax institution structured like the GATT would offer flexibility and could be adopted by countries on a graduated basis, beginning with minimal but binding general rules, leading to greater tax law reforms and a convergence of systems accomplished by bestowing on the GATT-like institution a more powerful interpretive role than that now possessed by the OECD); Avi-Yonah, *Treating Tax Issues Through Trade Regimes*, *supra* note 315 (arguing that tax expenditure competition threatens to undermine countries' ability to raise tax revenues and that the WTO may be “the most promising forum for finding a solution”).

move to such a system.³⁷⁶ To begin, the theoretical differences between trade and tax law are briefly sketched.

1. *Theoretical Bases of International Tax and Trade Policies*

Because taxation is often an important factor in determining the location and level of both foreign portfolio and foreign direct investments (FDIs), it may seem strange that international tax law and international trade law have developed on separate tracks since at least the mid-twentieth century when the OECD and United Nations first put forth their model bilateral tax treaties. Some countries, like the United States, have expressed the view that trade policy should not directly impact countries' overall tax policies or tax sovereignty, and that bilateral tax treaties are currently the most practical vehicle to resolve international tax conflicts between trading partners. Other countries have treated taxation as part and parcel to their trade objectives. For example, the European Economic Community (now the European Union), since its inception, has moved aggressively to eliminate Member States' taxes to the extent those taxes are perceived as posing barriers to the formation of a common market by unfairly discriminating against foreign products, foreign producers, and foreign production in favor of domestic products, domestic producers, and domestic production.³⁷⁷

Many reasons could be unearthed in the literatures of public finance, behavioral economics, and political science to explain why international tax policy and international trade policy have developed on essentially different tracks,³⁷⁸ and have not directly clashed in their stated objectives.³⁷⁹ The simplest answer is that the goal of international trade law is to remove barriers to cross-border investment, while the central goal of tax law is to fund governments. If trade tariffs are reduced to zero, trade will increase, and with free trade, the welfare of the trading states is also assumed to increase under the doctrine of comparative advantage.³⁸⁰ But while an ideal trade tariff might be zero, taxes cannot be reduced to zero if

376. An extended description of the WTO and IMF are beyond the scope of this article. For details as to the structure of these organizations, see their websites at <http://www.wto.org> (World Trade Organization) and <http://www.imf.org> (International Monetary Fund).

377. See Graetz & Warren, *Income Tax Discrimination*, *supra* note 252; see discussion *infra* at Part XII.D.3.b.

378. Certain issues do, however, come within the purview of *both* international tax law and trade law, particularly with respect to the GATT. For a discussion of the interaction of trade agreements and international tax, see Justus Fischer-Zernin, *GATT versus Tax Treaties? The Basic Conflicts Between International Taxation Methods and the Rules and Concepts of GATT*, 12 J. WORLD TRADE 39 (June 1987); Avi-Yonah, *Treating Tax Issues Through Trade Regimes*, *supra* note 315, at 1684–88 (discussing two articles of the GATT that bear directly on taxation).

379. See, e.g., RICHMAN, *supra* note 15; see MUSGRAVE, *supra* note 15 (arguing that taxes should be neutral to the tendencies of trade flows and that capital export neutrality (CEN) is the best tax policy criterion to cause world-wide resources to be allocated efficiently); Paul R. McDaniel, *Trade and Taxation*, 26 BROOK. J. INT'L L. 1622 (2001) (distinguishing between tax rules that are the normative benchmarks of a tax system which, according to McDaniel, should be outside the scope of trade agreements, and putative tax provisions that are actually special government subsidies, which should properly be scrutinized under trade law) [hereinafter McDaniel, *Trade and Taxation*]; Green, *Comparison of International Tax and Trade Regimes*, *supra* note 266, at 124–39 (observing that although both international tax and international trade agreements have the same goal of facilitating trade and investment, legalistic dispute resolution mechanisms are more critical to maintaining cooperation in the trade context, whereas conciliatory mechanisms work better in the tax context due to better information flows).

380. See DAVID RICARDO, *ON THE PRINCIPLES OF POLITICAL ECONOMY AND TAXATION* (3d ed. 1821) (1817), available at <http://socserv2.socsci.mcmaster.ca/~econ/ugcm/3ll3/ricardo/prin/prin1.txt> (in essence, Ricardo's theory of comparative advantage, which forms the basis of modern trade theory, holds that even if a country could produce everything more efficiently than another country, it would reap gains from specializing in what it was best at producing, and then trading with other nations for the rest of its needs) [hereinafter RICARDO, *POLITICAL ECONOMY AND TAXATION*].

governments are to survive. Moreover, trade policy has long assumed that reducing barriers to trade improves not only worldwide efficiency, but also the welfare of an individual state that might decide to reduce trade barriers unilaterally.³⁸¹ However, economists have not reached an equally strong consensus on whether these same welfare benefits occur in the international tax context when all restrictions on capital flows are removed.³⁸² Countries are thus much more reluctant to relinquish their power to raise revenues through the design of their tax systems, than to cede their power to place tariffs on imports and exports.

Professor Paul McDaniel has often made the point “that, as a conceptual matter, there is no inherent conflict between a normative income tax and [an] optimal trade policy.”³⁸³ McDaniel, along with his late colleague Stanley Surrey, argued in their seminal work on tax expenditures that the only tax provisions that tend to conflict with free trade objectives are those tax rules that are not absolutely essential to implement a given country’s tax system.³⁸⁴ Thus, if tax rules are confined to the essential tasks of defining a tax base, setting rates, identifying the taxable units, and accounting periods, these rules will usually not conflict with free trade objectives. But the ostensible tax rules that are designed to induce or discourage particular behaviors—putative tax rules that are really government subsidies, incentives, and penalties—will often conflict with trade policies.³⁸⁵ The great increase in international capital flows and cross-border transactions in the last two decades of the twentieth century has increased the incidence of conflicts between international trade and tax rules because, as capital has become more mobile, governments have tended to favor domestic investment and exports through preferential tax subsidies.³⁸⁶

2. *Substantive Desirability of Supranational Tax Institution Analogous to WTO*

The WTO is a multilateral organization that dates back to the Bretton-Woods Conference in 1944, where the contracting countries contemplated the creation of an International Trade Organization (ITO) and entered into the GATT³⁸⁷—a multilateral treaty that focuses mainly on the free trade of products, although it also impacts indirect taxes that affect product consumption. The GATT is the only formal element of the ITO proposal that has survived, and it is seen as the predecessor institution to the WTO. The Uruguay Round of negotiations, which began in 1984 and concluded in 1995, expanded the GATT’s coverage³⁸⁸ and established the WTO, which was charged with administering and extending

381. *See id.*

382. *See* Graetz, *Taxing International Income*, *supra* note 15, at 280 (arguing that the CEN does not necessarily benefit all nations, and that “the benefits of free trade are not replicated by free flows of capital. . . .”) (citing, *inter alia*, RICARDO, *POLITICAL ECONOMY AND TAXATION*).

383. McDaniel, *Trade and Taxation*, *supra* note 379, at 1626.

384. *See* STANLEY S. SURREY & PAUL R. MCDANIEL, *TAX EXPENDITURES* 186–87 (1985).

385. *See id.*

386. McDaniel, *Trade and Taxation*, *supra* note 379, at 1627–32.

387. General Agreement on Tariffs and Trade, Apr. 10, 1947, 55 U.N.T.S. 188.

388. The 1994 version of the GATT is part of the Marrakesh Agreement Establishing the World Trade Organization, established in the Uruguay Round of trade negotiations. *See* General Agreement on Tariffs and Trade: Multilateral Trade Negotiations Final Act Embodying the Results of the Uruguay Round of Negotiations, Apr. 15, 1994, 33 I.L.M. 1125 (1994) available at http://www.wto.org/English/docs_e/legal_e/final_e.htm [hereinafter GATT 1994].

both the GATT and approximately thirty other trade agreements. The WTO, unlike the GATT, has a substantial institutional structure comprised of a series of hierarchical councils that specialize in different fields, including goods, trade related aspects of intellectual property rights,³⁸⁹ and services.³⁹⁰ The WTO makes its decisions through a process of negotiation and consensus, with dispute resolution procedures that, unless there is a consensus otherwise, are binding on the countries whose regimes will be affected.

Although the councils within the WTO have numerous and precise undertakings aimed at lowering trade barriers and providing a platform for negotiation of trade, their governing principles are relatively general, and their rules tend to be worded very broadly compared to the provisions found in bilateral tax treaties. Although the trade agreements are more likely to impact indirect taxes (or taxes that are capable of being viewed as subsidies), several of the general principles have the potential to impact direct taxes: the requirements of according members most-favored-nation (MFN) status and national treatment, and the prohibition against expropriations.³⁹¹ In brief, the MFN principle provides that any country that is a party to the GATT must extend to other contracting parties any benefit, advantage, or favor granted to a third party's nationals or residents in specified matters. This type of mechanism does not normally appear in bilateral tax treaties, except occasionally in protocols as a special protection measure.

The national treatment obligation is similar to the Nondiscrimination article found in the OECD Model Tax Treaty and may impact direct taxes.³⁹² In general, national treatment requires a contracting party to accord to a person, item, or activity originating in another contracting country, treatment that is no less favorable than the treatment accorded to a domestic person, item, or activity. The national treatment concept is broader than the Nondiscrimination article found in the Japan-U.S. Tax Treaty, in that it has multilateral dimension and could apply to a much broader range of activities. Another driving principle underlying trade agreements administered by the WTO is the prohibition on expropriations. Since the GATT's inception, this basic principle has been used to call into question the propriety of certain taxes that arguably amount to expropriations. If the tax is found to be an expropriation, it is prohibited if it operates in a discriminatory manner.

The literature debating the advantages and drawbacks of creating a new supranational formal tax institution like the WTO (for direct taxes) is extensive and nuanced.³⁹³ Basically, the arguments for and against moving to such a system can be summarized as follows.

389. General Agreement on Tariffs and Trade: Multilateral Trade Negotiations (The Uruguay Round): Agreement on Trade-Related Aspects of Intellectual Property Rights Including Trade in Counterfeit Goods, Apr. 15, 1994, 33 I.L.M. 81 (1994) [hereinafter TRIPS]; see General Agreement on Tariffs and Trade, Oct. 30, 1997, 67 Stat. A-11, T.I.A.S. 1700, 55 U.N.T.S. 194.

390. General Agreement on Trade in Services, Apr. 15, 1994, 33 I.L.M. 1167 [hereinafter GATS].

391. See, e.g., Paul R. McDaniel, *Trade Agreements and Income Taxation: Interactions, Conflicts, and Resolutions*, 57 Tax L. Rev. 275 (2004) (tracing the history of the GATT and WTO decisions that held certain U.S. tax preferences were impermissible export subsidies under the trade treaties).

392. See, e.g., Japan-U.S. Tax Treaty, *supra* note 1, art. 26.

393. The United Nations has recommended establishing a supranational tax organization. See Recommendations of the High-level Panel on Financing for Development, delivered to the General Assembly. U.N. Doc. A/55/1000 (June 26, 2001); see also, Charles E. McClure, *Globalization, Tax Rules and National Sovereignty*, 55 BULL. INT'L FISCAL DOC. 328, 340-41 (2001) (pointing to "overwhelming political obstacles" that would be encountered in trying to create a GATT for taxes or a "WTaxO" with broad powers) [hereinafter McClure, *Globalization Tax Rules*]; Tanzi, TAXATION IN AN INTEGRATING WORLD, *supra* note 373 (suggesting the time has come to establish a world tax organization); Frances M. Horner, *Do We Need an International Tax Organization?*

a. Advantages

First, placing the development of international tax policy under the direction of a single, supranational, formal tax organization with sufficient powers to bind the participating nations would arguably be more flexible than the current network of bilateral tax treaties. For a rule change to be fully effected in the present bilateral system, over 2500 tax treaties must be renegotiated. With a supranational tax organization on the order of the WTO, rule and policy amendments would only have to be negotiated one time, and agreed protocols could arguably be instituted quickly.³⁹⁴ Second, proponents of such an organization argue that it would be able to forge a greater convergence in tax systems than that achieved by the bilateral tax treaty network. For example, the organization could create uniform definitions and set minimum or maximum tax rates so as to divide up the global tax base more fairly between developed and developing nations. Third, proponents argue that a formal tax organization on the order of the WTO would have the power to institute completely new approaches to international taxation, including, but not limited to, a system of formulary apportionment which, as previously discussed,³⁹⁵ could eliminate many of the systemic problems that plague the present international system, including treaty shopping,³⁹⁶ international tax arbitrage,³⁹⁷ inappropriate transfer pricing,³⁹⁸ and harmful tax subsidy competition.

Even if a new organization were not formed, and instead jurisdiction over direct tax policy was subsumed under the umbrella of the WTO, that arrangement might help resolve the problem of harmful tax subsidy competition because the WTO has many more official members than the OECD and already has rules in place to combat forms of such practices.³⁹⁹ Moreover, the WTO's dispute resolution procedures, unlike those of most bilateral tax treaties, are binding unless there is a consensus not to implement them. Finally, proponents argue that the MFN and national treatment principles, which underlie the treaties administered by the WTO, are flexible tools that could be used to combat the problems of tax subsidy competition.⁴⁰⁰

93 TAX NOTES 709; Avi-Yonah, *Fiscal Crisis of the Welfare State*, *supra* note 330, at 1670–74 (advocating an extension of tax measures through the WTO); Thuronyi, *Proposal for a Multilateral Treaty*, *supra* note 296, at 1675–81 (arguing that some kind of international organization with more power than the OECD is needed to administer a multilateral tax treaty). An extensive review of the abundant literature is beyond the scope of this article. For recent treatment, see Arthur J. Cockfield, *The Rise of the OECD as Informal World Tax Organization through National Responses to E-Commerce Tax Challenges*, 8 YALE J.L. & TECH. 136 (2006) [hereinafter Cockfield, *OECD as Informal World Tax Organization*].

394. But, unlike many nations' bilateral tax treaties, GATT provisions are not self executing and, in most cases, do not automatically become part of national law. See discussion *supra* Part III.A.3, B.4 (discussing status of tax treaties under U.S. and Japanese law, respectively).

395. See *supra* Part V (discussing formulary apportionment as a way to alleviate transfer pricing manipulation) and Part XII.B.3 (discussing whether formulary apportionment would be an advantage of adopting an explicit multilateral tax treaty).

396. See *supra* Part VII (discussing LOB article of Japan-U.S. Tax Treaty).

397. See *supra* Part VI (discussing how Article 4(6) of the Japan-U.S. Tax Treaty prevents certain tax arbitrage structures).

398. See *supra* Part V (transfer pricing).

399. See Avi-Yonah, *Treating Tax Issues Through Trade Regimes*, *supra* note 315, at 1686–90 (arguing that the WTO would be a well-suited forum to handle many forms of harmful tax subsidy competition and detailing what kinds of tax havens are covered by the GATT).

400. See Vann, *Treaty for the Asian-Pacific?*, *supra* note 30, at 157 (arguing that a supranational tax organization, to avoid the problems of manipulation created by the precise income categories and rules found in bilateral tax treaties, should probably apply "more general and flexible" rules similar to those found in the GATT).

b. Drawbacks

Many of the drawbacks to the creation of a supranational tax organization on the order of the WTO echo the disadvantages relating to the establishment of a multilateral treaty based on the OECD Model. Tax Treaty.⁴⁰¹ Skeptics of both proposals argue that their proponents are making a huge and misplaced assumption that formulary apportionment on a global scale would be a good thing. Just because formulary apportionment has been successfully implemented by constituent members of federations, like those of the United States and Canada, that should not lead to a hasty conclusion that similar success would occur if formulary apportionment were adopted at the international level. Economic conditions of the state jurisdictions within the United States that adopted formulary apportionment in the mid-twentieth century were far more integrated and their legal cultures, tax systems, and accounting systems were far more similar than those presently found within the extremely broad international spectrum.⁴⁰² U.S. tax practitioners highly experienced with various kinds of apportionment formulas have gone so far as to warn the U.S. Congress that any worldwide formula would be tantamount to a design for disagreement.⁴⁰³ They argue that despite the difficulties inherent in applying the arm's length method to transactions within integrated enterprises, that method at least provides a neutral standard that can be applied to any set of facts, while a formulary apportionment is no standard at all, but rather a set of political compromises that have neither an inherent rationale nor guiding principles as to what a fair allocation of tax authority should be. Those tax practitioners further contend that such an arbitrary formula would involve revenue risks greatly exceeding the usual uncertainties that accompany drastic changes in tax policy, and that for wealthy countries, like the United States and Japan, it would essentially be a "recipe for revenue hemorrhage" because of the concessions they would have to make to bring recalcitrant countries into the fold.⁴⁰⁴

Even if worldwide formulary apportionment were theoretically sound, implementing it in a practicable manner would probably be impossible. For one thing, because worldwide formulary apportionment would eliminate withholding, collecting revenue from foreign affiliates in any given unitary enterprise would become much more difficult because government tax auditors would be left to the mercy of books prepared and maintained outside their own jurisdictions, which are often more difficult, if not impossible, to audit and challenge. Moreover, such a drastic tax policy change could have huge unintended effects on taxpayer behavior. To take a simple example, any country that gives the payroll or assets factors more weight (in a three-factor formula) than the international average might be creating huge incentives to shift employment and investment

401. See discussion *supra* Part XII.B.2-3.

402. See Weiner, *Using U.S. States' Formulary Apportionment Experience*, *supra* note 356, ¶¶ 85-94, 175-76 (arguing that given the disagreements among the states of the United States in defining a tax base and apportionment formula, there is little to suggest that the world should mimic the states' approach, and noting that Canada's system would be a more viable model, but only if international economic conditions converged to a greater extent).

403. William J. Wilkens & Kenneth W. Gideon, *Memorandum to Congress: You Wouldn't Like Worldwide Formula Apportionment*, 65 TAX NOTES 1259 (Dec. 5, 1994) (arguing that replacing the current U.S. system for determining the income of multinational enterprises with a worldwide formulary apportionment method would create huge and enduring political debates among all the tax jurisdictions affected, and would be contrary to the interests of political and economic interests of the United States).

404. *Id.* at 1262.

overseas.⁴⁰⁵ Achieving an international agreement on a fair apportionment formula would essentially be a political wrangle in a zero-sum game for tax revenue. The controversy surrounding every aspect of any arbitrary formula, even small ones, would be magnified exponentially at the international level, generating a kind of eternal political debate and dissension that would dwarf any of the present problems created in applying the arm's length standard. Finally, if ever such a system were instituted, the "tyranny of the status quo might take over, and further change would proceed at a glacial pace, if at all."⁴⁰⁶

Those opposed to creating a WTO-type tax organization argue that not only is the need for such an organization obviated by the fact that the leading reason for creating one (i.e., facilitating worldwide formula apportionment) is an undesirable objective, but that some diversity in tax systems is advantageous because diversity can lead to policy experimentation and innovation that might lead to increased efficiency in the long run.⁴⁰⁷ A supranational organization with binding powers would likely discourage this type of tax innovation, and decrease the need for governments to administer their tax systems as efficiently as possible.⁴⁰⁸

A third argument against creating a WTO-type tax institution is that national governments are better equipped than any large, bureaucratic institution to tailor their tax regimes to their individual economic needs. The strength of this point has been questioned in light of the fact that countries' corporate income tax bases are shrinking due to uncurbed harmful tax practices. Advocates of a WTO-type tax organization have argued that it would allow developing countries to have real clout, as compared to the respect they are accorded in the OECD.⁴⁰⁹ But this assertion stands in stark contrast to the recent history of the WTO, in which developing countries and their sympathizers have engaged in violent protests to demonstrate their opposition to the WTO, claiming that the organization is dedicated to serving the interests of wealthy countries at the expense of the

405. See Reuven S. Avi-Yonah, *Slicing the Shadow: A Proposal for Updating U.S. International Taxation*, 58 *Tax Notes* 1511 (Mar. 15, 1993) (discussing the incentive effects of a three-factor formula, and advocating an apportionment formula using only the sales factor, which he argues would have desirable effects on U.S. exports).

406. McClure, *Globalization Tax Rules*, *supra* note 393, at 341; See Paul Blustein, *WTO Fissure May Magnify Tremors Over Globalization* (July 2006), available at <http://archives.seattletimes.nwsource.com/cgi-bin/texis.cgi/web/vortex/display?slug=wto30&date=20060730&query=World+Trade+Organization>.

407. For example, it will be an interesting learning experience to see how far the European Commission gets in its quest to create a common corporate tax base within the EU. All other tax jurisdictions will learn from its mistakes and successes.

408. In 2001, U.S. Treasury Secretary Paul O'Neill expressed strong reservations about U.S. participation in the OECD's efforts to fight so-called harmful tax competition, on the grounds that it would cause governments to administer their tax systems inefficiently. O'Neill said:

The United States does not support efforts to dictate to any country what its own tax rates or tax system should be, and will not participate in any initiative to harmonize world tax systems. The United States simply has no interest in stifling the competition that forces governments—like businesses—to create efficiencies.

Press Release, U.S. Treasury Dept. Treasury Secretary O'Neil Statement On OECD Tax Havens (May 10, 2001), available at <http://www.ustreas.gov/press/releases/po366.htm>. See also, Vogel et al, *Taxation of Cross-Border Income*, *supra* note 320, at 27–29 (Vogel argues that Source State taxation would be advantageous in that it would force states to administer their tax systems more efficiently so that they can provide goods and services at the lowest (tax) price).

409. See Avi-Yonah, *Treating Tax Issues Through Trade Regimes*, *supra* note 315, at 1689–90 (arguing that the OECD is identified as the "rich countries' club" and that developing countries would be better served in a WTO-type organization that has broader membership).

poorer, developing ones, and that, in any event, it is neither a democratic nor a transparent institution.⁴¹⁰

Overall, the primary argument against creating a supranational tax institution is the loss of national sovereignty it would require. In order for countries to be willing to cede their sovereignty to an international tax organization, they would have to be sufficiently threatened with losing their corporate income tax bases, and also convinced that an international tax institution can protect their bases through rules that bind the offending countries. However, given the present political landscape, in which large countries like the United States and Britain have demonstrated their unwillingness to include tax provisions in trade agreements,⁴¹¹ there is little reason to believe that countries will be willing to engage in a massive surrender of their national tax sovereignty to a WTO-type tax institution anytime soon.

D. REGIONAL TRADE BLOCK ALTERNATIVE

If increased economic efficiency achieved through the elimination of the tax barriers to unfettered trade is an underlying objective of increased international tax cooperation, might regional trade agreements provide a better model for achieving this objective, as compared to bilateral tax treaties? Some scholars have suggested that forming regional tax agreements within the context of regional trade agreements is a more realistic goal than attempting to negotiate a binding worldwide multilateral treaty. Regional tax cooperation, they argue, could produce more immediate benefits.⁴¹² Opponents of this idea, including this author, argue that regional tax agreements would likely diminish the influence of the OECD, and discourage or impede that organization's more broadly based and global efforts to coordinate diverse tax systems through its nonbinding Model Tax Treaty, studies, and other soft law and consensus-seeking initiatives. This section briefly explores the experiences of two treaty-based, regional trade agreements—the North American Free Trade Agreement and the treaties defining the European Community—to see whether regional trade agreements could serve as viable models on which to pattern new supranational tax institutions aimed at better coordinating or harmonizing international tax systems within particular regions. It also discusses the implications of the growing trend and recent calls among Asian Pacific nations, including Japan, to negotiate regional trade and tax agreements between Asian Pacific nations, and whether there should be an effort to harmonize the tax regimes of those nations, in much the same way that the European Union has tried to harmonize direct taxes, with limited success, in Europe.

410. See Kevin Sullivan, *Protesters Defend Cause at Trade Talks*, WASH. POST, Sept. 12, 2003, at A20; Charles Babington, *Protests Cloud Clinton Message on Free Trade*, WASH. POST, Dec. 3, 1999, at A32; but cf. Juliane Von Reppert-Bismarck, *Activists Take the Fight Inside*, WALL ST. J., Dec. 13, 2005, available at http://online.wsj.com/PA2VJBNA4R/article_print/SB113442804613020591.html.

411. See Press Release, U.S. Treasury Dept., Treasury Secretary O'Neil Statement On OECD Tax Havens (May 10, 2001), available at <http://www.ustreas.gov/press/releases/po366.htm> (then Treasury Secretary Paul O'Neill stating, emphatically, that the United States "will not participate in any initiative to harmonize world tax systems.").

412. See, e.g., Cockfield, *Developing an International Tax Policy Strategy for NAFTA Countries*, *supra* note 313, at 981–82 (recommending a number of short-term tax coordination proposals for the NAFTA countries, including elimination of withholding taxes on dividends paid by affiliated corporations within the NAFTA region, and the creation of a centralized body to grant case-by-case approval of certain tax-free mergers and acquisitions).

1. *Levels of Economic Integration*

Few scholars disagree with the proposition that taxes on income and capital can powerfully impact trade and capital flows. Indeed, taxes, particularly corporate income taxes, are viewed by some as one of the last great trade barriers left to be torn down or harmonized.⁴¹³ In general, the greater a region's degree of economic integration, the more likely tax rules will be incorporated into the region's trade policies. Economist Bela Balassa, in his seminal 1961 work, identified five different levels of economic integration that regions tend to pass through as they become more unified:

- (1) Free trade zone: Typically, in this first stage of trade cooperation, Member States agree to eliminate tariffs and quota restrictions on the free movement of goods, but only with respect to goods moving within the free-trade area. Each Member State is free to impose its own tariffs on third-party states, which could vary considerably.
- (2) Customs Union: Typically, at this stage, more obstacles to the free movement of goods are eliminated, and the customs union imposes a common external tariff on dealings with third-party states.
- (3) Common Market: At this stage of integration, the region strives to remove not only barriers to the free movement of goods, but also barriers to the free movement of capital, labor, and other factors of production.
- (4) Economic Union: At this stage, Member States' national policies are coordinated at many levels so as to eliminate the potential for unfair discrimination against the products, producers, or factors of production originating in other Member States. The Union usually imposes its own common tariffs on dealings with third-party states.
- (5) Full Economic Integration: In this last stage, Member States' fiscal, monetary, and social policies are harmonized and not merely coordinated. Member States are able to accomplish this by ceding more of their authority to a higher governmental authority whose decisions are binding on the Member States. Social integration often precedes or accompanies full economic integration, although it is not an absolute prerequisite for lower forms of economic integration.⁴¹⁴

As will be shown, North America, Europe, and East Asia are all at different stages in their efforts to become more economically integrated.

2. *North American Free Trade Agreement—NAFTA*

On January 1, 1994, the United States, Canada, and Mexico entered into a regional trade agreement—the North American Free Trade Agreement (NAFTA)⁴¹⁵—the broad purpose of which is to create a zone in which goods and services can move between the three countries free of the tariffs and other restrictions normally imposed by the three trading partners.

413. *But see* Graetz, *Taxing International Income*, *supra* note 15, at 297–99 (arguing that unencumbered flows of capital do not always benefit individual nations or serve the policy objective of inter-nation equity).

414. See BELLA A. BALASSA, *THE THEORY OF ECONOMIC INTEGRATION* 2 (1961).

415. North American Free Trade Agreement, U.S.–Can.–Mex., Dec. 17, 1992, 32 I.L.M. 605 (1993) [hereinafter NAFTA]. NAFTA is a treaty under international law, although it is classified as a congressional-executive agreement under U.S. law. It was passed in the United States as fast-track legislation by a simple majority in both houses of Congress, rather than as a treaty under Article 2 of the U.S. Constitution requiring two-thirds approval of the U.S. Senate. NAFTA was implemented in the United States through the adoption of the North American Free Trade Agreement Implementation Act, Pub. L. No. 103–182, 107 Stat. 2057 (1993) (codified as amended at 19 U.S.C. 3301–3473 (2000)).

Unlike the European Union, NAFTA does not create a set of supranational governing bodies or a body of law that is superior to national law.⁴¹⁶ The free flow of goods is accomplished under NAFTA by its imposition of a nondiscrimination rule requiring each trading partner to grant the same treatment to nationals of the other two trading partners that it would grant to its own nationals, and to treat foreign investors or investments originating in the other two countries the same as it would treat its domestic investors and investments. The three NAFTA countries also agreed to progressively remove numerous tariffs over a period of fifteen years.

Despite NAFTA's sweeping coverage, the agreement clearly and affirmatively left the subject of taxation untouched. The only article in NAFTA dealing directly with tax policy is Article 2103, which provides that "nothing in [NAFTA] shall apply to taxation measures" and that "[n]othing in [NAFTA] shall affect the rights and obligations of any [of the three countries] under any tax convention."⁴¹⁷ Thus, in stark contrast to the treaties forming the European Union, the NAFTA allows its three trading partners to develop their own tax policies, and it relies solely on bilateral tax treaties between the three countries to coordinate the trading partners' tax systems and to lower tax impediments to cross-border investments.⁴¹⁸

Although recent revisions to the NAFTA countries' bilateral tax treaties have helped to better coordinate their tax systems, little has been done within the context of the NAFTA itself to address the inefficiencies that have arisen due to increased trade. Most significantly, the three NAFTA countries are still applying the arm's length pricing rules embodied in their bilateral tax treaties and their domestic tax law. But, as foreign direct investment between the three countries continues to rise,⁴¹⁹ and as the activities of multinational corporations operating in the NAFTA countries become more integrated, proposals for enhanced tax cooperation between the NAFTA countries have been made with increasing frequency,⁴²⁰ including the controversial idea, previously discussed,⁴²¹ that a new system of formulary apportionment should seriously be considered by the NAFTA countries to replace the current arm's length method of allocating tax revenues among the three countries.⁴²²

416. However, NAFTA's dispute resolution mechanism creates special administrative panels to hear appeals from administrative determinations of antidumping and other trade issues under the authority granted to them by the national legislation implementing NAFTA. Domestic law gives the panels final and conclusive judicial review, except for constitutional challenges to the procedure itself. See Paul B. Stephan, *Part IV: Relationship of the United States to International Institutions—The New International Law—Legitimacy, Accountability, Authority, and Freedom in the New Global Order*, 70 U. COLO. L. REV. 1555, 1557 (1999).

417. NAFTA, *supra* note 415, art. 2103.

418. The official White House description of the agreement between the United States, Canada, and Mexico included the following statement: "The NAFTA provides that, as a general matter taxation questions will be governed by applicable double taxation agreements between the NAFTA countries. Description of the Proposed North American Free Trade Agreement proposed by The Government of Canada, The United Mexico States, and The United States of America (August 12, 1992), reproduced at INT'L TRADE REP. (BNA) Vol. 9, No. 34, at 1454 (August 19, 1992).

419. See U.S. Bureau of Economic Analysis, *U.S. Direct Investment Abroad: Country and Industry Detail for Capital Outflows, 1992-2002* (Wash., D.C., U.S. Dept. of Commerce, 2003).

420. See, e.g., Cockfield, *Developing an International Tax Policy Strategy for NAFTA Countries*, *supra* note 313, at 981-82 (recommending a number of short-term and long-term tax coordination proposals for the NAFTA countries).

421. See earlier discussion of formulary apportionment at text accompanying notes 355-58, 394-404, and 421-25.

422. See, e.g., Paul R. McDaniel, *NAFTA and Formulary Apportionment: An Exploration of the Issues*, in *ESSAYS ON INTERNATIONAL TAXATION IN HONOR OF SIDNEY I. ROBERTS* 293 (Herbert H. Alpert & Kees Van Raad, eds., 1993)

Proponents of formulary apportionment argue that as the level of exports and imports between the United States, Mexico, and Canada increase under NAFTA, the fundamental flaws in the arm's length method are being magnified, augmenting the complexity and opportunities for tax avoidance. They argue that given the common market ultimately envisioned by NAFTA, formulary apportionment makes more sense.⁴²³ They contend that NAFTA presents a viable opportunity to introduce formulary apportionment on a regional scale, and that the moving to such a system would be eased by the fact that only three countries are involved, and that the United States and the provinces of Canada already use formulas to apportion tax revenues between jurisdictions.

As envisioned by the proponents, the NAFTA countries would presumably adopt by treaty a formulary method of apportioning taxable income for enterprises doing business in one or more of the three countries. The formula would presumably be similar to the three-factor formula presently used in the United States based on property, sales receipts, and payroll.⁴²⁴ Although proponents argue that formulary apportionment would simplify business operations within NAFTA, there are a plethora of issues that would need to be resolved to institute such a system. First, at a bare minimum, the treaty would need to establish the minimum threshold of activity an enterprise would have to conduct in one of the three countries in order to trigger a country's jurisdiction to tax the enterprise. Presently, the definitions of permanent establishment in the countries' three bilateral treaties reflect their differing economic positions, and the definitions are thus not identical. Determining what constitutes a PE and what income is attributable to a PE are two of the most contentious issues in treaty interpretation and so can be expected to generate a great deal of debate in designing a new apportionment formula involving these same fundamental issues. Second, the treaty would have to set the parameters of what constitutes a unitary business, the income of which is to be apportioned; corporate forms would essentially be irrelevant, as they are often ignored under the current transfer pricing rules. Third, the three countries would have to reach agreement on how the three factors in the formula should be weighted, and what kind of income the formula should encompass—business income only, or business and investment income. If the current international tax rules were to continue to apply to portfolio income, the disparate treatment would introduce an additional layer of complexity for multinational corporations and tax administrators; they might have to apply two different apportionment methods to related transactions. Similarly, if a multinational

(stating "that in the common market ultimately envisioned by NAFTA, formulary apportionment is the more logical method to allocate revenue among the three countries") [hereinafter McDaniel, *NAFTA and Formulary Apportionment*]; See Avi-Yonah, *Slicing the Shadow*, *supra* note 405, (arguing that the United States should begin to shift to a system of worldwide formulary apportionment for multinational companies on the basis of sales); Jerome R. Hellerstein, *Federal Income Taxation of Multinationals: Replacement of Separate Accounting with Formulary Apportionment*, 93 TAX NOTES 179-62 (Aug. 27, 1993), available in LEXIS, FEDTAX Library, TNT file, 93 TNT 179-62 (calling for the United States to begin using formulary apportionment for multinational mercantile and manufacturing companies, and if that proves successful, to begin extending the formulary apportionment method to other industries); Robert S. McIntyre & Michael J. McIntyre, *Commentary: Using NAFTA to Introduce Formulary Apportionment*, TAX NOTES INT'L 851 (April 5, 1993), available in LEXIS, INTLAW Library, TNI file, 93 TNI 64-9 (calling for the United States to promote the use of formulary apportionment under NAFTA which, according to the authors, would give a major boost to the worldwide adoption of formulary apportionment).

423. See sources cited in preceding footnote.

424. See generally Weiner, *Using U.S. States' Formulary Apportionment Experience*, *supra* note 356. For a brief description of the formulary apportionment system employed among the states of the U.S., see *supra* note 356.

corporation has more than one unitary business, agreement must be reached on whether the arm's length method or the formulary method should apply to transactions between two unitary businesses.

Although some have argued that the countries subscribing to a common formula for apportioning income must necessarily have the same corporate tax rates, identical rates are probably not a prerequisite, though too great a disparity in tax rates would encourage manipulation of the formula. Some have also argued that formulary apportionment requires that countries have identical tax bases with identical rules for computing taxable income. However, Professor McDaniel contends that in the context of a limited common market involving only three countries, special tax expenditures, if confined to one country, will not necessarily operate to reduce the tax revenues produced by the original formula.⁴²⁵ Of course, the NAFTA countries would have to decide whether the formulary apportionment method should be applied on a worldwide or water's edge basis, both with respect to businesses based within the NAFTA countries and with respect to businesses based in third-party countries. Special rules would have to be established to define the extent to which a unitary business should take into account income-generating activities taking place outside of the NAFTA countries. If the formulary apportionment is to work within the NAFTA region, the countries would have to establish procedures to resolve, in a timely fashion, disputes regarding the proper interpretation and application of the formula. Because only three countries are involved, their competent authorities could be used, and if their competent authorities cannot agree, disputes could be referred to binding arbitration.

The thorniest problems in attempting to make a formulary apportionment method work well within a trade region like that defined by NAFTA are likely to stem from what happens at the geographical interface. If the formulary apportionment method is used inside NAFTA and an arm's length method applies outside NAFTA, the dual methods of apportioning income could create conflicts of law, as well as problems in applying existing bilateral tax treaties with third countries. Thus, the incidence of double juridical taxation is likely to increase. Moreover, NAFTA tax administrators and multinational corporations within the purview of NAFTA would be subject to significantly greater information gathering and reporting requirements. Having to comply with two fundamentally different income allocation schemes would multiply their transactions costs and possibly saddle them with such onerous compliance burdens that the new system may not be cost effective. Thus, while proponents of formulary apportionment argue that it would greatly simplify the calculation of international income, more thorough studies are needed to determine whether formulary apportionment carried out on a regional basis will, in fact, work better than the arm's length method. There is a real risk that such a fundamental shift away from the foundational norms and principles of income apportionment, which are now embodied in bilateral tax treaties and domestic laws, would subject multinational corporations and tax administrators to the worst complexities of both worlds.

3. *European Union*

By far the most integrated international trade bloc in the world is the European Union (EU). Indeed, Europe has moved far beyond its original aspirations of forming a customs

425. See McDaniel, *NAFTA and Formulary Apportionment*, *supra* note 422, at 303-304. It is worth noting that McDaniel's rationale may not pass muster in the European Union if formulary apportionment is adopted there, given the tenor and direction of the European Court of Justice's jurisprudence concerning nondiscrimination.

union involving just six countries in the 1951 Treaty of Paris,⁴²⁶ to subsequently a common market, known as the European Economic Community (EEC), first established in the 1957 Treaty of Rome.⁴²⁷ In 1986, the then twelve members of the EEC agreed to the Single European Act, further delineating the internal market by guaranteeing “the free movement of goods, persons [including corporations], services, and capital,” which have long been known as the four fundamental freedoms, and which have become a basis for invalidating many Member States’ tax laws that are found to infringe on these freedoms.⁴²⁸ Since at least 1992, when the Treaty of Maastricht was concluded,⁴²⁹ the Member States have functioned as a political and economic union, cooperating in areas as diverse as foreign relations, criminal law, and military defense, in addition to economic and fiscal matters, including trade, currency, and taxation.⁴³⁰ But despite this high level of integration, efforts to harmonize Member States’ various corporate tax regimes have proved to be one of the major failures in the European Community’s (EC) history.⁴³¹

This section briefly explores why Europe has not been able to pass legislation harmonizing company taxes, and how efforts to coordinate or harmonize direct taxes are now being left to the EU’s constitutional court, the European Court of Justice (ECJ).⁴³² Unfortunately, it appears that the ad hoc jurisprudence of the ECJ, which has invalidated an alarming number of national tax provisions in recent years, is impairing the ability of the EU

426. In 1951, the Treaty of Paris, Apr. 18, 1951, 261 U.N.T.S. 140, established the European Coal and Steel Community, consisting of Belgium, France, West Germany, Italy, Luxembourg, and the Netherlands, for the purpose of eliminating tariffs on coal and steel.

427. Treaty Establishing the European Economic Community, Mar. 25, 1957, 298 U.N.T.S. 11 (1958) [hereinafter Treaty of Rome]. Denmark, Ireland, and the United Kingdom joined the European Economic Community in 1973, followed by Greece in 1981, and Spain and Portugal in 1986.

428. Single European Act, art. 13, Feb. 17, 1986, 1987 O.J. (L 169) 1. The Treaty Establishing the European Community, Nov. 10, 1997, 1997 O.J. (C 340) 3, incorporated the so-called four fundamental freedoms of the Single European Act, but renamed them as follows: the freedom of movement for workers, *id.* art. 39; the freedom of establishment, *id.* arts. 43, 48; the freedom to provide services, *id.* aft. 49; and the freedom of movement of capital, *id.* arts. 56, 58.

429. The 1992 Treaty of Maastricht, also known as the Treaty on European Union, renamed and amended the Treaty of Rome, renamed the EEC the “European Community” and established the political union of Europe—the so-called European Union. Treaty on European Union, Feb. 7, 1992, 31 I.L.M. 247 [hereinafter EU Treaty]. The EU Treaty entered into force November 1, 1993.

430. *See id.* In 1995, Austria, Finland, and Sweden joined the EU, bringing the number of Member States to fifteen. In 1997, the Treaty of Amsterdam amended the EU Treaty, consolidating and renumbering its articles. *See* Treaty of Amsterdam Amending the Treaty on European Union, the Treaties Establishing the European Communities and Certain Related Acts, Oct. 2, 1997, 1997 O.J. (C 340) 1. In 2001, the Treaty of Nice further expanded the powers of the EU’s Parliament and revised the EU’s governance in anticipation of the EU’s expansion to twenty-five Member States [hereinafter Treaty of Nice]. *See* Treaty of Nice Amending the Treaty on European Union, the Treaties Establishing the European Communities and Certain Related Acts, Feb. 26, 2001, 2001 O.J. (C 80) 1. Hereinafter, citations to articles in the European Treaties will be to the Consolidated Version of the Treaty Establishing the European Community, Dec. 24, 2002, 2002 O.J. (C 325) 33 [hereinafter EC Treaty].

431. Jimenez, Corporate Tax Harmonization in the European Community, *supra* note 313, at 329 (strongly suggesting that the failure of the European Union to harmonize Member States’ corporate taxes may be due to the inadequate institutional structure of the EU, the lack of a constitution, and parliament’s lack of power to pass tax legislation without the unanimous consent of the Member States).

432. As further argued below, I do not believe the EU model would serve as a good substitute for the flawed OECD bilateral tax treaty network, or as a good model for East Asia, either in terms of removing trade barriers or harmonizing tax regimes. For one thing, East Asia is far more diverse economically, politically, and socially, than Europe.

Member States to stimulate their economies through corporate tax incentives, hampering their efforts to prevent international tax avoidance, and threatening to undo longstanding mechanisms designed to avoid international double taxation, and in so doing, also creating uncertainties regarding the continued viability of bilateral tax treaties both between EU Member States, and between EU Member States and countries that are not members of the EU.⁴³³

a. Overview of EU Institutions

To understand why the EU has been unable or unwilling to harmonize its Member States' corporate taxes through legislation, it is necessary to put the relative powers of the EU government institutions in context. The EC Treaty provides for a European Parliament, Council, Commission, Court of Justice,⁴³⁴ and Court of Auditors.⁴³⁵ The Parliament is the only institution whose members are directly elected by the people; members of Parliament are elected to five-year terms based on their political affiliation, not on their nationality. The Commission, as the EU's executive body, has the exclusive power to propose and draft legislation, and it regularly sets forth long-term tax policy objectives in Communications to its co-legislators, the Council and the Parliament. The Council is the EU's main decision making body, comprised of sitting ministers of Member States who have the authority to bind their respective states.

When it comes to income tax policy, neither the EU Parliament, nor the Council, nor the Commission has the authority to adopt direct tax measures independently, or without an extremely high level of consensus unheard of in federations like the United States and Canada. Moreover, the fundamental principle of subsidiarity, enshrined in the EC and EU Treaties,⁴³⁶ tends to limit major EU-level tax reforms by holding that action may only be taken at the EU level if it would be more effective at achieving the objectives of cooperation than action taken at the national government level. In other words, if a tax policy objective could be accomplished by cooperation at the Member State level, then a top-down, centralist approach is to be rejected.

Typically, the Commission will initiate or propose tax legislation to the Parliament and to the Council. The EU Council has the power to regulate commerce among Member States, and the Parliament is given a right of consultation in tax matters, but not a right

433. As will become apparent, I strongly agree with the assertions of Professors Graetz and Warren on this subject. See Graetz & Warren, *Income Tax Discrimination*, *supra* note 252 (arguing that the ECJ's approach to tax harmonization is incoherent because the court is trying to eliminate tax discrimination both on the basis of the origination of activity (or capital import neutrality) and on the basis of the destination of economic activity (or capital export neutrality), which is impossible in the absence of identical tax rates and bases).

434. The ECJ is comprised of twenty-five judges, each appointed by his or her respective Member State to a renewable six-year term. The ECJ has the power to resolve disputes between two or more Member States, disputes between Member States and EU institutions, or disputes between various EU institutions. For the jurisdiction of the ECJ, see EC Treaty, *supra* note 430, arts. 230–40 and EU Treaty, *supra* note 429, art. 35.

435. See EC Treaty, *supra* note 430, art. 7 (providing for a European Parliament, Council, Commission, Court of Justice, and Court of Auditors). The Court of Auditors monitors the internal activities and financial accounts of the Community, and will not be discussed any further. For a helpful and concise explanation of the EU governmental institutions, see RUTH MASON, *PRIMER ON DIRECT TAXATION IN THE EUROPEAN UNION* 4–17 (2005).

436. Article 5 of the EC Treaty states that “[i]n [matters] which do not fall within its exclusive competence, the Community shall take action, in accordance with the principle of subsidiarity, only if and insofar as the objectives of the proposed action cannot be sufficiently achieved by Member States.” Article 2 of the EU Treaty confirms the subsidiarity principle set forth in the EC Treaty. Treaty of Nice, *supra* note 430.

of co-decision with the Council.⁴³⁷ A branch of the Council, the Economy and Finance Council (ECOFIN), is specifically empowered to deal with tax matters.⁴³⁸ Article 94 of the EC Treaty gives the Council, acting on a proposal by the Commission after consultation with the Parliament and the Economic and Social Committee, the power to issue directives on tax matters. But the Council cannot issue a binding directive without the unanimous consent of members of the Council. This special rule effectively gives each Member State represented on the Council the right to veto, single-handedly, any tax proposal it finds objectionable. In recent years, there have been numerous calls to replace the unanimous voting rule with a more attainable threshold of approval. In its 2001 Communication,⁴³⁹ the EU Commission proposed moving to qualified majority voting on some tax matters since reaching a unanimous decision will only become more difficult as more countries become members of the EU. To date, however, the requirement that EU tax laws be unanimously approved by the Council has not been repealed and still poses a huge obstacle at the EU level to the effective harmonization of Member States' corporate tax laws. The draft EU Constitution, which failed to be ratified by France and the Netherlands in 2005, would not change the unanimity requirement.⁴⁴⁰

Not surprisingly, the pace of legislative reform of direct taxes, including efforts to harmonize corporate income taxes, has been very slow in the EU. So far, major substantive Council directives seeking to remove Member States' direct tax barriers to the internal market include: the Parent-Subsidiary Directive,⁴⁴¹ which eliminates Source-State withholding taxation (and thus double juridical taxation) of cross-border distributions from qualified subsidiaries located in countries other than where the parent corporation is situated; the Merger Directive,⁴⁴² which requires Member States to defer taxes on qualified transfers within the context of certain cross-border mergers and acquisitions; and the Interest and Royalty Directive,⁴⁴³ which seeks to eliminate Source-State taxation of interest and royalty payments between related companies established in different Member States. An underlying objective of these three Directives is to require that the taxation of a given cross-border transaction be no more burdensome than it would be had the same transaction taken place

437. Different legislative rules and thresholds of approval apply to different types of legislation. Most legislative proposals are subject to the co-decision procedure outlined in Article 251 of the EC Treaty, in which the Parliament and Council *share* legislative power and must *both agree* on the proposals for them to be enacted into law. However, with respect to tax issues, the Parliament has only the right of consultation with the Council and no power to vote on them. Article 93 of the EC Treaty provides that harmonization of indirect taxes shall be done in consultation with the Parliament, and Article 94 provides that directives for the approximation of law that directly affect the establishment or functioning of the common market (i.e., direct taxes) shall be issued only after consulting with the Parliament. See EC Treaty, *supra* note 430, arts. 93 and 94.

438. The ECOFIN Council is comprised of each Member State's minister of finance. See EC Treaty, *supra* note 430, art. 94; see also MASON, *supra* note 435, at 7.

439. See Tax Policy in the European Union—Priorities for the Years Ahead: Communications from the Commission to the Council, the European Parliament and the Economic and Social Committee, COM (2001) 260 final, at 7 [hereinafter 2001 Commission Communication, Priorities for the Years Ahead].

440. For the text of the draft EU Constitution and an overview of the ratification process, see the website of the European Union at http://europa.eu.int/constitution/index_en.htm.

441. Council Directive 90/435, 1990 O.J. (L 225) 6 (EC), amended by Council Directive 2003/123, 2004 O.J. (L 7) 41 (EU) (concerning parent-subsidiary taxation).

442. Council Directive 90/434, 1990 O.J. (L 225) 1 (EC), amended by Council Directive 2005/19, 2005 O.J. (L 58) 19 (EU) (concerning mergers).

443. Council Directive 2003/49, 2003 O.J. (L 157) 49 (EU) (concerning interest and royalty payments between related companies).

entirely inside one Member State. Thus, the directives proscribe various forms of fiscal discrimination against foreign factors of production within the EU.⁴⁴⁴

In its 1992 report, the Ruding Committee⁴⁴⁵ found significant differences between Member States' corporate tax bases, rates, and systems, and that these differences did indeed cause economic distortions violative of the tax neutrality objectives of CEN and CIN. However, the Ruding Committee failed to choose between CEN and CIN as the preferred tax policy objective and seemed to give short shrift to a serious analysis of tax neutrality in general. The Committee made numerous policy recommendations, including the recommendation that the Commission issue legislative proposals aimed at harmonizing corporate taxes. Specifically, the Ruding Committee recommended that a common corporate tax base be defined by setting minimum standards regarding Member States' tax treatment of depreciation, leasing, stock valuation, business expenses, thinly-capitalized companies, capital gains, and the carryover of foreign losses. More radically, the Ruding Committee recommended that the Commission consider proposing a common and complete corporate tax system for the entire European Community.⁴⁴⁶ Although the Commission issued a communication in response to the Ruding Committee's report,⁴⁴⁷ it did not attempt to advance the more radical recommendations contained in the Ruding Report, most likely because it knew such recommendations were not politically expedient and would never pass, given the staunch resistance to corporate tax harmonization already expressed by some Member States, especially Britain.⁴⁴⁸ Yet, even given the Commission's toned down legislative proposals, most of the proposals concerning company taxation were disregarded by the Council in light of the importance Council members placed on giving their respective Member States adequate leeway to use tax incentives to stimulate their economies.⁴⁴⁹ Since the Ruding Report, other proposals have been advanced to harmonize EU corporate tax regimes,⁴⁵⁰ but none have resulted in more directives. In sum, the task of corporate tax coordination and harmonization has fallen to the ECJ because the other EU institutions are inadequately empowered to accomplish the job due in large part to the Member States' retained power to implement tax policies consistent with the subsidiarity principle, and to effectively veto any tax proposal found objectionable.

444. Two other Council Directives impact EU Member States direct taxation. The Taxation of Savings Directive, which entered into force in 2003, is aimed at combating harmful tax competition caused by the easy mobility of capital. The Directive requires Member States to exchange information so as to ensure that the beneficial owner of any interest payment is subject to a minimum threshold of taxation on cross-border interest payments in the state of the beneficial owner's residence. See Council Directive 2003/48, 2003 O.J. (L 157) 38 (EU) (concerning taxation of savings). The Mutual Assistance Directive, which entered into force in 1977, was adopted to police tax avoidance and evasion by requiring the competent authorities of the Member States to exchange information that could assist in the proper assessment of taxes. This Directive was adopted at a time when many bilateral tax treaties did not have adequate Exchange of Information articles. See Council Directive 79/1070, 1979 O.J. (L 331) 8 (EU) and Council Directive 92/12, 1992 O.J. (L 76) 1 (concerning mutual assistance).

445. See *infra* note 451.

446. See *id.*

447. See Guidelines on Company Taxation Linked to the Further Development of the Internal Market: Communications from the Commission to the Council, the European Parliament and the Economic and Social Committee, SEC (92) 1118, June 26, 1992.

448. For a detailed description of the Commission's and Council's reaction to the Ruding Report, see Jimenez, Corporate Tax Harmonization in the European Community, *supra* note 313, at 131-36.

449. See *id.*

450. For a description of these proposals, including a 1996 memorandum submitted to an informal meeting of the ECOFIN by the former EU Commissioner Monti, see *id.* at 142-43.

b. Power and Recent Decisions of the European Court of Justice

The ECJ has jurisdiction to interpret the EU Treaties⁴⁵¹ and to decide whether Member States' laws are consistent or inconsistent with the four fundamental freedoms enshrined in the Treaties—the freedom of movement for workers, the freedom of establishment, the freedom to provide services, and the freedom of movement of capital.⁴⁵² Issues of direct taxation typically come before the ECJ in one of two ways: (1) when the Commission (or a Member State) brings an action against a Member State for failure to comply with EC law,⁴⁵³ or (2) when a national court of a Member State requests a preliminary ruling on an interpretation of EC law.⁴⁵⁴ Thus, the EU Commission need not rely on the cumbersome and often fruitless legislative procedures to carry out its preferred tax policies. Instead, the Commission can attempt to enforce its tax policies judicially by exercising its wide latitude to bring enforcement actions against Member States in the ECJ. In its 2001 Communication, the Commission indicated that it was planning to adopt a more proactive strategy in the area of tax infringements by initiating more actions against Member States in the ECJ.⁴⁵⁵ To date, the ECJ has considered numerous tax cases, and in most of these, the Member State's tax law was struck down because it was found to unlawfully discriminate on the basis of nationality⁴⁵⁶ or to violate one of the four fundamental freedoms guaranteed by the treaties.

Professors Graetz and Warren have astutely observed that the ECJ has been an extremely powerful and centralizing force in the EU by adopting “a different and more expansive view of nondiscrimination” going far beyond that typically required in international trade agreements and bilateral tax treaties.⁴⁵⁷ They note that there are three basic ways in which a country can use its income tax laws to discriminate against international commerce: a country “could favor domestic products over foreign products, domestic producers over foreign producers, or domestic production over foreign production.”⁴⁵⁸ Free trade agreements like the NAFTA⁴⁵⁹ and the GATT⁴⁶⁰ and successor agreements to the GATT, typically prohibit unfair discrimination against foreign products, while bilateral tax treaties prohibit Contracting States from discriminating against foreign producers.⁴⁶¹ The ECJ, however, has gone beyond these first two ways of prohibiting discrimination by holding, further, that a Member State's tax laws violate the nondiscrimination principle implied by the four freedoms whenever their laws favor domestic production over foreign production as in the case of

451. For the jurisdiction of the ECJ, see EC Treaty, *supra* note 430, arts. 230–40 and EU Treaty, *supra* note 429, art. 35.

452. See Treaty Establishing the European Community, Nov. 10, 1997, 1997 O.J. (C 340) 3, art. 39 (freedom of movement for workers); arts. 43, 48 (freedom of establishment); art. 49 (freedom to provide services); arts. 56, 58 (freedom of movement of capital).

453. See *id.*; see also EC Treaty, *supra* note 430, arts. 226–77.

454. See Treaty Establishing the European Community, *supra* note 452; see also EC Treaty, *supra* note 430, art. 234.

455. 2001 Commission Communication, Priorities for the Years Ahead, *supra* note 439, at 22–23.

456. EC Treaty, *supra* note 430, art. 12.

457. Graetz & Warren, *Income Tax Discrimination*, *supra* note 252, at 1194.

458. *Id.* at 1195.

459. *Supra* note 415.

460. General Agreement on Tariffs and Trade, Oct. 30, 1947, 61 Stat. A-11, 55 U.N.T.S. 194.

461. See discussion of the Nondiscrimination article (Article 24) in the Japan-U.S. Tax Treaty, *supra* Part X. Under most OECD-based bilateral tax treaties, including the Japan-U.S. Tax Treaty, a Contracting State is precluded from taxing a PE of an enterprise based in the other Contracting State more heavily than it would tax its own similarly situated domestic companies. See OECD Model Tax Treaty, *supra* note 29, art. 24(3).

domestic tax incentives.⁴⁶² Because this form of discrimination is not prohibited by either international trade agreements or bilateral tax treaties and is, in fact, deeply imbedded in many countries' tax systems in the form of tax incentives to stimulate domestic investment,⁴⁶³ the ECJ's jurisprudence is bound to conflict with many aspects of national tax systems and constrain their fiscal autonomy.

An important recent case illustrates how the ECJ is using the Treaty freedoms as a means to strike down national provisions that promote internal trade to the possible detriment of intra-community trade. *Marks & Spencer plc v. Halsey*⁴⁶⁴ involved a famous British retailer that had a number of subsidiaries in France, Belgium, and Germany, all of which had incurred substantial net operating losses before they were either liquidated or sold. In a request for a preliminary ruling, the issue before the ECJ was whether the U.K. could prevent the British retailer (i.e., the taxpayer) from using its foreign subsidiaries' losses to offset the income of its affiliated group on its consolidated tax return. As under U.S. and Japanese tax law, U.K. corporations are taxed on their worldwide income, although the income of their foreign subsidiaries is not recognized until their profits are repatriated to the U.K. When the profits are repatriated, double taxation is eliminated or mitigated through a foreign tax credit. As is typical with many consolidated corporate tax systems, including that of the United States and Japan, the U.K.'s tax law allowed only domestic subsidiaries to be included in a U.K. consolidated return; foreign subsidiaries were always excluded from group relief.

The taxpayer in *Marks & Spencer* argued that the freedom of establishment guaranteed by the EU treaties should be interpreted as preventing a residence country from interfering with its companies' freedom to invest abroad by favoring domestic investments over foreign investments. The U.K. government, on the other hand, argued that because the income of the taxpayer's foreign subsidiaries was not subject to U.K. income taxation for the years at issue, there was no reason to include their losses in the return—to do so would create unsymmetrical tax treatment. However, the ECJ was not persuaded by the government's argument and held that the U.K. provisions excluding the foreign losses from tax consolidation must be struck down as discriminatory in derogation of the EU treaty freedoms since they essentially disadvantaged investments abroad relative to investment in the U.K. The Advocate General⁴⁶⁵ noted that the only way the U.K. could prevent the offset of the foreign losses would be if the foreign subsidiaries were able to absorb their unused net operating losses in prior or future tax years.⁴⁶⁶ The *Marks & Spencer* decision has raised a great deal of controversy since many EU Member States have rules similar to the U.K.'s and the

462. See Graetz & Warren, *Income Tax Discrimination*, *supra* note 252, at 1198–1219.

463. Countries commonly favor domestic production over foreign production by offering various tax incentives to invest domestically. For example, in 2004, the United States enacted I.R.C. § 199, which allows for a special deduction for income attributable to domestic production activities. Other examples of this kind of preference include accelerated depreciation deductions, which are available for business equipment and machinery that is used predominantly inside the U.S. See I.R.C. § 168(b)(RIA 2005). However, the slower straight-line method of depreciation must be used if the depreciable assets are used predominantly outside the U.S. See I.R.C. § 168(g)(1)(A), (g)(2).

464. Case C-446/03, *Marks & Spencer plc v. Halsey* (Dec. 13, 2005), available at <http://www.curia.eu.int/en/content/juris/index.htm> (search for “Case C-446/03”).

465. Eight Advocates Generals assist the ECJ by rendering their own opinions, which the Court usually follows. See Mason, *supra* note 435, at 13.

466. Case C-446/03, *Marks & Spencer plc v. Halsey* (Apr. 7, 2005) (opinion of Advocate General Maduro), <http://www.curia.eu.int/en/content/juris/index.htm> (search for “Case C-446/03”).

ECJ's decision interpreting the Treaty freedoms is binding on all Member States of the EU. Thus, a great deal of money, tax planning, and the very fundamentals of nations' tax systems were at stake. The ECJ has invalidated a number of other national tax provisions relating to foreign production and foreign portfolio investment using a rationale very similar to that in its *Marks & Spencer* decision.

Although the ECJ's robust application of the nondiscrimination principle may be seen as necessary to remove tax barriers to the formation of a more perfect internal market in the EU, scholars have argued that the Court's recent decisions go too far and are greatly impairing the ability of Member States to stimulate their economies, to prevent double taxation, and even to prevent blatant tax avoidance.⁴⁶⁷ *Lankhorst-Hoborst GmbH v. Finanzamt Steinfurt*⁴⁶⁸ is a stunning recent example of how the ECJ has essentially struck down a set of laws, known as thin capitalization rules, designed to prevent tax avoidance through the shifting of highly taxed income into low-tax countries through deductible payments that are really disguised dividends in light of the meager capital account of the payor. In *Lankhorst*, the Court considered a German tax provision that disallowed deductions by thinly capitalized German subsidiaries on interest payments if such interest was being paid to a *foreign* parent (and was thus being removed from Germany's tax base). Under the provision in question, if the interest was instead being paid to a German parent corporation, the deduction would not necessarily be disallowed even if the subsidiary was thinly capitalized, most likely because the payment would still be within Germany's tax base when received by the German parent corporation. Despite this tax avoidance purpose of the law, the ECJ struck it down, holding that it violated the Treaty freedoms by discriminating against intra-community commerce in favor of domestic commerce. While the ECJ decision did not make thin capitalization rules in the EU illegal *per se*, such rules must be applied in a way that does not disadvantage the nationals of other Member States or discourage cross-border investments in order not to violate the Treaty freedoms.

One of the most striking and disturbing effects of the ECJ's far reaching nondiscrimination jurisprudence can be seen in the demise of shareholder-imputation credit systems to achieve corporate integration in European companies. As previously explained in Part III, there are several ways to prevent the double taxation of corporate income at both the entity and shareholder levels. For example, the United States now partially exempts certain dividends from income taxation. Until recently, many countries in the EU gave shareholders a dollar-for-dollar credit for taxes that were paid (or deemed paid) at the corporate level, so that the income was taxed only once, but at progressive shareholder rates. Longstanding issues inherent in this system include the extent to which such imputation credits should be granted to foreign shareholders, and whether foreign taxes paid by the corporation should be eligible for the credit. For years, many anticipated that the ECJ would eventually strike down some Member State's shareholder imputation credit system under the nondiscrimination principle. Although this did not happen until 2004,⁴⁶⁹ most countries in the EU had already anticipated this result by dismantling or replacing their imputation credit systems with exemption systems, which means that progressivity was sacrificed for simplicity.

467. See Graetz & Warren, *Income Tax Discrimination*, *supra* note 252, at 1201–02.

468. Case C-324/00, 2002 E.C.R. I-11,779.

469. Case C-319/02, *In re Manninen*, 2004 E.C.R. I-7477 (striking down the Finnish shareholder-imputed-credit system as discriminatory against foreign commerce).

Professors Graetz and Warren rightly point out that this choice seems “quintessentially legislative,” and when the ECJ makes “nondiscrimination the sole criterion for the choice [it] necessarily suppresses considerations of efficiency, fairness, and administrability that should inform difficult tax policy decisions.”⁴⁷⁰

How far the ECJ will extend its nondiscrimination doctrine is uncertain, but so far it appears to have no bounds. In April 2004, the ECJ was asked to invalidate a Member State’s controlled-foreign-corporation [CFC] regime, a complex regulatory mechanism for eliminating the tax deferral that is generally enjoyed by foreign subsidiaries of parent corporations that reside in jurisdictions employing the foreign tax credit.⁴⁷¹ The argument for striking down the CFC anti-deferral regime is that it penalizes only foreign subsidiaries engaged in passive or conduit activities, not domestic corporations, and so ostensibly discriminates against intra-community commerce.⁴⁷² Given that the majority of EU Member States have CFC provisions, the litigation has generated a great deal of controversy and criticism. At least one scholar has observed that if the ECJ does invalidate CFC regimes in Europe, that decision could trigger the demise of the whole system of taxing companies on their worldwide income and granting a foreign tax credit to eliminate double taxation.⁴⁷³ This is because the taxation of foreign income would be undermined by its indefinite deferral in the absence of the CFC anti-deferral provisions. Of course, the whole system of taxing persons on their worldwide income and granting a foreign tax credit to relieve double taxation arguably violates the EU’s fundamental treaty freedoms because this system effectively prevents a person residing in a high-tax country from fully enjoying the low taxes offered abroad.⁴⁷⁴ This argument, however, strikes at the very heart of CEN—the idea that capital will be allocated more efficiently when decisions about to where to locate an investment are based on the underlying business fundamentals, free of tax considerations.⁴⁷⁵ If the ECJ’s nondiscrimination jurisprudence goes so far as to dismantle the CFC and foreign tax credit systems, it will be hugely ironic since a foundational principle for the formation of the EEC was CEN, which is epitomized by the taxation of worldwide income and the accompanying foreign tax credit.⁴⁷⁶

The ECJ has made *nondiscrimination* the primary centerpiece of its direct tax jurisprudence, intended to promote the four freedoms guaranteed by the European treaties—the free movement of goods, people, services, and capital. However, the broad nondiscrimination concept, as articulated by the ECJ, does not appear to be an adequate device for

470. Graetz & Warren, *Income Tax Discrimination*, *supra* note 252, at 1212.

471. See Case C-196/04, *Cadbury Schweppes plc v. Comm’rs of Inland Revenue* (filed Apr. 29, 2004).

472. This argument is similar to the taxpayer’s position in *Marks & Spencer* that a residence country should not be able to interfere with its companies’ freedom to invest abroad. For a brief explanation of anti-deferral regimes, see the discussion *supra* Part III.A.1.b.

473. See, e.g., Malcolm Gammie, *The Role of the European Court of Justice in the Development of Direct Taxation in the European Union*, 57 BULL. INT’L FISCAL DOCUMENTATION 86, 96 (2003).

474. See Peter J. Wattel, *Home Neutrality in an Internal Market*, 36 EUR. TAX’N 159 (1996) (maintaining that the foreign tax credit does not comport with the concept of an internal market).

475. See discussion of CEN *supra* Part II.A.

476. See Jimenez, *Corporate Tax Harmonization in the European Community*, *supra* note 313, at 7–13 (discussing how the policy objective of capital export neutrality became identified with the concept of the common market in the early stages of the EC’s existence) and 19–38 (comparing various tax policy theories and noting that public finance economists in the late 1950s and early 1960s, including Peggy Musgrave and Richard A. Musgrave, advocated that CEN should be the guiding principle for a tax union like the European Economic Community).

determining how best to divide the worldwide tax base between source and residence countries, the historical resolution of which is the so-called 1920s' Compromise previously discussed,⁴⁷⁷ and not some inherently rational or scientific principle. The ECJ, as evinced by its jurisprudence, appears to view the four treaty freedoms as protecting transnational commerce from laws designed to serve domestic investments at any cost; the only relevant issue appears to be whether transnational commerce is disadvantaged by the law in question. The problem with the Court's emerging doctrine is that it produces irreconcilable claims of discrimination because of the inevitable overlap of source and residence. If the ECJ prohibits discrimination based on the *destination* of an investment (e.g., a holding that a country cannot prevent a company from enjoying the benefits of low-taxed foreign investments), then this holding automatically conflicts with a prohibition against discrimination based on the origin of an investment (e.g., holding that a country must treat domestic and foreign producers equally). In other words, the ECJ appears to be attempting to implement CEN and CIN simultaneously in its jurisprudence.⁴⁷⁸ But, as previously noted, the only way that CEN and CIN can both be served at the same time is where all jurisdictions' tax rates and bases are identical.⁴⁷⁹ And as noted, harmonized corporate tax rates in the EU appear very unlikely to occur in the near future unless and until the rule requiring the unanimous consent of the Council to enact new tax legislation is repealed in favor of a lower approval threshold.⁴⁸⁰

In the meantime, there are many possible future implications of the ECJ's nondiscrimination jurisprudence. Given the large number of Member States' corporate tax laws that have been struck down, it is conceivable that Europe's corporate income tax base will shrink over time, with Member States forced to raise revenues by other means—perhaps through excise and other indirect taxes. The EU Commission seems to have resigned itself to the fact that income tax rates will not be harmonized anytime soon, and has now launched a major legislative initiative to create a common corporate tax base for Europe,⁴⁸¹ coupled with the objective of replacing the arm's length method of allocating income among related enterprises with a formulary apportionment method.⁴⁸² The Commission has justified this initiative by pointing out that a uniform tax base will serve the tax policy goal of simplification and reduce compliance costs. Nonetheless, scholars have surmised that the Commission's push to create a common corporate tax base may be just another ploy to ultimately push

477. See discussion of the 1920s' Compromise *supra* Part II.D.

478. See Graetz & Warren, *Income Tax Discrimination*, *supra* note 252, at 1216–20 (arguing that the ECJ's nondiscrimination jurisprudence is inherently incoherent and setting forth logical proofs of this contention).

479. See *id.*; see also Jimenez, *Corporate Tax Harmonization in the European Community*, *supra* note 313, at 21 (noting that the two forms of neutrality are mutually exclusive in the absence of identical tax systems); see discussion of CEN and CIN *supra* Part II.A. & B.

480. The draft EU Constitution, which failed to be ratified by France and the Netherlands in 2005, would not change the unanimity requirement.

481. See, e.g., Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee: Towards an Internal Market Without Tax Obstacles—A Strategy for Providing Companies with a Consolidated Corporate Tax Base for Their EU-Wide Activities, COM (2001) 582 final (Oct. 23, 2001) [hereinafter *Communication on Consolidated Corporate Tax Base*]; Tax Analysts *EU Summarizes November Meeting of Harmonized Tax Base Working Group*, *WORLDWIDE TAX DAILY*, Jan. 21, 2005, 2005 WTD 18–16 (LEXIS) Tax Analysts, *EU Goals Include Harmonizing Company Tax Base, Reviving Constitution*, *WORLDWIDE TAX DAILY*, Jan. 16, 2007, 2007 WTD 10–8 (LEXIS).

482. See Tax Analysts, *EU Publishes Common Company Tax Base Paper on Group Taxation*, *WORLDWIDE TAX DAILY*, June 14, 2006, 2006 WTD 114–14 (LEXIS) (In the paper, the EU Commission discusses the definition of a group and how intragroup transactions would be identified and treated).

through tax rate harmonization.⁴⁸³ In the meantime, there remains a huge spectrum of corporate income tax rates in Europe, ranging from a zero percent rate in Estonia for the year 2005 to rates exceeding 30 percent in Belgium, France, Germany, Italy, Luxembourg, and Spain.⁴⁸⁴ The broad disparity in tax rates creates very real incentives to manipulate the location of capital within the EU. Without rate harmonization, it is fairly disingenuous for the Commission to contend that harmonizing the tax base will neutralize tax considerations in decision making.

The ECJ's tax jurisprudence with all of its direct ramifications and indirect effects is bound to have substantial repercussions in both the United States and Japan because of the extensive economic ties and bilateral tax treaties both the countries have with EU Member States. If formulary apportionment is instituted in the EU, it will undoubtedly affect how Japanese and U.S. corporations structure their investments and operations in the EU. At a minimum, some bilateral tax treaties may have to be renegotiated. At worst, a new tax base may generate even more litigation and opportunities for the ECJ to assert its nondiscrimination doctrine, which not only might further impair Member States' abilities to employ tax incentives and avoid double taxation, but also threaten to upset the entire bilateral tax treaty network, creating a high level of uncertainty, and weakening the relatively high level of consensus that has been reached on many difficult issues such as transfer pricing, the treatment of fiscally transparent entities, and the proper interpretation and breadth of the nondiscrimination principle now found in OECD-based bilateral tax treaties. At present, it seems that Professors Graetz and Warren got it exactly right when they characterized the ECJ's jurisprudence as incoherent and unstable from an international tax policy perspective.⁴⁸⁵ In short, the EU's method of attempting to develop international income tax policy on a case-by-case basis through the ECJ so as to remove barriers to its internal market is not theoretically sound. The ECJ's nondiscrimination jurisprudence is on a dead-end course, and serves neither as a desirable or practical substitute to replace the existing OECD bilateral tax treaty network (in fact, it could impair that network), nor as a viable model for Asian-Pacific international tax policy.

4. *Asian Trade Groups and Agreements—APEC, ASEAN, AFTA, and CAFTA*

Although the geographic proximity of countries in East Asia and along the Pacific Rim might be sufficient to catalyze their economic integration, this region has not had a major binding regional trade agreement on the order of the NAFTA or the European Union's treaties until quite recently, when the nascent free trade agreement between China and the Southeast Asian nations entered into force in 2005.⁴⁸⁶ The region encompassing East Asia and the Pacific Rim

483. See Graetz & Warren, *Income Tax Discrimination*, *supra* note 252, at 1229 (likening the Commission's push to create a common corporate tax base to a "stalking horse" for a subsequent push for rate harmonization); cf. McDaniel, *NAFTA and Formulary Apportionment*, *supra* note 422, at 302 (noting that a general convergence of tax rates is desirable to institute a system of formulary apportionment, but that such a close convergence would not be necessary in the three NAFTA countries were to consolidate their tax bases); *but cf.* Vann, *Treaty for the Asian-Pacific?*, *supra* note 30, at 160 (contending that uniformity of domestic tax systems is likely to grow out of a system in which the corporate tax bases of various countries are consolidated).

484. See Graetz & Warren, *Income Tax Discrimination*, *supra* note 252, at 1228–29.

485. See *id.* at 1188, 1219, 1243.

486. Agreement on Trade in Goods of the Framework Agreement on Comprehensive Economic Cooperation between the Association of Southeast Asian Nations and the People's Republic of China, Nov. 29, 2004, PRC-ASEAN, art. 23(1) (Entry into Force), available at <http://www.aseansec.org/16646.htm>. (last visited Sep. 1, 2006)[hereinafter the acronym CAFTA will be used to refer to this free trade agreement]. CAFTA is further discussed below at Part XII.C.4.b.ii.

lacks many of the commonalities that drive such agreements, such as a shared history, religion, or culture; similar levels of affluence; or equally amenable attitudes towards foreign trade and investment. The region is extremely diverse economically and politically, and includes highly industrialized nations like the United States, Japan, Australia, and Canada; newly industrialized nations like China; and many small developing nations in the South Pacific. But the sheer size of the region makes it a force to be reckoned with, since it encompasses over one-half of the world's population and 40 percent of its total gross domestic product.

a. Asia-Pacific Economic Cooperation forum—APEC

Despite the Asia-Pacific region's lack of legal, economic, or social cohesion, a number of regional economic forums emerged in the 1960s, founded on the general belief that some kind of dialogue between representatives of countries in the region was needed to benefit their respective private sectors and to facilitate a greater understanding of policymaking. In 1989, amalgamating efforts, spearheaded by Japan and Australia, led to the emergence of the Asia-Pacific Economic Cooperation forum (APEC) as the predominant group for facilitating economic growth, cooperation, trade, and investment in the Asia-Pacific region.⁴⁸⁷ APEC was founded with twelve members, but has since grown to twenty-one countries, which refer to themselves as Member Economies.⁴⁸⁸ Every year, one of the Member Economies plays host to the annual APEC conference, which includes various ministerial, academic, and leaders' meetings.⁴⁸⁹

APEC is distinguishable from other regional economic arrangements in several key respects. First, unlike the WTO and the EU, APEC is not a supranational body; rather, it operates as a collective secretariat with its headquarters in Singapore. Second, unlike the WTO, the EU, and the NAFTA, APEC has no binding multilateral treaty—its operative principle is voluntary action, not binding negotiations. Thus, although APEC produces

Many countries in the Asian-Pacific and East Asia are also members of the WTO. APEC played a significant role in the success of the GATT's Uruguay Round and the creation of the WTO. See ASIA-PACIFIC ECONOMIC COOPERATION FORUM, EMINENT PERSONS GROUP, IMPLEMENTING THE APEC VISION, THIRD REPORT OF THE EMINENT PERSONS GROUP I (1995).

487. Other regional groups emerged in the 1960s, which helped pave the way for the creation of APEC in 1989. These other groups include the Asian Development Bank (ADB), the Pacific Basin Economic Council (PBEC), the Pacific Trade and Development Conference (PAFTAD), and the Pacific Economic Cooperation Council (PECC), all of which are still in existence but now have much lower international profiles than APEC. For an overview of these groups' respective roles in Asian economic cooperation, see EDWARD J. LINCOLN, EAST ASIAN ECONOMIC REGIONALISM 114–27 (2004).

488. According to APEC's website, "[t]he term Member Economies is used because the APEC cooperative process is predominantly concerned with trade and economic issues, with members engaging with one another as economic entities" rather than as political entities. See Asia-Pacific Economic Cooperation, Frequently Asked Questions, <http://www.apec.org/apec/tools/faqs.html#Q3>. APEC's Member Economies are: Australia; Brunei Darussalam; Canada; Chile; People's Republic of China; Hong Kong, China; Indonesia; Japan; Republic of Korea; Malaysia; Mexico; New Zealand; Papua New Guinea; Peru; The Republic of the Philippines; The Russian Federation; Singapore; Chinese Taipei; Thailand; United States of America; and Viet Nam. Asia-Pacific Economic Cooperation, Member Economies, http://www.apec.org/apec/member_economies.html.

Inclusion of so many new members with diverse economies and thinner links to the Asia-Pacific region has arguably diluted APEC's sense of direction and focus on economic issues. See LINCOLN, *supra* note 487, at 312–33 (2004). Thus, in 1997, a 10-year moratorium was placed on adding new APEC members, ostensibly to give APEC time to strengthen its platform.

489. APEC is funded by annual donations of its Member Economies, which are used to fund a small Secretariat in Singapore. For more information on APEC's bureaucratic structure and operations, see its official website at: http://www.apec.org/content/apec/about_apec/structure.html.

recommendations and nonbinding codes, they may or may not be implemented by the individual Member Economies. Obviously, this non-binding aspect of APEC's reform agenda is similar to the international tax recommendations of the OECD,⁴⁹⁰ except that the OECD Model Treaty has spawned over 2500 binding multilateral treaties, while APEC's role has proven to be primarily a forum for dialogue and for the establishment of nonbinding trade goals and recommendations. Moreover, APEC has made almost no progress in proposing explicit tax coordination rules for the region.

i) *The Bogor Declaration*

Initially, APEC's meetings were attended only by trade and foreign ministers from the Member Economies, but the meetings soon assumed a higher profile by adding a leaders' meeting, which included high ranking government officials. In 1993, U.S. President Bill Clinton spoke at the Seattle meeting of APEC, held on Blake Island, an historic Indian village. Although APEC began its existence with no clear mission other than to meet to discuss topics of mutual interest, its broad agenda has become more refined. At its 1994 summit meeting following President Clinton's appearance, APEC adopted a free trade proposal incorporating two ambitious, long-term goals: (1) the achievement of "free and open trade and investment" in the Asia-Pacific region by 2010 for developed economies, and (2) the same achievement for developing economies by 2020. These two goals, agreed to by APEC Economic Leaders in Bogor, Indonesia in 1994, are often dubbed the "Bogor Goals" or the "Bogor Declaration."⁴⁹¹

The Bogor Declaration was followed one year later with the establishment of an action plan, the 1995 Osaka Action Agenda, for achieving the broad Bogor Goals. The agenda delineated three broad areas of cooperation, known as the "Three Pillars" of APEC: (1) liberalizing trade by working towards the eventual elimination of tariffs and non-tariff barriers to trade and investment; (2) facilitating cross-border business by improving access to trade information, and by better aligning policy goals with modern business strategies; and (3) enhancing APEC members' economic and technical capacities so that both institutions and individuals can take better advantage of electronic commerce and the new economy.⁴⁹² However, neither the 1994 Bogor Goals, nor the 1995 Osaka Action Plan explicitly defined what was meant by "free and open trade and investment."⁴⁹³

APEC's Eminent Persons Group (EPG)⁴⁹⁴ recommended that the Bogor Goals be achieved by a process of open regionalism, the key principle implying regional integration

490. See Seiichi Kondo, OECD Deputy Sec'y-Gen., Remarks concerning the APEC-OECD Cooperative Initiative on Regulatory Reform (Singapore, Feb. 21, 2001), transcript of speech available at <http://www.oecd.org/dataoecd/39/26/2350080.pdf> (noting the similarities between OECD and APEC reform agendas and approaches, but stressing that regulatory reform must "go beyond talking about principles . . . by building domestic capacities for quality regulation.") [hereinafter Kondo, OECD Deputy Sec'y General, 2001 Conference Address].

491. See APEC Leaders' Declaration of Common Resolve (Bogor, Indonesia, Nov. 15, 1994), available at http://www.apec.org/content/apec/leaders_declaration/1994.html [hereinafter either Bogor Goals or Bogor Declaration].

492. A description of APEC's 1995 Osaka Action Agenda is available on the APEC website at http://www.apec.org/apec/about_apec/how_apec_operates/action_plans_.html.

493. See *id.*

494. The Eminent Persons Group was established in 1992 to help APEC develop a clearer vision of its role and objectives. The EPG is comprised of distinguished leaders from academia, business, and the private sector, drawn from each of APEC's Member Economies. The EPG issues an annual report, which often contains analysis and recommendations as to how the Bogor Goals can be achieved.

without trade discrimination against non-APEC countries.⁴⁹⁵ In general, open regionalism is analogous to nondiscrimination implemented through the MFN mechanism.⁴⁹⁶ But, in contrast to the approach taken by most regional trade agreements, including the NAFTA and the EU, open regionalism involves the extension of trade benefits on a unilateral basis, regardless of whether those benefits are reciprocated. As several economists have observed, APEC is “[c]haracterized by market-driven integration, rather than by institutional integration; involves economies at different stages of economic development rather than economies with similar income levels; and [is] outwardly oriented rather than inward-looking.”⁴⁹⁷

According to recommendations in the EPG’s 1994 report,⁴⁹⁸ open regionalism has four dimensions to its meaning, the essence of which is to create a free trade area that will engage with the rest of the world liberally, with “absolutely no contemplation of creating a customs union that would require members to maintain common [external] trade policies toward nonmembers.”⁴⁹⁹ Thus, according to the EPG’s vision of open regionalism, Member Economies should commit to further reducing their trade and investment barriers toward non-APEC countries; they should be encouraged to lower their own trade barriers unilaterally to the maximum possible extent; and APEC should, as an organization, extend APEC benefits to nonmembers on a mutually reciprocal basis. And yet, APEC should allow individual Member Economies to relate to third-party countries on a bilateral basis, by sanctioning extension of free trade benefits unconditionally or reciprocally.⁵⁰⁰

This formulation, however, is problematic in that it advocates applying the MFN principle on *both* a unilateral and reciprocally contingent basis, depending on the stance of the trading partner. Subregional trading blocks within the APEC region usually apply their benefits to insiders only. For example, NAFTA countries do not unilaterally extend their agreement to non-NAFTA countries (at least until 2010), a restriction that ostensibly conflicts with the open regionalism policy advocated by APEC. There remains a question as to how APEC Member Economies are to treat outsiders. The options include: (1) closed regionalism, whereby trade benefits are not extended at all; (2) conditional MFN status, whereby benefits are extended only if reciprocated; and (3) open regionalism, whereby benefits are

495. The concept of “open regionalism” was mentioned as an APEC goal years earlier, at least as early as 1991. See 3rd APEC Ministerial Meeting—Joint Statement, Seoul, Korea, Nov. 12–14, 1991 (stating that APEC should set an example of open regionalism), available at http://www.apec.org/apec/ministerial_statements/annual_ministerial/1991_3th_apec_ministerial.html.

496. As mentioned, the MFN principle generally stands for the proposition that the country implementing such principle must extend to other party-countries, its nationals, or its residents, any benefit, advantage, or favor that is has granted to any country’s nationals or residents in specified matters. The MFN principle can apply on a unilateral basis (i.e., without the requirement of reciprocal treatment). However, reciprocity is usually made a condition, meaning that countries will extend MFN status to countries on a bilateral or multilateral basis, but only if and to the extent that such countries extend the same benefit to them. See discussion of MFN status *supra* Part XII.C.2.

497. Peter Drysdale, Andrew & Hadi Soesastro, *Open Regionalism: The Nature of Asia Pacific Integration in Europe, East Asia and APEC* 103, 107 (Peter Drysdale & David Vines ed., 1998).

498. See ASIA-PACIFIC ECONOMIC COOPERATION FORUM, EMINENT PERSONS GROUP, *ACHIEVING THE APEC VISION: FREE AND OPEN TRADE IN THE ASIA PACIFIC*, APEC #94-EP-01, ISBN 981-00-5925-6 (1994), available at http://www.apecsec.org.sg/apec/publications/all_publications/eminent_persons_group.html [hereinafter APEC Eminent Persons Group, 1994 Report].

499. *Id.* at 4.

500. *Id.* at 3–4.

extended unilaterally. In 1997, an intellectual leader of APEC, C. Fred Bergsten of the United States, attempted to help APEC refine the meaning of open regionalism by pointing out that if all APEC Member Economies lowered or extended MFN status to all other nations on a unilateral basis, APEC members would essentially be giving up their leverage and potential bargaining power in trade negotiations with non-APEC countries.⁵⁰¹

Although clearly APEC leaders originally wanted APEC to be distinguished from preferential regional trade blocks like NAFTA and the EU, which extend their benefits only on an exclusive basis to other in the region,⁵⁰² the meaning of open regionalism with respect to non-APEC countries has never been clearly delineated and remains nebulous. In recent years, APEC leaders have expressed their approval of subregional preferential trade agreements, noting that they can help lead to increased economic cooperation, even though such arrangements probably fall short of open regionalism.⁵⁰³

Further obfuscating APEC's mission is the fact that despite APEC's verbal reaffirmations of its Bogor free trade objectives, it still has never defined free and open trade and investment, a key APEC objective that is to be accomplished by the target dates set forth in the Bogor Declaration. To industrialized countries, free trade may automatically imply the lifting of all bans, quotas, and tariffs; but to poorer countries, free trade may mean something much less. To developing countries, free trade may imply the mere removal of bans on imports, but not the elimination of tariffs. The lingering ambiguities over the practical meaning of these putatively guiding APEC principles—open regionalism and free trade—combined with the fact that compliance with APEC's principles is strictly voluntary, have both clouded APEC's mission and hindered its progress toward achieving free trade in the region by its target dates of 2010 for advanced countries, and by 2020 for developing countries.

Indeed, as an institution, APEC has trouble getting its members to implement the MFN principle on either a mutually exclusive or unilateral basis, except within the context of their WTO commitments.⁵⁰⁴ Thus, Japan, for example, apparently had no qualms in protecting its domestic rice market in 2001,⁵⁰⁵ despite the Bogor Goals, despite APEC's three so-called Pillars of Cooperation, despite APEC's support of and self-proclaimed leadership role in the WTO,⁵⁰⁶ and despite the EPG's attempts to promote its broad and blurry vision of open regionalism.

501. See C. FRED BERGSTEN, OPEN REGIONALISM 11–15 (Inst. for Int'l Economics, Working Paper No. 97–3, 1997).

502. See APEC Eminent Persons Group, 1994 Report, *supra* note 498, at 29–30 (strongly recommending “that APEC members liberalize their trade and investment barriers unilaterally to the maximum extent possible” and advocating that APEC propose revising Article 24 of the GATT to require that new regional trade groups do the same).

503. See, e.g., 12th APEC Economic Leaders' Meeting Santiago Declaration, *One Community, Our Future*, Santiago de Chile, Nov. 20–21, 2004 (renewing commitment to achieving APEC's Bogor Goals through unilateral measures, as well as other “collective market-opening actions,” including preferential free trade agreements and regional trade agreements); 13th APEC Economic Leaders' Meeting Busan Declaration, *Towards One Community: Meet the Challenge, Make the Change*, Busan, Korea, Nov. 18–19, 2005 (reaffirming commitment to the Bogor Goals through both unilateral actions and preferential trade agreements). The texts of APEC's annual Economic Leaders' Declarations are available at http://www.apec.org/apec/leaders_declarations.html.

504. See LINCOLN, EAST ASIAN ECONOMIC REGIONALISM, *supra* note 487, at 134–35.

505. See *id.* (citing Hisane Masaki, *APEC Nears Compromise*, JAPAN TIMES ONLINE, Sept. 14, 2001, available at www.japantimes.co.jp/cgi-bin/getarticle.pl?nb200110914a2.htm).

506. See, e.g., 17th APEC Ministerial Meeting—Joint Statement, Busan, Korea, Nov. 15–16, 2005 (recommending APEC Leaders provide “strong political leadership and commitment necessary to produce a sound platform for successfully concluding the [WTO] negotiations in Hong Kong, China. . .”).

ii) *APEC's Effect on Tax Impediments*

Not only has APEC's progress in implementing its original vision of trade liberalization through the MFN mechanism been disappointing, APEC has also not had a discernable impact on lowering tax barriers to FDI. Although APEC has co-sponsored non-tax initiatives with the OECD,⁵⁰⁷ APEC has not exercised its guiding MFN principle to induce the broad removal of tax barriers to foreign investment within the APEC region, as has been attempted by the EU through litigation in the European Court of Justice. Clearly, the MFN principle, as announced by APEC's EPG, is broad enough, theoretically, to restrict tax impediments to foreign investment.⁵⁰⁸ But, as contrasted to the situation in the EU, the nondiscrimination principle, in the form of MFN status, has not been implemented in the APEC region; there is no regional multilateral treaty that explicitly requires it, and no supranational tax authority to enforce it.

Japan's well-publicized reluctance to legally authorize share exchanges with foreign investors provides a striking example of the non-enforcement of APEC's MFN principle, even when reciprocity is present. Most developed OECD nations, including the United States, authorize share-for-share exchanges with foreign corporations as a technique enabling corporations to invest abroad by acquiring or merging with foreign corporations. However, merger-and-acquisition (M&A) activity between Japanese and foreign corporations has long been hindered by Japan's insular corporate culture and protective laws that prohibit Japanese corporations from swapping their shares with those of a foreign corporation. To ameliorate this situation and stimulate more FDI, a controversial provision was adopted in Japan's 2005 Companies Law, which expands the categories of permissible consideration in triangular mergers to include cash, bonds, and shares of foreign corporations.⁵⁰⁹ This new provision will permit a Japanese target corporation to merge into a Japanese subsidiary of a foreign corporation with the target's shareholders receiving as consideration the acquiring foreign parent's stock and a limited percentage of cash or bonds. The amendment will make it easier and less expensive for foreign corporations to acquire Japanese companies and to buy out any dissenting shareholders.

But this very possibility has sparked a great deal of alarm in Japan that the provision will make foreign triangular mergers too easy to execute.⁵¹⁰ Amid widespread fears of a sudden

507. See APEC-OECD Co-operative Initiative on Regulatory Reform, 2001–2006, available at http://www.oecd.org/document/25/0,2340,en_2649_201185_2397017_1_1_1_1,00.html (aimed at reforming anti-competition laws); OECD-APEC Workshop on Security of Information Systems and Networks—Seoul, 5–6 September 2005, summarized at <http://www.oecd.org/dataoecd/1/23/35808919.pdf> (aimed at improving computer network and database security). In October 1996, APEC and the OECD co-sponsored an international tax conference in Sydney, Australia. However, the conference did not produce any APEC-sponsored tax initiatives.

508. Indeed, this has been the theoretical basis of the ECJ's decisions invalidating many of its Member States' tax laws. See discussion *supra* Part XII.C.2.b.

509. A proposal to authorize stock swaps directly with foreign corporations was eliminated from the Companies Law bill. See 2005 Companies Law, *supra* note 94 and sources cited therein.

510. But, this fear is unfounded and apparently has its genesis in a general misunderstanding by Japanese lawmakers of the difference between negotiated mergers and unwanted (i.e., hostile) takeovers. Mergers must necessarily be negotiated and are not tantamount to hostile takeover bids. Moreover, a triangular merger is an "extraordinary transaction" under Japanese law, requiring approval of at least two-thirds of the merging companies' shareholders. Although garnering this level of approval is theoretically possible, it is highly unlikely, even in a U.S. corporation, much less in a Japanese one.

surge in foreign hostile takeovers of Japanese companies, Japan's legislature postponed the effective date of the foreign-merger provision to May 2007 at the earliest, a move disparaged by foreign business interests as too protective and discriminatory. The delay will make it harder for Japan to achieve former Prime Minister Koizumi's well-publicized goal of doubling FDI by 2009, an ambitious objective established in 2004.⁵¹¹ Even when foreign triangular mergers become legal under Japanese law in 2007, they are not likely to become a popular acquisition technique unless Japan's tax law is also amended to make them tax deferred to the target's shareholders, which is the tax treatment accorded such transactions by many of Japan's trading partners, including the United States.⁵¹² Arguably, Japan's tax laws constitute a form of discrimination against foreign producers and investors since tax-deferred mergers, involving share-for-share exchanges as a method of acquiring or reorganizing a corporation, are available to domestic but not foreign corporations.⁵¹³

Because many of Japan's trading partners, including the United States and other APEC members, have long sanctioned tax deferred, share-for-share exchanges between domestic and foreign companies as a means of effecting FDI,⁵¹⁴ and Japan has meanwhile routinely shunned the technique, even when its benefits are offered on a reciprocal basis by its trading partners, the MFN principle has obviously been ineffective in removing a major tax barrier to direct investment in Japan, an APEC-member economy.⁵¹⁵

iii) APEC's Future

Assessments of APEC's impact and accomplishments vary. While APEC's actual record in inducing its Member Economies to lower their institutional trade barriers has been weak, especially as compared to the accomplishments of the NAFTA and the EU, APEC has provided a much needed forum for discussing issues related to international trade and economic integration in the Asia-Pacific region. This regular interaction, combined with specific agendas and annual progress reports by its Member Economies, has arguably had the cumulative effect of building a legion of government officials and academics whose consciousness of technical trade issues, problems, and possible solutions has been raised

511. Junichiro Koizumi, Prime Minister of Japan, General Policy Speech to the 159th Session of the Diet (Jan. 19, 2004) ("We will make Japan an attractive market for foreign companies in order to achieve the goal of doubling the amount of investment within the next five years." [provisional translation issued by Prime Minister's Cabinet]), available at http://www.kantei.go.jp/foreign/koizumispeech/2004/01/19sisei_e.html.

512. Currently, shareholders of a Japanese target who, pursuant to a merger, exchange their shares for shares in another Japanese corporation can defer their tax gains until they dispose of the newly acquired shares in a taxable transaction. However, an exchange of domestic shares for foreign shares is immediately taxable. This rule is not on a par with the tax rules in many other industrialized countries, including the United States which allow gains realized in cross-border corporate reorganizations to be deferred indefinitely if certain requirements are satisfied. See, e.g., U.S. Treas. Reg. § 1.367(a)-3(c) and 1.367(a)-3(d)(3), Example 5 (1998).

513. For a discussion of the application of the nondiscrimination principle in the European Union, see discussion *supra* in Part XII.C.2.b.

514. Most of the countries that sanction share exchanges between domestic and foreign corporations are industrialized, OECD member countries. See, e.g., U.S. Treas. Reg. § 1.367(a)-3(c) and 1.367(a)-3(d)(3) (1998). Developing countries are more reluctant to open their doors to such forms of investment, fearing expropriation.

515. For a more thorough analysis of Japan's new provision sanctioning foreign triangular mergers, Japan's 2005 Companies Law, and its emerging market for corporate control, see Pamela A. Fuller, *Whither M&A in Japan?* N.Y.L.J. 10, Nov. 7, 2005; Fuller, 2005 Int'l Legal Development, Asia and Pacific Law—Japan *supra* note 97, at 515–523; Pamela Ann Fuller, *Japan, International Legal Developments in Review: 2005, Corporate—International Mergers and Acquisitions—Japan*, in 40 INT'L LAW. 311, 325–328 (2006).

and sharpened. Requiring members to present action plans and progress reports has also created some peer pressure to conform to APEC's principles. This soft law aspect of APEC has caused some observers to liken APEC to the OECD.⁵¹⁶ However, APEC has spawned nothing on the order of the OECD's more than 2,500 bilateral tax treaties, all of which have similar provisions and allocation rules.

Although voluntary compliance with APEC's MFN principle has been far from impressive,⁵¹⁷ some economists believe that APEC has nonetheless had a long-term positive effect on the direction of trade liberalization and levels of gross domestic product (GDP)—not only within the APEC region, but also in the European/OECD economies that are well outside the APEC region.⁵¹⁸ Although the effect has not been robust, these economists maintain that APEC's progress in facilitating trade (by expediting and reducing the cost of customs clearance procedures) and its limited success in reducing trade barriers unilaterally have generated efficiency gains evinced by increases in real GDPs and expanded exports.⁵¹⁹

On the other hand, many scholars and U.S. government officials clearly regard APEC as an inefficient institution, a waste of time, and only peripheral to the process of removing trade and tax barriers to economic integration.⁵²⁰ APEC is not likely to produce anything approximating the EU or NAFTA treaties, a perceived shortcoming contributing to its critics' discontents. There is a widespread belief that APEC is a flawed institution because of its failure to accomplish its trade liberalization goals. However, these goals were probably too ambitious *ab initio*, given that the APEC region has long exhibited far greater economic and cultural diversity than that of either Western Europe or North America. One result of the rampant dissatisfaction with APEC has been the emergence of narrower approaches to economic integration in Asia, including increased calls and negotiations for sub-regional free trade agreements.⁵²¹ The following briefly explores this development and explains how increased East Asian regionalism could have negative implications for international tax policy and global economic welfare.

b. Emergence of Narrower Asian Economic Alliances

In recent years, a vision of a narrower East Asian region has emerged to compete with APEC's vision of a broad, transcontinental Asia-Pacific zone where trade benefits are extended on a non-preferential basis. Although the idea of an East Asian economic sphere

516. See Kondo, OECD Deputy Sec'y General, 2001 Conference Address, *supra* note 490 (noting the similarities on OECD and APEC principles).

517. See LINCOLN, EAST ASIAN ECONOMIC REGIONALISM, *supra* note 487 at 133–35 (attributing APEC's lack of progress toward free trade primarily to its weak, nonbinding process and its failure to explicitly define its objectives).

518. See Seunghee Han & Inkyo Cheong, *APEC Trade Liberalisation: Its Implications* 23–31 (O.E.C.D., Working Paper, No. 197, May 1998), available at <http://www.oecd.org/dataoecd/34/48/1864956.pdf> (arguing that their empirical study shows that APEC's long-term effect has been to boost the levels of gross domestic product "throughout OECD as well as non-OECD economies").

519. See *id.*

520. See, e.g., JOHN RAVENHILL, APEC AND THE CONSTRUCTION OF PACIFIC RIM REGIONALISM, 193 (2002) (characterizing APEC's agenda regarding technical (ECOTECH) issues as "a triumph of process over substance"); LINCOLN, EAST ASIAN ECONOMIC REGIONALISM, *supra* note 487, at 115 (noting that "mention of APEC in Washington often brings little more than a yawn").

521. See LINCOLN, EAST ASIAN ECONOMIC REGIONALISM, *supra* note 487, at 138–39.

is not new and has probably long been simmering in the consciousness of government leaders and intellectuals, there has recently been a noticeable swell in momentum for creating distinctly East Asian institutions and economic deals to manifest and embody this growing consciousness. In particular, a number of East Asian trade groups have evolved, including the Association of Southeast Asian Nations (ASEAN) and its larger sister group, ASEAN +3 (with China, Japan, and South Korea), raising concerns that their strong rhetoric and exclusionary tendencies could result in Asian protectionism on many fronts, which could easily alienate Western business and political interests, and impair broader efforts to achieve higher levels of economic efficiency.

i) *Catalysts Sparking East Asian Regionalism*

The reasons underlying the desire of some nations to create and formalize a so-called East Asian consciousness are deeply rooted and multifaceted. However, Edward Lincoln notes that any efforts to formally bind the region would have to overcome some formidable impediments—namely, extreme economic, political, and cultural diversity.⁵²² Lincoln has identified five basic factors that have stimulated the recent calls for forming an East Asian economic block. First, there has been a growing perception that the region shares social, cultural, and economic attributes that are now often labeled Asian values. This perception, which many scholars believe is illusory and deeply flawed, was pushed so vigorously in the late 1980s and 1990s by certain countries in the region that some began to believe in it. The notion of Asian values is ostensibly founded on Confucian ethics, including an emphasis on the family, hierarchy and order, education, and the predominance of a group orientation over individualism. However, some nations in the region do not have a strong Confucian tradition, including Thailand, Indonesia, and the Philippines. Thus, the notion of the Asian way and the putative, deeply rooted, Asian cultural traditions, have often been invented or exaggerated by government elites wanting to get a tighter grasp on the nature and direction of reforms and development.⁵²³ Lincoln believes the notion of Asian values was advanced mainly by Singapore and Malaysia as a means of fleshing out their national identities and aligning themselves with more powerful countries in the region, particularly Japan.⁵²⁴

A second set of related motives for establishing a more cohesive East Asian economic sphere was the recognition by Southeast Asian nations in the late 1980s that Japan was becoming a major source of much needed foreign aid and investment. While these developing nations saw the need to strengthen their political and economic alliances with Japan, Japan, on the other hand, wanted to cultivate low-cost manufacturing centers in those countries and to legitimize its distinctive economic model and corporate governance system by exporting them. Thus, it was in these nations' interests to adopt the rhetoric of Asian exceptionalism, as distinct from Western ways. The view that East Asia needed institutions to compete with the EU and NAFTA provides a third motive for creating an East Asian

522. See *id.* at 140.

523. See, e.g., Frank K. Upham, *Weak Legal Consciousness as Invented Tradition*, in *MIRROR OF MODERNITY—INVENTED TRADITIONS OF MODERN JAPAN* 48, 55–58 (Stephen Vlastos ed., 1998) (arguing that Japan's elites, wanting to channel legal disputes away from the courts where litigators might be able to forge social reforms, instead created the erroneous notion that Japanese have traditionally had a “weak legal consciousness”—an innate cultural attribute that prevents them from being litigious).

524. See, LINCOLN, *EAST ASIAN ECONOMIC REGIONALISM*, *supra* note 487, at 142.

economic block. Japanese officials, in particular, have advocated the formation of a free business zone among Japan, China, and South Korea, which they see as necessary to mitigate the trade diversion losses that it suffers by being excluded from the world's two largest regional trade blocks—the EU and the NAFTA.⁵²⁵

Perhaps, the most potent catalyst igniting the recent rally to coalesce East Asia has been the widespread anger and frustration over the way the United States and the IMF responded to the 1997 Asian financial crisis. The motivating perception was that the United States had been too financially disinterested in the region, that the IMF's conditions for assistance on bad loans were too stringent, and that Western powers were too manipulative in pushing for structural reforms in East Asia, reputedly as a strategy to capitalize on the crisis and gain a more advantageous foothold in East Asia.⁵²⁶ The fifth and most recent set of factors underlying the desire of East Asian governments to coalesce, according to Lincoln, stem from anti-American sentiment. In particular, many East Asian nations are concerned that the United States responded too unilaterally in the wake of the terrorist attacks of September 2001 and that the United States has also been overly and increasingly protective of its markets, especially its steel industry.⁵²⁷ American protectionism, according to Lincoln, is a principle economic issue prompting East Asian nations to conclude free trade agreements with their Asian neighbors.⁵²⁸

ii) *Other Manifestations of Asian Regionalism—Free Trade Agreements*

While the desire to form an East Asian economic block is largely rooted in opposition to American and Western policies, this visceral frustration has resulted in more talk than tough action. The ASEAN, which predates the trends discussed above,⁵²⁹ has always been a very loosely organized, non-legalistic institution.⁵³⁰ Nine years after its founding, ASEAN established the ASEAN Secretariat, although it has no supranational decision making power. The Bangkok Declaration, ASEAN's founding document, speaks in broad terms about its purpose, which is generally “[t]o promote regional peace and stability through abiding respect for justice and the rule of law,” and “[t]o accelerate the economic growth, social progress and cultural development in the region through joint endeavours.”⁵³¹

In 1992, ASEAN announced the creation of the ASEAN Free Trade Area (AFTA),⁵³² which obligated ASEAN members to gradually reduce their tariffs on goods traded within the ASEAN region. Following some back peddling and amendments to the agreement,

525. See *id.* at 145–47 (citing Shinji Fukukawa, *East Asia Needs a Free Business Zone*, DAILY YOMIURI, July 12, 2001, at 16).

526. See *id.* at 147–48.

527. In 2002, the Bush administration imposed punitive import duties on certain steel products from several countries, including Japan. See *id.* at 149.

528. *Id.*

529. The Association of Southeast Asian Nations or ASEAN was established as a Secretariat in August 1967 in Bangkok by the five original member countries—Indonesia, Malaysia, Philippines, Singapore, and Thailand. Brunei Darussalam joined ASEAN in 1984; Vietnam joined in 1995; Lao PDR and Myanmar joined in 1997; and Cambodia joined in 1999. For more information about ASEAN's membership and organizational structure, see its official website at <http://www.aseansec.org>.

530. ASEAN's founding document, the so-called Bangkok Declaration, was merely a political statement, requiring no ratification. See ASEAN Declaration [Bangkok Declaration], Aug. 8, 1967, available at <http://www.aseansec.org/1212.htm> (last visited Aug. 1, 2005).

531. *Id.*

532. Framework Agreement on Enhancing ASEAN Economic Cooperation (Jan. 28, 1992), ASEAN, available at <http://www.aseansec.org/1165.htm> (last visited Nov. 3, 2005) [hereinafter AFTA]. ASEAN has added several protocols to the AFTA, which are available on its website at: <http://www.aseansec.org/12039.htm>.

the target dates for complete elimination of all tariffs by the original AFTA members is set to be accomplished by 2010 and by 2015 for the newer members. Although ASEAN characterizes AFTA as a big success and claims that its goals have now all been virtually established,⁵³³ many economists and scholars are skeptical of these claims, pointing to the nontransparent means by which these alleged results were computed,⁵³⁴ and prompting some scholars to characterize the advancement towards the achievement of AFTA's target deadlines a struggle.⁵³⁵ In 2002, the six original members appeared to have lowered most of their tariffs to the target level of 5 percent, a deadline originally set for 2008. Yet, despite this seeming success, the relatively low levels of intra-ASEAN trade have lessened the efficiency gains that could have been realized had trade been more robust.⁵³⁶ Moreover, some members, most prominently Singapore, have become so impatient with the various loopholes in the AFTA and its later protocols, their many exceptions, and AFTA's deference to the foot-dragging ASEAN members, they have gone outside AFTA to set up their own bilateral trade agreements.⁵³⁷ Notwithstanding AFTA's tendency to generate other free trade agreements, some scholars have praised it as being the most rationally sound trade agreement in East Asia, given the members' geographic proximity, similar sizes, and other commonalities.⁵³⁸

In 1990, Malaysia proposed forming another group, the East Asian Economic Caucus (EEAC), whose membership was narrower than APEC's, but broader than ASEAN's. Like ASEAN, EEAC's organization was non-legalistic, but its purpose seemed more centered on the promotion of Asian values and shared opposition to Western policies. Both the United States and Australia opposed the group's formation for fear that it would diminish APEC's role in the region, leaving them out of the dialogue.⁵³⁹ The EEAC initiative eventually morphed into a successor group known as ASEAN+3, which initially included all the ASEAN members, with Japan, China, and South Korea joining the association in 1995.⁵⁴⁰ Although, like APEC and ASEAN, ASEAN+3 is not formalized by any binding, multilateral treaty and has an extremely loose organizational structure, it has nonetheless played an important role in promoting the interests of East Asia and encouraging the region's economic integration. Since the Asian debt crisis of 1997–98, the ten ASEAN countries have initiated a regular series of meetings at the cabinet and ministerial levels with their counterparts from Japan, China, and Korea, respectively.⁵⁴¹ These annual, high profile conferences

533. For a detailed ASEAN description of AFTA's alleged effects, see ASEAN's website at <http://www.aseansec.org/12021.htm>.

534. See LINCOLN, EAST ASIAN ECONOMIC REGIONALISM, *supra* note 487, at 172.

535. Teofilo C. Daquila & Le Huu Huy, *Singapore and ASEAN in the Global Economy: The Case of Free Trade Agreements*, 43 ASIAN SURV. 908, 912 (2003) [hereinafter Daquila & Huy, Singapore and ASEAN].

536. Low levels of intra-ASEAN trade may be attributable to the fact that ASEAN's members' economies and industries were more competitive than complementary of each other. See LINCOLN, EAST ASIAN ECONOMIC REGIONALISM, *supra* note 487, at 152.

537. See Daquila & Huy, Singapore and ASEAN, *supra* note 535.

538. See, e.g., LINCOLN, EAST ASIAN ECONOMIC REGIONALISM, *supra* note 487, at 168–69, 174.

539. See *id.* at 155–56.

540. The ASEAN+3 group has no formal secretariat, as all of its meetings are held in the host country. For a detailed description of the ASEAN+3 group and its initiatives, see the ASEAN official website at <http://www.aseansec.org/16580.htm>.

541. Sometimes these meetings are held on an ASEAN-plus-three basis and sometimes on an ASEAN-plus-one basis, the latter arrangement allowing the ASEAN consortium to focus more closely on the details of its relationships with each of the other three larger countries—China, Japan, and South Korea, respectively.

include meetings of the countries' ministers of foreign affairs, trade and investment, and finance, in addition to meetings by heads of state.⁵⁴²

The importance of ASEAN and its spin-off ASEAN+3 derives primarily from several key initiatives they have facilitated aimed at enhancing the trade relationships between ASEAN and the larger economic players in the region, namely China and Japan.⁵⁴³ In what could become ASEAN's crowning and most significant achievement, a new free trade agreement between the Peoples Republic of China and the ten ASEAN countries (CAFTA) entered into force on January 1, 2005,⁵⁴⁴ obligating China and the original ASEAN members, including Singapore, to establish free trade in goods by the year 2010, with the newer ASEAN countries being required to establish free trade by 2015.⁵⁴⁵ The CAFTA employs the MFN principle on a reciprocal basis to eliminate discrimination in goods, and Japan and South Korea, the other two members of ASEAN+3, are presently not part of the agreement.⁵⁴⁶

Not surprisingly, CAFTA has the potential to become the world's largest trading block.⁵⁴⁷ If it is successful, CAFTA will surpass the EU and the NAFTA in terms of the size of the economic region it encompasses (i.e., 1.7 billion consumers), and the total estimated trade it could help generate (i.e., \$1.23 trillion [U.S.]).⁵⁴⁸ It is not clear, however, that CAFTA will live up to its expectations. Scholars have pointed to the fact that the trading patterns of Southeast Asia and China are in more of a competitive posture than a complimentary one.⁵⁴⁹ The parties to the trade agreement are all primarily oriented toward exporting their manufactured products to the same industrialized countries, including the United States and Japan, not to each other.⁵⁵⁰ Thus, while the signing of the China-ASEAN free-trade agreement is a remarkable development in itself, and certainly evinces China's growing economic power and influence in East Asia, there remains a big question as to whether it can be carried out. There is no guarantee that CAFTA will generate the estimated levels of trade in East Asia, and the hoped-for efficiency gains.

Although Japan is not a party to CAFTA, its diplomatic and economic policies have clearly played an important role in strengthening the informal regional network that is

542. In 1999, representatives of the ASEAN+3 countries hammered out a joint declaration dedicating themselves to achieving the objectives of continuing structural reforms, strengthening economic and political ties, enhancing monetary and financial cooperation within the region, and intensifying their cooperative efforts with the U.N. and the WTO. See ASEAN+3 Joint Statement on East Asia Cooperation, ASEAN+3 Summit Meeting, Manila, Philippines, Nov. 28, 1999, available at <http://www.aseansec.org/5301.htm>.

543. The Chiang Mai Initiative, undertaken in Chiang Mai, Thailand in 2000, is one of the major achievements of the ASEAN+3 group. It advocated a series of agreements among the central banks in the region to swap their foreign exchange reserves with one another, thereby spreading and attenuating their inherent volatility risk in an effort to stabilize their currencies on the foreign exchange markets. For an overview of other ASEAN+3 initiatives, see ASEAN's official web site, <http://www.aseansec.org/16580.htm>.

544. See CAFTA, *supra* note 486, art. 23(1) (Entry into Force).

545. *Id.*

546. *Id.*

547. See Vincent Wei-Cheng Wang, *The Logic of China-ASEAN FTA: Economic Statecraft of "Peaceful Ascendancy,"* in CHINA AND SOUTHEAST ASIA: GLOBAL CHANGES AND REGIONAL CHALLENGES 17, 26 (Ho Khai Leong & Samuel C.Y. Ku eds., 2005) [hereinafter Wei-Cheng Wang, China-ASEAN FTA].

548. See ASEAN-CHINA EXPERT GROUP ON ECONOMIC COOPERATION, FORGING CLOSER ASEAN-CHINA ECONOMIC RELATIONS IN THE TWENTY-FIRST CENTURY 2, 30 (2001), available at http://www.aseansec.org/new-data/asean_chi.pdf (last visited Nov. 14, 2005).

549. See John Wong & Sarah Chan, *China -ASEAN Free Trade Agreement: Shaping Future Economic Relations*, 43 ASIAN SURV. 507, 517 (2003).

550. See *id.*

emerging in East Asia. The Asian debt crisis of 1997–98 gave Japan new opportunities to strengthen its somewhat paternalistic role in the region. Desiring to establish itself as the de facto leader of East Asia, but not wanting to alarm its neighbors or the United States by advocating formal institutions, Japan has sought to bind the region by unilaterally increasing its own level of foreign aid and investments in nearby developing countries; finessing its historically troubled relationship with China by making diplomatic overtures (especially following China's Tiananmen Square Massacre), and attempting to speak for Asia at international meetings.⁵⁵¹ All of these actions demonstrate Japan's aspiration to build an informal East Asian economic block, with Japan at its hub, which would enable Japan to more rigorously pursue its own economic agenda.

At the 2003 ASEAN+1 summit meeting in Tokyo, Japan and ASEAN leaders executed the Tokyo Declaration,⁵⁵² pledging the countries to form a closer East Asian community, and to consider implementing various trade liberalizations by the year 2012. The Tokyo Declaration, however, is broadly drafted, covers many areas, and does not begin to approximate a regional free trade agreement on the order of CAFTA. In fact, the provisions mentioning trade barriers are rather vague, reflecting Japan's historical reluctance to open its borders to free trade and unbridled foreign investment.

Thus, despite Japan's recent commitments and its continual reminders to the ASEAN countries of its long and mature relationship to Southeast Asia, China has seized much of the momentum for economic integration in East Asia. Compared to China's commitment to form an explicit free-trade zone, Japan's recent proposals for lowering barriers to cross-border trade and investment appear hesitant and vague, its commitment seems comparatively weak, and its leadership role rather faltering. Thus, while China's star is rising, Japan's presumed role as East Asia's putative leader and spokes-nation appears to be fading.

XIII. Whither the Direction of International Tax Regulation?

The foregoing discussion has delineated the major deficiencies in the OECD bilateral tax treaty network⁵⁵³ and evaluated some major alternatives to bilateralism, including the advantages and drawbacks of forming an explicit multilateral tax treaty; a supranational body similar to the WTO; and cooperative tax agreements under the umbrellas of existing regional free-trade areas.⁵⁵⁴ This Part XIII is devoted to my claim that, despite its flaws and weaknesses, the OECD bilateral tax treaty network, which operates within the informal, multilateral, consensus seeking framework provided by the OECD and its Model Treaty, is still the best institutional approach for allocating international tax authority, given the broad spectrum of economies, domestic tax rules, and diverse political regimes. Not only does the informal OECD network appear to be the most promising alternative in terms of its dedication to preserving the traditional tax policy objectives of "neutrality, efficiency,

551. See LINCOLN, EAST ASIAN ECONOMIC REGIONALISM, *supra* note 487, at 153–55.

552. Tokyo Declaration for the Dynamic and Enduring Japan-ASEAN Partnership in the New Millennium, Dec. 12, 2003, available at <http://www.aseansec.org/15500.htm> [hereinafter Tokyo Declaration].

553. See discussion *supra* Part XII.A.

554. See *supra* Part XII.B (discussing a binding multilateral treaty based on the OECD Model Treaty), Part XII.C (evaluating the possibility of using a supranational institution like the WTO to enhance international tax cooperation), and Part XII.D (exploring the viability of using regional free trade agreements as models for harmonizing national tax systems, especially in the diverse Asian-Pacific and East Asian regions).

certainty and simplicity, effectiveness and fairness, and flexibility,⁵⁵⁵ it also appears to be the most pragmatic and economically efficient option available.⁵⁵⁶ An informal network, like that provided by the OECD, is better than the institutional alternatives at preserving nations' fiscal sovereignty; maintaining flexibility by providing alternative standards and soft law enforcement mechanisms; and proceeding organically towards the goal of global tax cooperation through transgovernmental channels of communication and less restrictive, bilateral links. But, to adapt to the challenges posed by the digital commerce revolution, and the increased integration and mobility of multinational firms, the OECD network will have to change. If the network fails to flexibly evolve in a way that incorporates the interests of more diverse economies, the risks that international tax cooperation will be weakened by regionalism will rise.

This Part is divided into four sections. The first describes how the bilateral tax treaty network is exhibiting certain synergistic attributes, known in economics as network effects, which serve to increase the value and utility of the network to participating Contracting States, especially as it expands. In particular, so-called *transgovernmental networks*, comprised of Contracting States' national tax administrators, competent authorities, and contributing academics, appear to be serving a key cooperative function by dialoguing, increasing information flows, establishing informal standards and expectations to bolster compliance with explicit treaty rules and principles, resolving taxpayer disputes, and also addressing systemic problems within the broad parameters of the bilateral network, thereby lowering transactions costs. The second section seeks to defend the bilateral tax treaty network from the sharp criticisms it has received, and argues that rather than it being time to completely replace the network and substitute a different institutional approach, it is time to recognize the OECD's growing status and value as the world's informal international tax organization. The third section focuses again on the new Japan-U.S. Tax Treaty, and considers the extent to which it is signaling new norms and inspiring reforms—particularly in Asia, where many developing countries are only now negotiating modern tax treaties. In this context, the continued viability of the alleged anachronistic principles, income source and taxpayer residency, as a means to delineate nations' tax sovereignty is finally evaluated.

A. NETWORK EFFECTS OF OECD BILATERAL TAX TREATIES

In the economics literature, “network effects” has generally referred to a group of theories focused on the question of whether and to what extent “the utility that a user derives from consumption of a good [or service] increases with the number of other agents consuming the good [or service].”⁵⁵⁷ In other words, a network effect exists where a consumer of a good or service, or a user of the network, finds that the good, service, or network, has greater utility and value as more consumers buy the good, subscribe to the service, or plug-in to the

555. See OECD Ottawa Taxation Framework, *supra* note 310 (reiterating “a set of broad taxation principles that should apply to e-commerce” that were part of the Ottawa Taxation Framework Conditions adopted at the Ottawa OECD Ministerial Conference in 1998).

556. These claims are offered hypothetically since more empirical analyses are needed to fully substantiate them. The economic network effects of the OECD's bilateral tax treaty consortium would likely be an interesting and fruitful area for further study.

557. Michael L. Katz & Carl Shapiro, *Network Externalities, Competition, and Compatibility*, 75 AM. ECON. REV. 424, 424 (1985) [hereinafter Katz & Shapiro, *Network Externalities*]; See also Philip H. Dybvig & Chester S. Spatt, *Adoption Externalities as Public Goods*, 20 J. PUB. ECON. 231, 231–32 (1983).

network. The term network effects has been applied not only to situations where the thing being acquired is identical to the things being acquired by others, but also to circumstances where the value of the thing being acquired increases because another person or entity has something that is compatible with it.⁵⁵⁸ The analysis of the network effects of various organizations and business cultures has become increasingly popular in the law-and-economics literature.⁵⁵⁹ However, the phenomenon of network effects is not new or novel; rather, it is ancient and pervasive. For example, any language exhibits network effects because the benefits of being able to speak and understand the language increase as the language becomes more common. The Internet provides an obvious example of network effects since the benefits of being connected to it increase as more websites, people, and organizations are accessible on-line. Likewise, the value of Microsoft Windows increases, and the value of other incompatible operating systems generally decrease, as Windows becomes more dominant in the marketplace. Moreover, software and systems that are merely compatible with Windows become more valuable. Linux is Windows's competitor, but even it may indirectly benefit from the network effects of Windows's dominance to the extent that it generates new software developers for Linux.

One way of analyzing the effects of networks is to view them along a spectrum where networks employing tangible, physical links (e.g., telephone or Internet connections) are situated at one end, networks employing less tangible links are situated at the other end (e.g., informal discussion groups), and networks employing virtual links are in between (e.g., software users).⁵⁶⁰ Physical, virtual, and intangible networks can generate positive, value-adding effects, characterized by extensive information sharing, brainstorming, collaborating, and joint problem solving, among others benefits. Conversely, all networks can exhibit negative effects, which can be triggered by various causes, including overuse and congestion on the network. To take a simple example, if the network of freeways leading into New York City is overused, gridlock can result, lowering the value of that particular network. When the costs of using the network of highways exceed the benefits, users will search for and choose another network, like subways or water taxis.

Networks can result in a phenomenon known in the economics literature as lock-in, when an emerging standard quickly spreads throughout the network to the point of displacing competing standards—even ones that may be inherently superior in the long run. Thus, the lock-in effect or tipping as it is sometimes called, can lead to inefficiencies when a particular standard is popularized and becomes dominant in a network, not because it is necessarily superior to other standards, but rather due to the jump-on-the-bandwagon effect. Because network users need to communicate with each other, a particular language or standard can be so promoted among the users that at some point, the network itself

558. See Lemley & McGowan, *Legal Implications of Networks*, *supra* note 334, at 483 (citing Joseph Farrell & Garth Saloner, *Standardization, Compatibility, and Innovation*, 16 RAND J. ECON. 70, 70 (1985)).

559. See, e.g., Katz & Shapiro, *Network Externalities*, *supra* note 557; Lemley & McGowan, *Legal Implications of Networks*, *supra* note 334; Robert B Ahdieh, *Making Markets: Network Effects and the Role of Law in the Creation of Strong Securities Markets*, 76 S. CALIF. L. REV. 277 (2003); Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 764 n.16 (1995); Dennis W. Carlton & J. Mark Klamer, *The Need for Coordination Among Firms, with Special Reference to Network Industries*, 50 U. CHI. L. REV. 446, 450 n.15 (1983); DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE 7–8 (1990) (very broad application of both path dependence and network effects).

560. See Kal Raustiala, *The Architecture of International Cooperation: Transgovernmental Networks and the Future of International Law*, 43 VA. J. INT'L L. 1, 63 (2002) [hereinafter Raustiala, *International Cooperation*].

seems to generate the momentum for the resulting dominance of the language or standard. The well known contest between VHS and Betamax to dominate the videotape world is often used to illustrate the lock-in effect. VHS became the dominant standard, not because it necessarily had superior technology, but rather because VHS was able to acquire more users to the point that it had a tipping effect. This lock-in tendency of networks is the motive underlying the common practice of software companies like Microsoft, as well as Internet providers like MSN, to distribute copies of their software packages or even web browsers for free. They recognize that one of the economic effects of networks is that they tend to create standards as the network expands, and as it expands, both the users and the proprietor of the standard usually benefit.

1. *Direct and Indirect Effects of OECD-based Bilateral Tax Treaties*

Obviously, the Japan-U.S. Tax Treaty, standing alone (i.e., without regard to the OECD tax treaty network) benefits the taxpayers of both countries by immediately lowering cross-border transaction costs and mitigating risks associated with uncertainty and lack of information. To the extent that tax barriers to trade between Japan and the United States are lowered, CEN is served,⁵⁶¹ ostensibly increasing global welfare (assuming that the economic distortions caused by any trade diversion do not exceed the levels of trade creation).⁵⁶² These benefits are generally derived from the bilateral treaty itself, not from the larger, informal OECD network of bilateral treaties, of which the Japan-U.S. Tax Treaty is a part. Technically, these inherent benefits are not network effects.

Network effects can be direct or indirect. The fact that the Japan-U.S. Tax Treaty is part of the OECD network generates benefits to the taxpayers, to Japan and the United States as sovereign countries, and to third-party countries that have similar bilateral tax treaties. Direct network effects result from the immediate increase in value that other countries belonging to the tax treaty network experience as a result of an additional treaty being added to the network. However, compared to a multilateral treaty, the direct effects of negotiating a new bilateral tax treaty are more limited because third-party countries cannot take advantage of the latter. Whereas a user of the Internet is able to connect directly to all other Internet users, a resident of Japan, for example, can normally only claim reduced tax rates on cross-border income pursuant to the bilateral tax treaties that Japan has entered into because residency is one of the prerequisites for that treaty benefit.⁵⁶³ A Japanese resident cannot claim a reduced withholding rate on a Chilean-sourced royalty since Japan has no tax treaty with Chile, even though both Japan and Chile have bilateral tax treaties based on the OECD Model with other countries, and are thus members of the informal OECD Tax Treaty network.

However, as more bilateral tax treaties are added to the informal OECD network, an indirect effect is the increased value and utility of the network to numerous countries around the world, not only to those that are formal members of the OECD, but also to non-member countries that have treaties based on the OECD Model, to developing countries that have treaties based on the U.N. Model (which is similar to the OECD Model), and to countries that seek to form cooperative tax agreements in the future. The indirect

561. See Part II *supra* discussion providing a discussion of a possible explanation for capital export neutrality CEN.

562. See JACOB VINER, *THE CUSTOMS UNION*, Issue 44(1950).

563. See Japan-U.S. Tax Treaty, *supra* note 1, at art. 1(1).

benefits of an expanding, robust, bilateral treaty network are extremely diverse and not always easy to identify, let alone quantify. They are defined, in part, by the beneficiary's identity and posture. In this context, indirect network effects can include, *inter alia*, access to a common set of tax treaty articles, well-known principles, and recurrent issues arising out of the network's overwhelming reliance on the OECD Model Tax Treaty; broader access to OECD enforcement efforts and to information about taxpayer activities in other countries;⁵⁶⁴ the opportunity to discuss and ideate beliefs concerning the proper interpretation and application of tax treaty provisions,⁵⁶⁵ as well as the best methods for handling recurrent issues like transfer pricing techniques, financial instruments, hybrid transactions, electronic commerce, treaty shopping, and harmful tax subsidy competition; increased opportunities to promote certain regulatory standards within the network;⁵⁶⁶ harmonization of treaty policies; and the cost savings associated with the ability to obtain off-the-shelf tax regulation, which is effectively provided by the OECD Model Tax Treaty.

According to the economic theory, the addition of the new Japan-U.S. Tax Treaty to the OECD network will generate many, if not most, of these network effects. As further discussed below, the network makes it more likely that certain provisions in the new Treaty, such as its complete elimination of withholding tax on certain categories of portfolio income,⁵⁶⁷ will set a new global standard and become an objective in treaty negotiation. Moreover, the mere fact that the world's two largest industrial giants have negotiated a new OECD-based bilateral tax treaty, incorporating what ostensibly is the latest thinking on some difficult issues, has the effect of affirming for other countries in the network, that this bilateral method of obtaining international tax cooperation is not being degraded or in serious danger of being replaced by another institution in the near future. This strong affirmation enhances the reputational value of other bilateral tax treaties (especially those with similar, updated provisions), as well as the prestige of belonging to the network.

a. *Standardization in OECD Network—Risk of Lock-In*

As mentioned, networks have a tendency to standardize rules and regulations. This effect is evinced by the rapid and widespread adoption of bilateral treaties based on the OECD Model, which now number over 2500 treaties. Networks increase the incentives for regulatory convergence because the more similar a particular nation's laws, tax rules, and treaties are to other jurisdictions' laws, rules, and treaties, the easier it is to transact business, access markets, and create political alliances. As the OECD network has expanded, so too have the incentives for countries to adopt the Model's standard treaty provisions. Frequently, the policies that have become the Model's standards were borrowed (or exported) from the more influential nations belonging to the network. For example, Articles 10, 11, and 12, allocating to the Residence State most of the authority to tax portfolio income, became the part of the 1920s' Compromise reflected in the OECD Model because that allocation rule

564. See *supra* Part XI.B. (discussing Exchange-of-Information article (Article 26) in the Japan-U.S. Tax Treaty).

565. See *supra* Part XI.A. (discussing Mutual Agreement Procedure (Article 25) of the Japan-U.S. Tax Treaty).

566. See *supra* Part VI (discussing the likely impact of the Japan-U.S. Tax Treaty's treatment of fiscally transparent and hybrid entities in Article 4(6) and noting that "because it is the world's two largest economic powers that have agreed to this complex but useful provision . . . their inclusion of it may signal . . . a growing consensus that the OECD's approach to fiscally transparent entities is pragmatic and the best solution . . .").

567. See *supra* Part IV.A. (discussing the elimination of withholding tax on royalties, certain dividends, and certain categories of interest).

served the interests of the influential, industrialized countries.⁵⁶⁸ The U.N. Model,⁵⁶⁹ which is more closely aligned with the interests of developing countries, allows the Source State to tax portfolio income at higher rates, which serves the interests of developing countries. Of course, one of the most salient examples of regulatory convergence within the OECD tax treaty network is the OECD's adoption of the arm's length standard for pricing transactions between associated enterprises.⁵⁷⁰ Again, because the industrialized countries are the ones that have most frequently been faced with transfer pricing issues, their standard was the one adopted by the network.⁵⁷¹

Once a regulatory standard becomes dominant in a network, there is often little incentive for states to change course, even if a more efficient standard exists, because the costs of making the switch seem too high. As earlier discussed, many tax scholars have argued vociferously that the arm's length standard for pricing inter-company transactions has reached the tipping point within the OECD network, causing it to be locked-in even though a formulary apportionment method would, according to them, be a better alternative in a world where firms are increasingly integrated and mobile, and transactions increasingly digital and invisible.⁵⁷² Clearly there are reasons to be concerned that the 1920s' Compromise of allocating tax authority between countries on the basis of income source and taxpayer residence has become an inadequate and outdated allocation method. These principles were adopted in another era when business enterprises were usually identifiable by the bricks and mortar that housed them. Value creation in the new, electronic, global marketplace strains many other key treaty concepts like permanent establishment and arm's length price, making income allocation more difficult. The ambiguous site of firms exacerbates the dual threats of noncompliance and double taxation. Proponents of formulary apportionment believe that the existing system of bilateral tax treaties is just not up to the task of handling the challenges posed by globalization and electronic commerce. Some contend that the Information Age necessitates a whole new supranational institution to replace the bilateral network, so that new allocation rules can be administered.⁵⁷³

However, this contention is paradoxical because the risk that an inefficient standard will get locked into an explicit network (e.g., a network circumscribed by a binding multilateral treaty), is theoretically greater than the risk existing in a nonbinding, virtual network like the informal OECD consortium. Indeed, it could be argued the EU's network of Member States is presently being infected by an inefficient standard for allocating income: the European Court of Justice's unbridled nondiscrimination doctrine,⁵⁷⁴ which some well-versed

568. See *supra* note 35 and accompanying text (discussing how nonindustrialized countries, wanting their own model tax treaty, signed treaties based on the United Nations Model Tax Treaty, which more strongly reflects the Mexico Model (i.e., source based taxation) than the London Model (i.e., residence based taxation). (However, because the U.N. Model has relied on the 1977 OECD Model as its starting point, the framework and much of the textual language of the two models is similar.)

569. See discussion *supra* note 35.

570. See *supra* Part V (discussing how the Japan-U.S. Tax Treaty imposes the arm's length standard) and Part XII.C.2 (evaluating the advantages and weaknesses of the formula apportionment method, as opposed to the arm's length standard).

571. See *infra* Part XIII.B.3 (setting forth a brief overview in the footnotes of the development of transfer pricing rules in the OECD, the U.S., Japan, and China).

572. See *supra* Part XII.C.2, notes 389-91 and 394-404 (citing scholars who favor some kind of formula apportionment method, and evaluating such method).

573. See *id.*

574. See *supra* Part XII.D.3.b (discussing recent decisions of the ECJ invalidating EU Member States' tax laws on grounds they infringed one of more of the four freedoms guaranteed by the EC Treaty).

international tax scholars believe leads to an incoherent result.⁵⁷⁵ Network theorists have observed that open and informal networks, as opposed to closed and explicit ones, usually provide an environment where network members have opportunities to choose among a multiplicity of alternate standards, thus mitigating the risk that an inefficient standard will become dominant, displacing more efficient ones. Indeed, one of the principle tenets of antitrust jurisprudence is that fair competition in a marketplace serves the policy objective of economic efficiency.⁵⁷⁶ Although proponents of formulary apportionment contend that a supranational tax institution like the WTO would be better equipped than the loose OECD consortium of bilateral treaty partners at selecting the most efficient international tax rules, that contention contravenes market principles and rational choice theory, which argues that rational, self-interested actors (e.g., Nation States or market participants) are extremely good at making efficient choices if they have adequate information and opportunities to act.⁵⁷⁷

2. *Transgovernmental Networks*

A fundamental question now facing the OECD countries is whether electronic commerce is so dissimilar from traditional forms of commerce as to merit a paradigm shift in the existing international tax order. The answer to this question will depend on whether the OECD's transgovernmental network can dissuade competing tax policy architectures by garnering sufficient resources in time to help governments create regulatory and fiscal environments that strike a balance between the need to promote electronic commerce "and the need to secure a revenue base on which so much government expenditure is based."⁵⁷⁸ An ongoing debate is whether the OECD's Model Treaty, and the architecture of bilateral agreements it has spawned, is designed to handle this challenge. Fifteen years ago, Professor Richard Vann of Australia noted that as the OECD bilateral tax treaty network expands, the more difficult it is for the entire network to accept a major change in the OECD Model or to take a novel approach:

Although it is possible to refine the actual terms of the OECD Model and to elaborate the commentary so as to cover new cases as they arise, the time has passed for radical revision within the current bilateral framework. In a sense the opportunity to go in another direction was lost before the 1963 draft appeared. The failure to adopt any new approach to international tax after

575. See Graetz & Warren, *Income Tax Discrimination*, *supra* note 252, at 1219 (arguing that regulating the division of the tax base between source and residence countries in the EU, from a principle of nondiscrimination as articulated by the ECJ "ultimately produces an incoherent result.").

576. See Mark A. Lemley & David McGowan, *Could Java Change Everything? The Competitive Propriety of a Proprietary Standard* (Feb. 1998), available at <http://ssrn.com/abstract=57515> (arguing that open standards may be achieved in the open market. Where they are not, the law may intervene, but it must be cautious not to overreach and to avoid disturbing the incentives provided by intellectual property protection.); Franklin M. Fisher & Daniel L. Rubinfeld, *United States v. Microsoft: An Economic Analysis*, 46 ANTITRUST BULL. I (2001) (commentary on the economic issues presented in the Microsoft antitrust case by two economists who testified in the case); Nicholas Economides, *The Microsoft Antitrust Case*, (N.Y.U. Center for L. & Bus., Working Paper No. 01-003, 2001), available at <http://ssrn.com/abstract=253083> (analyzing the legal and economic issues in the landmark antitrust case, *U.S. v. Microsoft*, involving the propriety of antitrust intervention in network industries). The roots of the neoclassical economic theory of general equilibrium stretch back to the Lausanne School of Economics, founded by Leon Walras and Vilfredo Pareto around the turn of the nineteenth century.

577. See Marc-Andreas Muendler, *The Existence of Informationally Efficient Markets when Individuals are Rational* (Center for Econ. Stud. & Info. Inst. For Econ. Res. Working Paper Series, Paper No. 1295, 2004), available at <http://ssrn.com/abstract=612142>.

578. OECD Ottawa Taxation Framework, *supra* note 310, at 11.

the Second World War (compared to trade law and the international monetary system) meant that effectively the solution adopted after the First World War continued by default. In other words, the OECD Model is the culmination of 50 years of development, rather than a new departure.⁵⁷⁹

Skeptical of the OECD network's flexibility, Professor Vann has been one of the more vocal proponents of adopting a whole new GATT-like approach to tax cooperation, which he says would be an optimal model for the Asian Pacific region.⁵⁸⁰ However, as mentioned, a growing number of economists and legal scholars are not as doubtful of a large international network's ability to evolve, and seem confident of a network's ability to support the sovereignty of Nation States and to supplement the States' existing treaty relationships.⁵⁸¹ This theory, known as transgovernmentalism, has emerged in the international relations literatures as economies have become increasingly integrated. Transgovernmentalists believe:

that, despite many claims to the contrary, the [nation] state is not disappearing as the major force in the international system. The state is instead *disaggregating* for purposes of cooperation: domestic officials are reaching out to their foreign counterparts regularly and directly through networks, rather than through state-to-state negotiation of the kind that dominated 20th century cooperation.⁵⁸²

To deal with the regulatory problems presented by the globalization process, transgovernmental networks are expanding rapidly and organically in many areas of international law, including antitrust, environmental, securities, and tax law. These loosely structured networks are typified by direct interaction between domestic officials, agency regulators, and academics; peer-to-peer meetings and conferences formed to study specified problems; and joint policy-making activities, including the establishment of special task forces and goals aimed at achieving higher levels of international cooperation. The networks are transgovernmental (rather than international) because they typically function with minimal interference by high level, national bureaucrats.⁵⁸³

The OECD is an example of a transgovernmental network even though it has an established secretariat structure. Even its name—the Organisation of Economic Co-Operation and Development—seems to subscribe to the whole theory of transgovernmentalism. On closer examination, the progress that the OECD has made on its recent initiatives addressing major problems presented by globalization demonstrate that the OECD's strategy of relying heavily on soft law without binding commitments, monitoring, and peer-to-peer policy making

579. Vann, *Treaty for the Asian-Pacific?*, *supra* note 30, at 103 (citation omitted).

580. *See id.* at 160–63.

581. Raustiala, *International Cooperation*, *supra* note 560, at 6 (“Under some conditions networks should make treaties work better. Under other conditions networks perform a gap-filling role.”); *cf.*, David Zaring, *Informal Procedure, Hard and Soft*, in *International Administration*, 5 *CHI. J. INT'L L.* 547 (2005) (The internationalization of regulation “has occurred quietly—not through laws passed by legislatures, treaties agreed to by executives, or mandates laid down by international organizations such as the United Nations. Instead, the internationalization of regulation has happened informally, and the primary impetus for its development has been domestic bureaucracies themselves.”). *See also* Andrew T. Guzman, *Is International Antitrust Possible?*, 73 *N.Y.U. L. REV.* 1501, 1504 (1998) (“The incentives facing individual countries make it extremely difficult—perhaps impossible—to negotiate substantive international antitrust agreements.”).

582. Raustiala, *International Cooperation*, *supra* note 560, at 10–11 (citing Andrew Moravcsik, *Taking Preferences Seriously: A Liberal Theory of International Politics*, 51 *INT'L ORG.* 513 (1997)); Anne-Marie Slaughter, *International Law in a World of Liberal States*, 6 *EUR. J. INT'L L.* 503 (1995) (footnote omitted).

583. *See* Raustiala, *International Cooperation*, *supra* note 560, at 9–11, 63–64.

through its Technical Advisory Groups, is increasingly effective at getting governments to take coordinated steps to adapt their tax regimes to the Information Age. Specific OECD initiatives include the OECD's Transfer Pricing Guidelines; the 1998 Report on Harmful Tax Competition; the E-Commerce Tax Report and Recommendations; the Bank Secrecy Report; the Financial Task Force Money Laundering Report; and amendments to the Model Tax Treaty itself.⁵⁸⁴ The impact of these OECD initiatives extends far beyond the countries that are formal members of the OECD club.⁵⁸⁵ Indeed, some international legal scholars might go so far as to predict that the OECD, which typifies a transgovernmental network, will prove to be "the optimal form of organization for the Information Age."⁵⁸⁶ While this characterization seems overstated given the glaring deficiencies in the present level of international tax cooperation, many scholars seem too eager to go back to the tax policy drawing board and start from scratch, not recognizing the relative success of the OECD's recent initiatives.⁵⁸⁷

B. OECD TAX TREATY NETWORK: EVOLVING AND ADDING VALUE

Despite the rapid proliferation of bilateral tax treaties since World War II, both bilateralism and the OECD's informal approach to obtaining international tax cooperation have come under heavy attack from critics, especially since the digital revolution of the 1990s transformed the way business was conducted. Part XII of this article explored several major alternatives to the present system, including the possibilities of forming a binding multilateral tax treaty based on the OECD Model's text, creating a supranational tax institution similar to the WTO, and expanding the purview of regional trade agreements to include international tax issues. None of these alternatives seem convincingly viable. This section seeks to defend the OECD Model Tax Treaty and the OECD as an institution, using examples provided by the Japan-U.S. Tax Treaty. My main claim is that despite its weaknesses, the OECD's system of bilateral tax treaties, which operates within an informal, transgovernmental network, still provides the most optimal approach for achieving effective tax cooperation between diverse national economies and tax regimes in the Information Age. In addition, methods to improve the present system to surmount its current challenges are suggested at the end.

1. *Does the Nonbinding Nature of the OECD Network Hurt or Help Tax Cooperation?*

a. Criticism

Those calling for a new supranational institution to oversee the development of international tax policy have long contended that a major weakness of the present international tax system is that the OECD has no explicit power to bind its members, enforce the tax

584. See Cockfield, *OECD as Informal World Tax Organization*, *supra* note 393, at 184; Ault, *International Cooperation in Forging Tax Policy*, *supra* note 353, at 1696 (noting the OECD's accomplishments in achieving international tax cooperation without binding commitments).

585. Some scholars, who are skeptical of the OECD's impact and have called for a paradigm shift in international tax cooperation, have observed that developing countries tend to identify the OECD "as the rich countries' club." Revven S. Avi-Yonah, *Treating Tax Issues Through Trade Regimes*, *supra* note 315, at 1689.

586. Anne-Marie Slaughter, *Governing the Global Economy Through Government Networks*, in *THE ROLE OF LAW IN INTERNATIONAL POLITICS: ESSAYS IN INTERNATIONAL RELATIONS AND INTERNATIONAL LAW* 204 (Michael Byers ed., 2000) (arguing that transgovernmental networks, in general, will prove to be the "optimal form of organization in the Information Age.").

587. See *supra* Part XII.C.2, notes 389–91 and 394–404 (citing scholars who favor some kind of formula apportionment method, and evaluating such method).

treaties based on its Model, or sanction countries that breach tax treaty norms. They argue that international tax cooperation suffers from the fact that the OECD Model Tax Treaty is merely a recommended draft, open to different interpretations by various Contracting States, creating conflicts in the application of identical treaty provisions. A binding multilateral treaty, according to critics, would obviate the need to renegotiate numerous tax agreements each time the OECD alters its consensus.

b. Defense

The fact that the OECD Model Tax Treaty is not explicitly binding lies at the heart of its astonishingly high level of acceptance. Sovereign nations find it easier to enter bilateral agreements than multilateral agreements, which require a greater sacrifice of their tax sovereignty. The Model's success is evinced by the fact that there are now over 2500 bilateral tax treaties, the vast majority of them with structural features similar to the OECD Model Tax Treaty.⁵⁸⁸ Apart from sovereignty concerns, a second reason why the OECD has been so successful in advancing its Model, as well as its many proposals concerning complex and sensitive tax issues, is that countries can incorporate as many or as few of the propounded rules and principles as they wish in their tax treaties and related practices. The OECD's lists of best practices, like the OECD Model Tax Treaty itself, are not put forth as binding multilateral agreements or even strict templates, but rather as recommendations and suggested blueprints. This soft law method is effective. More often than not, new treaties, like that between Japan and the United States, incorporate the OECD's latest thinking on various problems.⁵⁸⁹

Given all the hype over the potential benefits of strong-form convergence, it is somewhat ironic that the OECD has steadily built a multilateral consensus on so many thorny tax issues. Although the OECD's power is not explicit, its influence is obvious. One can read virtually any bilateral tax treaty and find one's way around the document; the numbers of the articles are usually identical, the texts are strikingly similar, and virtually all Contracting States look to the OECD's official Commentaries for guidance on the articles' proper interpretation and application.⁵⁹⁰ Indeed, the American Law Institute has observed that "[t]he OECD Model [Tax Treaty] has almost acquired the status of a multilateral agreement."⁵⁹¹ Although not legally binding, the OECD Model is a rules-based instrument that has been forged through a multilateral, consensus-seeking process. Would this document have achieved the present level of international tax cooperation if it had, instead, been advanced as a legally binding, multilateral agreement, restricting the signatory countries' powers to design and impose taxes on the vast majority of cross-border transactions

588. See *supra* note 296 and sources cited therein.

589. See *supra* Parts IV-XII.

590. The text of the United Nations Model Convention is based on the text of the OECD Model Tax Treaty. Not surprisingly, the Commentaries to the OECD Model are often used to aid in the interpretation of similar articles of non-OECD bilateral treaties, such as those based on the U.N. Model. See BAKER, *DOUBLE TAX CONVENTIONS*, *supra* note 30, at 31. Because the U.N. Model allocates more tax from investment income to the Source State, more developing countries rely on the U.N. Model when drafting bilateral tax treaties, while industrialized countries use the OECD Model Treaty. The Introduction to the OECD Model Treaty notes that its impact "has extended far beyond the OECD area." OECD Model Tax Treaty, *supra* note 29, ¶¶ 14-15 (2005).

591. AMERICAN LAW INSTITUTE, *FEDERAL INCOME TAX PROJECT — INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION II, PROPOSALS ON UNITED STATES INCOME TAX TREATIES* 3 (1992).

affecting them in the future? It is doubtful, given that the power to tax is the very "lifeblood of government,"⁵⁹² and not lightly yielded.⁵⁹³

Despite its weaknesses, the present system of bilateral tax treaties has the singular advantage that each treaty can be tailored to account for the idiosyncrasies and peculiarities of each Contracting State's tax system and legal culture. Given the limited state of global economic and legal convergence, the bilateral tax treaty is a relatively expedient way of knitting together the nitty-gritty details of each Contracting State's tax system within a general framework of international consensus respecting tax rules and treaty interpretation as expressed in the OECD Model Treaty and the official Commentaries thereto. Although the Commentaries to the Model are not legally binding, they have gained widespread acceptance as an important tool of treaty interpretation.⁵⁹⁴

Accordingly, while the OECD Model Tax Treaty is not a binding multilateral agreement, it has been broadly influential, providing a multilateral platform extending well beyond the small circle of approximately thirty official OECD member countries. The Model has been used as a basic document of reference in treaty negotiations between non-Member States, between states participating in regional tax agreements, including the European Community, and most notably, in the revision of the United Nations Model Double Taxation Convention between Developed and Developing Countries.⁵⁹⁵ Given the present direction and recent accomplishments of the OECD, the influence of the OECD Model Tax Treaty will likely become more widespread, and the OECD, as an institution, will likely earn its increasing status as the informal world tax organization.⁵⁹⁶

2. *Anachronistic and Rigid, or Realistic and Flexible?*

a. Criticism

As mentioned, many scholars contend that treaties based on the OECD Model are too vulnerable to exploitation because of their schedular layout of discrete income categories,

592. *Bull v. United States*, 295 U.S. 247, 259 (1935) (The U.S. Supreme Court observing that "taxes are the lifeblood of government, and their prompt and certain availability an imperious need.").

593. Of course, a bilateral treaty is a negotiated limit on the Contracting States' power to tax. Unilateral decisions to reduce tax rates can be viewed as market-induced limits on tax sovereignty. See McClure, *Globalization, Tax Rules*, *supra* note 393, at 328, 329–30, 339 (observing that U.S. Treasury Secretary Paul O'Neill expressed strong reservations in 2001 about U.S. participation in the OECD's efforts to fight so-called harmful tax competition, ostensibly on efficiency and sovereignty grounds) (citing Press Release, U.S. Treas. Dept. (May 10, 2001), available at <http://www.ustreas.gov/press/releases/po366.htm>).

594. Professor John F. Avery Jones of the United Kingdom has observed that "There is surely a case for saying in the treaty itself that it is intended to be interpreted in accordance with the Commentary in force at the time of [the treaty's] conclusion." John F. Avery Jones, Visiting Professor of Taxation at the London School of Economics, and Sr. Partner at Speechly, Bircham, London, The David R. Tillinghast Lecture delivered at New York University School of Law: *Are Tax Treaties Necessary?* (Sept. 25, 1997) in 53 *Tax L. Rev.* 1, 19 (1999) [hereinafter J. F. Avery Jones, *Are Tax Treaties Necessary?*]. See *infra* Part XIII.B.4 (discussing how elevating the status of the OECD Commentaries would strengthen the present multilateral framework for international tax cooperation).

595. See United Nations Double Tax Convention Between Developed and Developing Countries, U.N. Publications (New York, 1980, 2001) (reproducing many provisions and Commentaries of the OECD Model Convention); Introduction to OECD Model Tax Treaty, ¶ 14 (2005).

596. See Cockfield, *OECD as Informal World Tax Organization*, *supra* note 393, at 136 (arguing that a formal World Tax Organization, which could impose binding rules on participating countries, is not truly necessary as evinced by the success of OECD in developing guiding principles and tax rules to confront challenges posed by e-commerce); Ault, *International Cooperation in Forging Tax Policy*, *supra* note 353, at 1696 (questioning the wisdom of making the OECD Model Tax Treaty more explicitly multilateral when international cooperation, without binding commitments, has accomplished so much to date).

and their allocation of tax authority based the income's source, the taxpayer's residence, and the so-called arm's length price. According to these critics, these concepts are anachronistic and ambiguous, inviting manipulation. They argue that a supranational tax institution with powers to issue binding tax rules would be preferable to the current system because the supranational institution could introduce an entirely new method for allocating tax authority based on a uniform, global formula, thereby eliminating reliance on the anachronistic principles of income source, taxpayer residence, and arm's length price.⁵⁹⁷

b. Defense

The concepts of taxpayer residence and income source derive from, and serve to support, the territorial jurisdiction of the Nation State. The power of the Nation State is compromised to the extent these concepts are compromised as a method of dividing up international jurisdiction to tax cross-border transactions. Presently, there is not much to indicate "that countries will soon engage in a massive surrender of national sovereignty over [their] tax [policies]."⁵⁹⁸ As the fifty-year European experiment has shown, even in regions where there is a relatively high level of social and economic integration, harmonizing sovereign states' direct taxes in a top-down fashion is extremely difficult, if not impossible.⁵⁹⁹ So far, the EU has failed in that endeavor. The political obstacles in getting a sufficient number of countries to cede sufficient levels of their taxing powers to a new supranational institution in order to hammer out a whole new deal weakening their territorial jurisdiction appear overwhelming, unrealistic, and utopian. Sovereign states are sovereign, and extremely reluctant to relinquish their inherent powers of taxation, which they use to stimulate their economies, fund public works, and institute social and economic reforms.

Although critics contend that the arm's length method of apportioning income in inter-company transactions has become increasingly arbitrary, their alternative is a simply a bad idea. A worldwide system of formulary apportionment is fraught with procedural and technical problems, some of which have probably not surfaced. There is no guarantee that worldwide formulary apportionment would be easier to administer than the present system, or less vulnerable to manipulation. To the contrary, apportionment would depend heavily on the identification of a unitary enterprise, an ambiguous concept that is bound to be manipulated and to trigger continual disputes over the interpretation of applicable local laws as any given enterprise expands or contracts over time.

Although electronic commerce and economic globalization have challenged the concepts of income source, residence, and arm's length transactions, there are many reasons to believe that the present system is becoming more flexible and organic through the synergistic efforts of transgovernmental networks within the informal multilateral framework spearheaded by the OECD. Increasingly, treaties based on the OECD Model Treaty are replacing bright-line rules with more flexible principles. There are examples of this new approach in the new Japan-U.S. Tax Treaty. For example, in Article 9, the arm's length pricing methods set forth in the OECD Transfer Pricing Guidelines are explicitly incorporated as a source of authority under the Treaty on an ambulatory basis, meaning that references to the OECD Guidelines are to that document as it evolves over time. This flexible,

597. See *supra* Part XII.C.2, notes 389–91 and 394–404 (citing scholars who favor some kind of formula apportionment method, and evaluating such method).

598. McClure, *Globalization, Tax Rules*, *supra* note 393, at 341.

599. See *supra* Part XII.D.3 (analyzing the EU's attempts to harmonize direct taxes).

principles-based approach means that the Contracting States' obligations under the Treaty may continue to evolve as the OECD Guidelines are updated to better reflect modern business practices.⁶⁰⁰

The treatment of partnerships and other fiscally transparent entities is another area in which the OECD has encouraged Contracting States to replace rigid, bright-line tests with flexible rules. As earlier explained,⁶⁰¹ Article 4(6) of the Japan-U.S. Tax Treaty essentially codifies the basic approach of the OECD Report on Partnerships by establishing the general rule that one must look to the internal tax laws of the Residence State to determine whether or not an entity is fiscally transparent and who is actually liable to tax. Thus, even though the relevant Residence State or the relevant foreign laws of the Residence State may change, Article 4(6)—requiring the State applying the Treaty to look to foreign law to determine whether or not treaty benefits should be granted—will now operate to properly assign tax jurisdiction. This new, more flexible approach represents a radical departure from the earlier promulgated treaty, which did not take into account the other State's tax treatment.⁶⁰²

The fact that the OECD is now encouraging more reliance on the decisions of the Contracting States' competent authorities through the Mutual Agreement Procedure is another way flexibility is being infused into the system. Competent authorities are a major component of the OECD's transgovernmental network, because they allow bilateral treaty partners to work out solutions to their disputes without having to cede their sovereignty to a supranational court or institution.⁶⁰³ This flexibility is clearly evident in the text of the new Japan-U.S. Tax Treaty,⁶⁰⁴ which makes the countries' competent authorities the final arbiter of many disputes arising under the Treaty.⁶⁰⁵ Admittedly, without adequate guidelines, this process can take on the spirit of a political compromise, which has prompted allegations that the authorities are engaging in horse-trading and that the taxpayer is being denied the benefit of a transparent process and well reasoned judicial decision.⁶⁰⁶

3. *Can Current Network Produce a Convergence of Tax Systems?*

a. Criticism

Critics of the present bilateral tax treaty network contend that it is not likely to produce much rule convergence—neither in nations' tax treaty practices, nor with respect to their domestic tax regimes. One of Britain's leading tax scholars, John Avery Jones, maintains that because bilateral tax treaties carry with them the incentive to maintain a bargaining position, bilateral treaties discourage meaningful harmonization of domestic tax laws.⁶⁰⁷ For example, if country X imposes exceedingly high withholding taxes on a foreign persons' X-source investment income, country X can use the prospect of lowering its high withholding taxes as a bargaining chip in treaty negotiations to extract concessions from

600. See Technical Explanation of Japan-U.S. Tax Treaty, *supra* note 9, ¶ 165; see *supra* Part V (discussing transfer pricing rules in the Japan-U.S. Tax Treaty).

601. See discussion *supra* Part VI.

602. OECD Report on Partnerships, *supra* Part VI.C.

603. See discussion *supra* note 301 (noting that critics argue that mandatory binding arbitration clauses should be introduced so that taxpayers are assured of having their tax disputes resolved).

604. See discussion of Mutual Agreement Procedure *supra* Part XI.

605. See, e.g., discussion of LOB article *supra* Part VII.

606. See discussion of Mutual Agreement Procedure *supra* Part XI.

607. See Jones, *Are Tax Treaties Necessary?*, *supra* note 594, at 3.

another Contracting State. Country X will not be motivated to lower its withholding rates through amendments to its domestic law, according to Jones, because to do so would mean relinquishing a valuable bargaining position in bilateral tax treaty negotiations.⁶⁰⁸

b. Defense

The informal network of bilateral tax treaties has proved capable not only of forging an international consensus on the proper allocation of tax authority through its Model Treaty and interpretive Commentaries, it has also shown a strong tendency to stimulate tax reforms at the domestic level through peer pressure, conciliatory dialogue, so-called soft law recommendations and, just as importantly, the desire of Contracting States to create a wider pool of countries with which they can more meaningfully communicate and conduct business. Although Contracting States are bound to think about their optimal bargaining positions in any treaty negotiation, this factor does not justify replacing the informal network of bilateral treaties with a more explicitly binding multilateral arrangement. To the contrary, this type of pre-negotiation posturing could become more pronounced if the stakes were raised in a binding multilateral treaty. The higher the stakes in the multilateral negotiation, the more of an incentive a country will have to bargain and posture.

Moreover, recent economic studies on international cooperation have concluded that so-called transgovernmental networks—the type that has evolved through the OECD's bilateral network of tax treaties—create powerful incentives for regulatory convergence, with weaker jurisdictions tending to import foreign models that comport with legal standards employed by the more powerful nations.⁶⁰⁹ Although multiple standards and rule options may continue to exist in an informal network, studies show that the incentives to cooperate are strong and largely self-executing due to jurisdictions' desire to cultivate deeper and larger markets, and advantageous political relationships.⁶¹⁰

This convergence phenomenon is evident in the OECD bilateral network. With increasing regularity, nonbinding OECD proposals, reflecting the consensus of the OECD member countries and the positions of non-member countries,⁶¹¹ are incorporated in both the OECD Model's text and the official Commentaries to the Model,⁶¹² and end up shaping the development of both real tax treaties as well as domestic law. One of the salient examples

608. *See id.*

609. *See* Raustiala, *International Cooperation*, *supra* note 560, at 68 (“[T]he existence of a network strengthens incentives for jurisdictions to seek convergence because convergence allows for deeper and broader cooperation.”).

610. *See id.* at 62–69.

611. Recognizing the growing influence of the OECD Model Tax Treaty in non-OECD-member countries, the OECD decided in 1997 to reflect their positions in the Model Treaty and its Commentaries. *See* OECD Model Tax Treaty, *supra* note 29, ¶ 14.

612. The Introduction to the sixth edition of the condensed version of the OECD Model Tax Treaty states that the revision of both the Model Treaty and the Commentaries “had become an ongoing process.” Thus, in 1991:

... the Committee on Fiscal Affairs adopted the concept of an ambulatory Model Convention providing periodic and more timely updates and amendments without waiting for a complete revision. It was therefore decided to publish a revised updated version of the Model Convention which would take into account the work done since 1977 by integrating many of the recommendations made in the above-mentioned reports.

OECD Model Tax Treaty, *supra* note 29, ¶ 9.

Between 1992 and 2005, the OECD has issued six revisions of its Model Tax Treaty and Commentaries. *See id.* ¶ 3.

of the OECD's influence in forging a worldwide consensus is the OECD Transfer Pricing Guidelines,⁶¹³ which now are: (1) expressly incorporated in the official Commentary to Article 9 (Associated Enterprises) of the OECD Model Tax Treaty;⁶¹⁴ (2) expressly incorporated as a binding commitment in the Japan-U.S. Tax Treaty;⁶¹⁵ and (3) the inspiration and foundation for many countries' domestic transfer pricing regulations,⁶¹⁶ including that of Japan and the United States.⁶¹⁷ As further evidence of convergence in this area, in 2004, Japan announced its decision to conform its transfer pricing enforcement policy to that of the OECD and to crack down on tax shelters, tax haven companies, Japanese silent partnerships, and non-performing loan schemes.⁶¹⁸

613. See Revised OECD Transfer Pricing Guidelines (as amended 2000), discussed in relation to Japan-U.S. Tax Treaty *supra* Part V.

614. See OECD Committee on Fiscal Affairs, *Commentary on Article 9 Concerning Associated Enterprises*, ¶ 1 and n.1 (noting that OECD Transfer Pricing Guidelines constitute "internationally agreed principles" and provide guidance for applying the arm's length standard of which article 9 is the "authoritative statement"). Although the Commentaries are not binding, they can "be of great assistance in the application and interpretation of the conventions and, in particular, in the settlement of any disputes." Introduction to OECD Model Tax Treaty, *supra* note 29, ¶ 29.

615. The Revised OECD Transfer Pricing Guidelines are binding authority in applying the arm's length standard under Article 9 (Associated Enterprises) of the Japan-U.S. Tax Treaty, which provides that references to the Guidelines include any future revisions of them. See *supra* Part V.

616. Most countries, including China, have developed transfer pricing rules that rely heavily on the OECD Transfer Pricing Guidelines as a general framework for their pricing methods. See AULT & ARNOLD, *supra* note 289, at 420-24.

617. In 1979, the OECD Committee on Fiscal Affairs produced an authoritative (but non-binding) report intended to describe methods and practices that were acceptable in determining transfer prices. See OECD Committee on Fiscal Affairs, *Transfer Pricing and Multinational Enterprises* (1979). Another updated report was issued in 1984, followed by the 1992 Transfer Pricing Guidelines. See OECD GUIDELINES FOR MULTINATIONAL ENTERPRISES (as amended June 27, 2000), available at <http://www.oecd.org/dataoecd/56/36/1922428.pdf>.

Japan introduced transfer pricing regulations in 1986, effective for taxable years beginning in 1987. Japan's transfer pricing rules closely correspond to the OECD Transfer Pricing Guidelines as they evolve. See Japan Nat'l Tax Agency, APA Program Report 2005 1 (Sept. 2005).

Transfer pricing under U.S. tax law has also been influenced by the OECD's reports and guidelines although, historically, the U.S. has been a leader in the area. The U.S. rules are more developed than the OECD's Revised Transfer Pricing Guidelines, and contain a hierarchy of methods that must be used. See Treas. Reg. §§ 1.482-1 to -8 (as amended). The predecessor to § 482 of the U.S. Internal Revenue Code was § 45, enacted in 1928. The provision allows the IRS to allocate income, deductions, credits, and other allowances among commonly controlled corporations "in order to prevent evasion of taxes or clearly to reflect [their] income." I.R.C. § 482(RIA 2006). Detailed regulations were promulgated under § 482 in 1986, see Treas. Reg. §§ 1.482-1 to -8 (as amended)—(the same year that § 482 was amended by the addition of a very controversial sentence allowing income from the transfer of intangibles to be priced "commensurate with the [future] income attributable to the intangible."). I.R.C. § 482. This so-called super royalty provision allows the IRS to adjust the income generated by an intangible for tax purposes if the profits of the transferee are higher than expected at the time the transaction was entered into. See *id.* Because the super royalty provision allows tax authorities to adjust allocations of the income generated by an intangible years after the deal was entered into, the provision has been heavily criticized by the OECD and other countries, on the grounds that it contravenes fundamental principles of contract law—specifically, that the buyer should be able to benefit from an unforeseeable bargain.

618. See, e.g., Gary M. Thomas, *Opportunities and Challenges in New International Tax Era in Japan*, 34 TAX NOTES INT'L 1161 (June 14, 2004) (reporting on Japan's decision to more closely conform its transfer pricing enforcement policy to that of the OECD and to crack down on tax shelters, tax haven companies, Japanese silent partnerships, and non-performing loan schemes); Cockfield, OECD as Informal World Tax Organization, *supra* note 393 (detailing how the OECD was able to persuade over forty countries with so-called harmful tax regimes to dismantle certain aspects of their tax regimes, reforming their laws, and enhancing transparency and information exchange).

The OECD's influence is also evident in the development of special treaty rules and domestic legislation to deal with the taxation of fiscally transparent entities,⁶¹⁹ thin capitalization,⁶²⁰ and abusive conduit structures.⁶²¹ As mentioned, the method of dealing with fiscally transparent entities in Article 4(6) of the Japan-U.S. Tax Treaty is derived from an OECD Report. This same innovative approach is being incorporated into more bilateral tax treaties, as well as national tax laws.⁶²² The OECD reports on thinly capitalized companies and conduit structures have been equally influential in shaping normative rules—both national and international—to address exploitive tax practices.⁶²³ Indeed, the Japan-U.S. Tax Treaty reflects the conclusions reached in these OECD-sponsored studies throughout its text.⁶²⁴ The OECD's program to study the effects of electronic commerce has resulted in a set of broad tax principles applicable to electronic commerce, which have been well received, as well as detailed guidance on recordkeeping, audit, and administrative procedures that countries can use to avoid the evasion of taxes.⁶²⁵

Perhaps the most stunning recent demonstration of the OECD's power to effect real changes in domestic tax policies is its recent success in persuading over forty countries with so-called harmful tax regimes⁶²⁶ to dismantle certain aspects of their regimes by reforming their laws, enhancing their transparency, and cooperating in better information exchanges.⁶²⁷ Accordingly, the OECD has demonstrated its influence in the domestic tax law sphere. With

619. See OECD Report on Partnerships, *supra* Part VI.C., ¶ 1.

620. See OECD Committee on Fiscal Affairs, *Report on Thin Capitalisation* (Paris: OECD, Nov. 26, 1986), reproduced in volume II of the loose-leaf version of the OECD Model Tax Convention on Income and Capital, at p. R(4)-1.

621. See OECD Committee on Fiscal Affairs, *Double Tax Conventions and the Use of Conduit Companies*, in *INTERNATIONAL TAX AVOIDANCE AND EVASION: FOUR RELATED STUDIES* (1987), reproduced in Vol. II of the loose-leaf version of the OECD Model Tax Convention, at PP R(5)-1 and R(6)-1.

622. U.S. tax regulations targeting abusive, cross-border, financing schemes involving hybrid entities and treaties employ a mechanism similar to that reflected in the OECD Partnership Report and Article 4(6) of the Japan-U.S. Tax Treaty. See Treas. Reg. § 1.894-1(d) (as amended in 2002) (disallowing tax treaty benefits for certain payments made to or by a "domestic reverse hybrid entity").

623. See, e.g., I.R.C. § 163(j) ("Limitation of deduction for interest on certain indebtedness.") (RIA 2006); I.R.C. § 7701(l) (authorizing regulations "recharacterizing any multiple-party financing transaction as . . . appropriate to prevent avoidance of any tax imposed by this title.") Regulations under I.R.C. § 7701(l) were issued in 1995, and allow the IRS to "disregard . . . the participation of one or more intermediate entities in a financing arrangement" for purposes of §§ 871, 881, 1441, and 1442 (i.e., the withholding tax). See Treas. Reg. § 1.881-3(a)(1) (1995); Treas. Reg. § 1.894-1(d) (as amended in 2002) (disallowing tax treaty benefits for certain payments made to and by a "domestic reverse hybrid entity").

624. See, e.g., *supra* Part IV.A.1-3 (discussing withholding limits on royalties, dividends, and interest), Part V (discussing transfer pricing), Part VI (discussing new approach to tax arbitrage involving hybrid entities), Part VII (discussing the prevention of treaty shopping in Article 22 of the Japan-U.S. Tax Treaty), Part XI (discussing recent OECD initiatives reflected in the Mutual Agreement Procedure (Article 25) and the Exchange-of-Information article (Article 26) of the Japan-U.S. Tax Treaty).

625. For an overview of the issues raised by electronic commerce, see OECD Conference Report, Finland, Nov. 19-21, 1997, *Dismantling the Barriers to Global Electronic Commerce*, available at <http://www.oecd.org/dataoecd/37/55/2751237.pdf>, and OECD Ottawa Taxation Framework, *supra* note 310.

626. For an overview of the initiative on harmful tax competition, see OECD Committee on Fiscal Affairs, *Harmful Tax Competition*, *supra* note 310; OECD Forum on Harmful Tax Practices, OECD Committee on Fiscal Affairs, *OECD's Project on Harmful Tax Practices: The 2004 Progress Report* (progress report to the Ministerial Council meeting) (2004), available at <http://www.oecd.org/dataoecd/60/33/30901115.pdf>.

627. See Cockfield, OECD as Informal World Tax Organization, *supra* note 393, at 165 (detailing how the OECD was able to disentangle "fair tax competition from harmful tax competition," thus forging a consensus and extracting offending countries' promises to reform, with possible retaliatory measures for noncompliance).

its clout apparently growing, the OECD has become increasingly empowered to obtain consensus on issues at the international level, and also to catalyze regulatory convergence through tax reforms at the national level. Although the pace of reform may seem rather sluggish, there is no guarantee that a supranational tax organization like the WTO could do any better.

4. *How to Improve the OECD's Effectiveness in Obtaining Tax Cooperation*

The evolving international tax system is now at a critical juncture. If the bilateral tax treaty network cannot be adapted to meet its current challenges, countries will start turning to inferior institutional structures to lower tax barriers to trade. Now is the time for the OECD consortium to focus on improving the effectiveness of the Model Tax Treaty, strengthening its dispute resolution mechanisms, and expanding the network to incorporate developing countries, such as those in Asia. The following explains why these suggested reforms are needed immediately.

a. Elevate Status of Commentaries

The official Commentaries to the OECD Model Tax Treaty constitute one of the most important tools for achieving the consistent application of treaties based on the OECD Model. However, the Commentaries are not explicitly binding, which leads to inevitable disputes between Contracting States as to the weight that should properly be accorded to them. Clearly, national courts are increasingly relying on the Commentaries: “[T]he Commentaries have been cited in the published decisions of the courts of the great majority of [OECD] member countries.”⁶²⁸ Moreover, in these decisions, the Commentaries “have frequently played a key role in the judge’s deliberations.”⁶²⁹ Nonetheless, the status of the Commentaries is blurred because they seek to interpret double tax conventions that have a dual nature: on one hand, a tax convention is an international agreement between two countries to regulate the exercise of their fiscal jurisdiction. Its status as an international agreement puts the convention squarely within the domain of public international law. On the other hand, a tax convention becomes part of a Contracting State’s domestic law when it is ratified, and thus becomes subject to the Contracting State’s domestic rules for interpreting binding agreements.⁶³⁰

Professor Philip Baker has noted that the status of the OECD Commentaries does not fit precisely within any of the recognized categories of the Vienna Convention⁶³¹ that describe what can be properly used to interpret an international treaty.⁶³² However, there appear to be three plausible categories that would properly describe the OECD Commentaries:

- (a) Article 31(2): an agreement of *all parties* in connection with the conclusion of the treaty, or an instrument made by one party and accepted by the other;
- (b) Article 31(3): any *subsequent agreement* or practice of the parties;
- (c) Article 32: supplementary means of interpretation, including *travaux préparatoires*.⁶³³

628. Introduction to OECD Model Tax Treaty, *supra* note 29, ¶ 29.3 (2005).

629. *Id.*

630. See *supra* Part III (discussing the status of treaties under U.S. and Japanese domestic law).

631. Vienna Convention on the Law of Treaties, May 23, 1969, 1155 U.N.T.S. 331, 8 I.L.M. 679, art. 31(a)-(b) (1969) [hereinafter Vienna Convention]. The text of the Vienna Convention is available at http://untreaty.un.org/ilc/texts/instruments/english/conventions/1_1_1969.pdf.

632. BAKER, DOUBLE TAX CONVENTIONS, *supra* note 30, at 29–30.

633. Vienna Convention, *supra* note 631, art. 31(3), art. 32 (as paraphrased by Baker).

These categorical distinctions are not merely academic. As Professor Baker points out:

Article 31(2)(b) could bring in the non-OECD states who accept the Commentaries, Article 31(3) would only apply to *subsequent* Commentaries, and Article 32 refers to *travaux préparatoires* (i.e., prior Commentaries) only if the materials in Article 31 leave the meaning unclear or to confirm the meaning. Material in Article 31(2) may also have a more binding nature.⁶³⁴

The practical answer is that the OECD Commentaries fit within all three categories of the Vienna Convention as aids to proper tax treaty interpretation. However, the inherent uncertainty as to the proper weight leads to many disputes and inconsistent applications of tax treaties negotiated under the OECD Model.

One way to avoid these uncertainties is to elevate the legal status of the Commentaries themselves. Professor Avery Jones, a leading expert on tax treaty interpretation, believes that the best way of doing this is to have the Contracting States adopt a formal Memorandum of Understanding explicitly stating their intention that their tax treaty is to be interpreted in accordance with the OECD Commentaries.⁶³⁵ Although Japan and the United States have not made the Commentaries explicitly binding, both Contracting States and their taxpayers could probably avoid future disputes by doing so. The U.S. and Austria included such a Memorandum in their 1996 tax treaty.⁶³⁶

A related issue regarding the status of the Commentaries is whether subsequent revisions to them should be given weight in interpreting tax treaties that were negotiated before the revisions.⁶³⁷ The Committee on Fiscal Affairs believes that bilateral tax treaties should be interpreted in accordance not only with the Commentaries that were in force at the time of the treaty's conclusion, but also, as far as possible, any Commentaries that are added or revised after a particular treaty was concluded.⁶³⁸ Some scholars have characterized this view as wishful thinking on the part of the Committee and have questioned whether any court would give much legal weight to subsequently revised Commentaries in light of the fact that tax treaties are part of a nation's internal law that directly affects taxpayers.⁶³⁹ The Committee's argument would have more force if the Commentaries themselves were explicitly binding. The mere prospect of making the existing Commentaries explicitly binding should give one pause. The Commentaries reflect the consensus of the OECD—a group of countries that are not formally parties to the bilateral treaty in question. Thus, making the Commentaries explicitly binding seems to be a step away from bilateralism and towards multilateralism. The higher the status of the Commentaries, the more the informal network of bilateral agreements begins to function like a multilateral treaty.

634. BAKER, *DOUBLE TAX CONVENTIONS*, *supra* note 30, at 30.

635. Jones, *Are Tax Treaties Necessary?*, *supra* note 594, at 19.

636. See Memorandum of Understanding Regarding Interpretation of the Convention, May 31, 1996, U.S.-Aus., 1 Tax Treaties (CCH) P703A.

637. Cf. Vienna Convention, *supra* note 631, art. 31(3) (providing that any subsequent agreement or practice of the treaty parties may be used as an aid to treaty interpretation).

638. OECD Model Tax Treaty, *supra* note 29, ¶¶ 33–36 (2005) (noting that normally, revised Commentaries should be used to clarify the proper interpretation of a previously existing treaty since such Commentaries represent the consensus of the OECD Countries on a given article's proper application. However, any Comment that has been amended as a direct result of an amendment to the text of the Model Treaty should not be used to interpret a previously concluded treaty where the provision in question differs in substance from the amended model article).

639. See Jones, *Are Tax Treaties Necessary?*, *supra* note 594, at 22–23 (1999) (“[I] am doubtful any legal weight should be given to the Committee's retrospective views about proper interpretation. Tax treaties are different from normal international treaties under which the contracting states can agree to any interpretation.”).

b. Strengthen Dispute Resolution System

One of the major weaknesses of the present bilateral tax treaty system is that its dispute resolution mechanism is too weak. As previously discussed, this weakness is no doubt a product of its past.⁶⁴⁰ The Mutual Agreement Procedure was originally envisioned to serve not as process of litigation but rather as a kind of on-going channel of negotiation to iron out the Contracting States' differences as to how their tax jurisdiction should be divided up and regulated.⁶⁴¹ While the use of competent authorities to resolve disputes infuses a great deal of flexibility into the system, the process is hampered by the fact that the authorities are under no legal obligation to resolve a dispute—they need only to endeavor to resolve it. Moreover, without set time frames and legal precedents, the process can take on the character of political compromise—or worse, a horse-trading show where all kinds of extraneous factors enter into the deal.

One way to eliminate many of the vagaries of the Mutual Agreement Procedure is to institute binding arbitration. As mentioned, although the Japan-U.S. Tax Treaty does not provide for the binding arbitration of disputes, the United States is one of the countries that has begun to incorporate such clauses into its treaties and protocols. The OECD's Committee on Fiscal Affairs has convened a working group to study supplementary methods of dispute resolution, including binding arbitration.⁶⁴² The working group's findings and proposals are due to be released in 2007, but it will probably take much longer before an optional or mandatory arbitration clause finds its way into Article 25 of the Model Treaty. In the meantime, more countries should attempt to negotiate protocols and Memoranda of Understanding to institute some method of binding arbitration.⁶⁴³ This modification to bilateral tax treaties would greatly improve the existing international tax system, perhaps allaying calls to make more dramatic institutional changes. Although binding arbitration raises sovereignty concerns,⁶⁴⁴ this concern seems to be greatly outweighed by other tax policy concerns—namely, efficiency, simplicity, fairness, and certainty.

c. Reach Out Globally—Shed “Rich Countries’ Club” Image

The OECD's ability to attain consensus on international tax issues is aided by the fact that its formal voting membership presently consists of only thirty countries. This elite group of nations includes all of the world's most advanced economies that together control the vast majority of the world's funds, technology, and capital-producing industries.⁶⁴⁵ As mature economies, most of these countries share similar national interests and, as a Japanese ambassador to the OECD put it, a like-mindedness concerning the normative

640. The advantages and disadvantages of the Mutual Agreement Procedure, within the context of the Japan-U.S. Tax Treaty, are discussed in Part XIA., *supra* and will not be recapitulated here.

641. See LINDENCORNA & MATTSON, *ARBITRATION IN TAXATION*, *supra* note 258, at 24.

642. See discussion *supra* note 302. The working group convened by the Committee on Fiscal Affairs has already issued a list of best practices, including one that advocates that competent authorities take a more principled approach to their decision making. See *id.*

643. As noted, the U.S. and Germany signed a protocol to their existing treaty which will, when it becomes effective, provide for the *mandatory arbitration* of disputes when the competent authorities fail to reach an agreement. In addition, non-mandatory arbitration clauses have been included in other recently negotiated U.S. tax treaties. See discussion *supra* note 268.

644. See discussion *supra* notes 268–69 (noting that the new U.S. Model Tax Treaty, released in November 2006, does not contain any provision providing for mandatory arbitration).

645. Both the United States and Japan are longtime members of the OECD.

objective of promoting market-based economies, democracy, and human rights.⁶⁴⁶ While its small, heterogeneous membership helps the OECD to expedite reforms, it also tends to alienate smaller, developing countries that have different economic interests, creating an obstacle to achieving the OECD's goals of international tax cooperation, inter-nation equity, efficiency, fairness, and increased global welfare.

Although the OECD is considering various global outreach strategies, including offers of formal membership to a number of countries,⁶⁴⁷ there are legitimate reasons why it has not been anxious to throw open its doors to all countries. First, as mentioned, there is a critical need to achieve consensus in order to make progress on major projects and initiatives, and limiting voting membership helps. Secondly, there are normative criteria for OECD membership: prospective members must demonstrate a commitment to being like minded and must have sufficiently reformed their fiscal and domestic policies to reflect the OECD mandate of promoting democracy, protecting individual human rights, and establishing and upholding the rule of law. Some criteria involve expensive tax measures such as the requirement that all tax holidays be extended to all resident companies—not just domestic ones.⁶⁴⁸ Paradoxically, meeting the OECD criteria would serve these developing countries well, since transparent corporate governance and fiscal systems, open markets, and governance by a rule of law, all work to create a more stable business environment, thereby attracting more inward FDI, which would help their struggling economies to grow. However, many developing countries fall short of meeting these prerequisites for membership. Moreover, many developing and newly industrialized countries are extremely suspicious of the OECD's reform initiatives—viewing them as self-serving measures designed to protect rich, industrialized countries at the expense of the less affluent, underdeveloped ones.⁶⁴⁹

From the OECD's perspective, it is imperative that it expand its global outreach. The stakes are high. If the network fails to engage the developing countries in its initiatives and take them into the OECD fold, the OECD's cooperative tax initiatives will fail, and the entire international tax order will likely splinter into something less than a global approach—perhaps into competing and conflicting architectures aimed only at regional cooperation.⁶⁵⁰ Just

646. OECD, Chair of OECD Working Groups, Seiichiro Norboru (Ambassador of Japan), *A Strategy for Enlargement and Outreach* at 16–17 (May 13, 2004) (inferring that OECD Member States share a “like-mindedness” for democratic principles, market economies, free trade and competition, and human rights), available at http://www.oecd.org/LongAbstract/0,2546,en_2649_201185_37301337_1_1_1_1,00.html [hereinafter OECD Outreach Strategy].

647. See *id.* (detailing OECD mandate to consider membership expansion and outreach). Mexico was granted OECD membership in 1994, after entering into its first OECD-based tax treaty with Canada only two years earlier in 1992.

648. This criterion is consistent with the Nondiscrimination article found in the OECD Model Tax Treaty. See OECD Model Tax Treaty, *supra* note 29, art. 24(1).

649. For example, many developing countries object to the 0% withholding rates set forth in the OECD's Model Tax Treaty, which clearly favor net exporters of technology. See Positions of Non-Member Countries on Article 12 (Royalties) and Commentary, OECD Model Tax Treaty, (Condensed Version, 2005) (listing all the non-member countries that have reservations about, or objections to, this article).

650. The WTO is becoming increasingly alarmed that the proliferation of regional trade agreements is substantially impeding the international trade system by creating a web of incoherent rules. See Pascal Lamy, Director-General of WTO, Address to Confederation of Indian Industries in Bangalore, India: Regional Agreements: the ‘Pepper in the Multilateral ‘Curry’ (Jan. 17, 2007). available at http://www.wto.org/english/news_e/spp1_e/spp153_e.htm.

like regional trade agreements can pose a threat to bilateral tax treaties, so too can explicit regional tax agreements.⁶⁵¹

Recently, the OECD has taken steps to recognize and informally incorporate the views of non-Member States into its informal network. In 1997, the OECD began publishing non-Member States' official positions and reservations to the Model Treaty and its Commentaries as an addendum. This step alone is likely to have a big impact because it brings these countries into the OECD's bilateral treaty dialogue. In 2002, the OECD, World Bank, and IMF created a special forum called the International Tax Dialogue to consider developing countries' perspectives on various tax measures and OECD initiatives, to share best practices, and to discuss ways to coordinate the tax objectives of developing and advanced economies.⁶⁵² In addition, the OECD sponsors numerous annual conferences around the world, including its Global Forum and a number of multilateral tax centers to reach out to nonmember countries, to find common ground, and to cultivate opportunities for coordinated tax policy making.⁶⁵³

Recognizing that the OECD is at a critical juncture and desperately needs to engage developing countries in order to achieve its objectives, a two-tier membership structure is now being studied.⁶⁵⁴ The advantage of a two-tier membership structure is that it would allow the existing thirty members to preserve their exclusive voting rights, while also legitimizing the role played by non-voting members in the network. As one scholar envisions it:

The first tier would include all OECD member countries—consensus among these members would continue to be needed to enact major policy changes, such as amendments to the OECD Model Tax Treaty. The second tier would include non-member countries who wished to be granted permanent membership within this tier. Countries from both tiers would be invited to deliberate policy changes through the Committee on Fiscal Affairs and its committees, but only tier-one countries could ultimately make these changes (this approach is similar to the OECD's e-commerce tax reform efforts).⁶⁵⁵

Although nonmember countries may balk at being given only second-class status with this structure, they would be gaining a permanent voice in the international tax network and increased opportunities to access OECD resources. Creating a two-tier OECD membership structure seems to have few drawbacks and great potential for transforming the bilateral tax treaty network so that it can continue to coordinate nations' tax policies in an economically diverse and dynamic global environment.

Herein lies an opportunity for Japan. Japan is by far the most prominent member of the OECD in Asia, and the network's critical need to expand its global outreach puts Japan

651. Although regional agreements to lower tax barriers to investment are better than no agreements, they are a second-best alternative, and can threaten the development of more consistent, worldwide approaches to tax policy. As two international tax experts have observed, the EU's efforts to harmonize its Member States' corporate tax regimes through the ECJ's "incoherent" nondiscrimination jurisprudence "render the future of bilateral treaties between the United States and EU member countries uncertain." Gratz & Warren, *Income Tax Discrimination*, *supra* note 252, at 1254.

652. See Duncan Bentley, *International Constraints on National Tax Policy*, 30 TAX NOTES INT'L 1127 (June 16, 2003) (describing OECD efforts to dialogue with developing countries on such issues as harmful tax competition, anti-corruption, and information exchange); Cockfield, OECD as Informal World Tax Organization, *supra* note 393, at 178.

653. See Charles Gnaedinger, *OECD Tax Centers Spark Dialogue for Non-OECD States' Benefit*, 2004 WORLDWIDE TAX DAILY, May 4, 2004, available in LEXIS, Intlaw library, TNI file, 2004 WTD 86-7.

654. See Cockfield, OECD as Informal World Tax Organization, *supra* note 393, at 185 (fleshing out his idea of what a two-tier membership structure should look like).

655. *Id.* at 183.

in the perfect position to provide leadership and increase its own sphere of influence among developing countries in East Asia and along the Pacific Rim.⁶⁵⁶ It is no accident that a *Japanese* ambassador is heading up the OECD's global outreach initiative. The fiscal policies Japan adopts, the standards Japan sets for itself, and the trade and investment ties Japan is able to secure with countries in Asia are bound to affect the development of those nations' fiscal infrastructures and tax policies. And, what happens in those dynamic Asian economies will undoubtedly impact the formulation of international tax policies within the OECD and around the world.

C. FUTURE IMPACT OF JAPAN-U.S. TAX TREATY

There is little wonder why U.S. Treasury officials have characterized the new Japan-U.S. Tax Treaty as "one of the most important tax treaties in the world."⁶⁵⁷ Not only does the Treaty remove trade barriers between the world's two most powerful economies, it is bound to be highly influential outside the explicit bilateral relationship on a number of levels: by signaling new norms and standards in international tax policy; by stimulating reforms in domestic tax laws, as well as future bilateral tax treaties and protocols; and by evincing the continued dominance of the Nation State in the continuing development of international tax policy.

1. *Signaling New Norms?*

Clearly, the new Japan-U.S. Tax Treaty does not represent a radical departure from the foundational norms that have evolved within the informal OECD bilateral tax treaty network since the 1920s' Compromise was first reached—most fundamentally, the construct of assigning income on the basis of its source and the taxpayer's residence, under an economic entitlements theory.⁶⁵⁸ However, within this normative framework, the Treaty does incorporate what ostensibly is the latest thinking on some difficult issues, thereby signaling new norms and emerging best practices.

Of course, the reciprocal reductions in gross-basis withholding taxes imposed by the Source State are among the most striking revisions reflected in the new Treaty.⁶⁵⁹ The complete elimination of withholding tax on broad categories of investment income—including royalties, qualifying dividends, and certain kinds of interest—constitutes an "unprecedented departure from historic Japanese tax treaty policy,"⁶⁶⁰ signaling Japan's newfound willingness to open its markets more liberally to free trade and foreign investment. For the United States, the zero percent withholding rate on all royalties and inter-company dividends also sets a new standard; in its other recently negotiated treaties reflecting that rate—for example, those with the United Kingdom, Australia, and Mexico—the tax-exempt categories of investment income are more narrowly defined. Although the complete elimination of Source-State withholding taxes on dividends from controlled subsidiaries is not the current U.S. Model Treaty position,⁶⁶¹ it is clear that the exemption will routinely be used as a

656. In trade theory terms, Japan is an Asian economic hub, with spokes extending out to surrounding developing economies that seek to sell products into the large Japanese consumer market. See *infra* note 674 and sources cited therein.

657. Tax Analysts, *Japan-U.S. Tax Treaty of Crucial Importance*, U.S. Treasury's Angus Says, *supra* note 12.

658. See *supra* Part II.D (discussing economic entitlements theory).

659. See *supra* Part IV.A (discussing Treaty's maximum withholding rates on investment income).

660. See 2003 Tax Treaty Hearing, *supra* note 5.

661. See Bell, *supra* note 147 (article quotes Patricia A. Brown, U.S. Treasury Deputy International Tax Counsel).

bargaining chip by the U.S. to exact treaty provisions designed to prevent treaty abuse and to better verify whether the requisite equity ownership levels for qualifying for the withholding tax exemption have been met: sophisticated LOB articles and verifiable information exchange procedures, as well as domestic laws requiring a sufficient level of banking and accounting transparency. As the criteria for qualifying for the withholding tax exemptions become easier to verify, it is conceivable that the complete elimination of Source-State withholding tax will gradually evolve into a normal treaty practice or, at the very least, become a widespread objective for tax treaty negotiations. The Japan-U.S. Tax Treaty's broad exemptions of Source-State withholding tax thus serve as powerful compliance incentives to other countries seeking to negotiate tax treaties with major economic powers like the United States and Japan, and suggest the emergence of a new standard in this regard.⁶⁶²

Article 9 (Associated Enterprises) of the new Japan-U.S. Tax Treaty makes no attempt to depart from the well-established practice of employing the arm's length method and the commensurate-with-income standard to price transactions between commonly controlled enterprises.⁶⁶³ And while proponents of the formulary apportionment method will argue that the addition of a new Treaty to the OECD network further entrenches an inefficient and anachronistic pricing method,⁶⁶⁴ neither Japan nor the United States have made serious attempts to embrace the use of formulary apportionment in the international context.⁶⁶⁵ Nonetheless, Article 9 of the new Treaty does include some features that introduce more flexibility into the existing transfer pricing system—for example, the Treaty's incorporation of the OECD Transfer Pricing Guidelines on an ambulatory basis as those Guidelines evolve over time. This feature, along with Article 9's expanded coverage of various transactions, and the competent authorities' augmented powers to devise creative solutions to transfer pricing disputes pursuant to the Mutual Agreement Procedure (Article 25), are features that are expected to mitigate the problems inherent in the arm's length standard. These features will likely be reproduced in other bilateral tax treaties.

The new Japan-U.S. Tax Treaty is also signaling an emerging tax treaty norm in its treatment of fiscally transparent entities in Article 4(6).⁶⁶⁶ That provision essentially codifies the basic approach of the OECD Report on Partnerships by establishing the general rule that one must look to the internal tax laws of the Residence State—not the State from which the income is sourced—to determine whether or not an entity is fiscally transparent and who is actually liable to tax.⁶⁶⁷ Critics of the 1920s' Compromise will undoubtedly contend that the need to include such an elaborate provision to more efficiently allocate income between the Source State and the Residence State in transactions involving hybrid entities gives credence to their argument that the Source and Residence concepts no longer work well and are anachronisms in a world where transactions are increasingly borderless and companies are increasingly transnational. But Article 4(6) ingeniously infuses flexibility and

662. U.S. treaty negotiators have staunchly maintained that each tax treaty stands on its own, and that treaty benefits are negotiated with other countries on a case-by-case basis. See *id.* However, this unofficial bargaining position seems to contradict the fact that the U.S. requires that a Limitation-on-Benefits clause and a Savings clause be included in all of its new treaties and protocols.

663. See *supra* Part V.

664. See discussion of the "lock-in" phenomenon in the context of network effects *supra* Part XIII.A.1.a.

665. For a discussion of the problems with instituting formulary apportionment in the international context, see *supra* Part XII.C.2.b.

666. See discussion of Article 4(6) and fiscally transparent entities *supra* Part VI.

667. But see art. 1(4) (Savings Clause), discussed *supra* Part VI.E.

fairness into the Residence concept, looking beyond mere labels to the Residence State's actual tax treatment of the entity in question. Article 4(6) clearly sets a new standard in that its purview is much broader than similar provisions found either in earlier negotiated tax treaties⁶⁶⁸ or in domestic law.⁶⁶⁹ And because it is the world's two largest economic powers that have agreed to this complex but useful treaty provision, their inclusion of it strongly suggests what some have termed a growing consensus that the OECD's approach to fiscally transparent entities is the most pragmatic solution to the problems posed by attempts to fairly tax fiscally transparent entities, or payments made through those entities, in the cross-border context.

Perhaps the aspects in which the Japan-U.S. Tax Treaty is most likely to have a profound and normative effect on international tax policy are found in the Treaty's provisions that mandate a high level of information sharing by the competent authorities and augment their powers to interpret the Treaty to more efficiently resolve tax disputes. This is because increased reliance on these mechanisms—specifically, the Mutual Agreement and Exchange-of-Information Procedures and Article 3(2)—will enhance the growth and impact of the transgovernmental networks within broader parameters of the OECD network. As previously explained,⁶⁷⁰ transgovernmental networks serve a key cooperative function within the informal OECD network by dialoguing, by setting informal standards and expectations to bolster compliance, and by resolving systemic problems within the network itself. If the informal OECD network of bilateral tax treaties is to deter competing architectures for international tax cooperation, it will have to surmount the challenges posed by electronic commerce and the increased integration and mobility of multinational firms. The ability of transgovernmental networks to infuse flexibility into the system and to lower transaction costs is thus critical to the network's evolution and survival.

Certainly, the new Treaty's Mutual Agreement Procedure (Article 25) and the Exchange-of-Information Article (Article 26) will play important roles in establishing transgovernmental networks. Moreover, the expansive language the Treaty employs in Article 3(2) is critical to the impact of informal negotiations in that it expressly augments the capacity of the U.S. and Japanese competent authorities to establish the meaning of treaty terms that are left undefined in the Treaty's text.⁶⁷¹ This special grant of authority represents a departure from the OECD Model Tax Treaty's text⁶⁷² and may end up establishing an important new method of treaty interpretation if the provision is picked up in other treaties.⁶⁷³

2. *Inspiring Reforms?*

If a scorecard were being kept in the debate between those in favor of replacing the informal bilateral tax treaty network with an explicitly multilateral institution and those in favor

668. Unlike older treaties, Article 4(6) of the new Japan-U.S. Tax Treaty covers more than just the treaty benefits accorded to dividends, interest, and royalties. For example, it can also be applied to identify the person who is liable to tax on an item of business profit (Article 7) paid through a fiscally transparent entity.

669. See, e.g., Treas. Reg. § 1.894-1(d) (as amended in 2002) (denying treaty benefits on certain payments to domestic reverse hybrid entities).

670. See discussion of transgovernmental networks *supra* Part XIII.A.2.

671. See discussion of Article 3(2) of the Japan-U.S. Tax Treaty *supra* Part XI.A.

672. Article 3(2) of the OECD Model Treaty neither includes the reference to the States' competent authorities, nor infers that their agreement will be determinative of the meaning of an undefined term. See OECD Model Treaty, *supra* note 29, art. 3(2).

673. The disadvantages of relying on the competent authorities to resolve tax disputes has been previously discussed. See *supra* Part XI.A (Mutual Agreement Procedure).

of forging further international tax cooperation within the parameters of the present system, the successful conclusion of the new Japan-U.S. Tax Treaty would definitely score big points for the team rooting for the status quo with progressive modifications. The mere fact that a new OECD-based bilateral tax treaty was concluded between the world's two largest economies cannot be very encouraging to the proponents of more radical international tax reforms that call for a return to the international tax policy drawing board. This is not to say, however, that the new Treaty will fail to inspire changes within the existing framework. The Japan-U.S. Tax Treaty is already inspiring reforms, both in domestic tax laws and in treaty negotiations due to the seemingly unavoidable phenomena of "competitive liberalization" and the "indirect network effects" of adding the Treaty's newly revised provisions and standards to the network.

According to the well-established free trade doctrine of competitive liberalization propounded by C. Fred Bergsten and others,⁶⁷⁴ when trade barriers are reduced by a major new preferential treaty, particularly a treaty with or between economic superpowers like the United States and Japan, that new treaty immediately creates strong incentives for other countries to negotiate similar tax treaties of their own so as to avoid the costs of having trade diverted from their markets to the markets of the Contracting States that negotiated the new preferential treaty. This phenomenon has already been noted above in the discussion of national welfare concerns, game theory, and harmful tax competition.⁶⁷⁵

In another variant of this domino effect, smaller economies tend to react to the success of their competitors in securing a new bilateral tax treaty with a major economy like the United States by attempting to secure their own bilateral treaty with the same major economy. Hub-and-spoke patterns of cooperative agreements tend to result from this type of competitive liberalization; the Contracting States with major markets wield more bargaining power as hub economies and so can dominate the treaty negotiations by extracting more concessions such as the inclusion of sophisticated anti-treaty-abuse mechanisms from Contracting States that are merely spoke economies.⁶⁷⁶ Thus, the overall effect of competitive liberalization is not limited to a race to lower withholding rates. Rather, it also encourages the smaller spoke economies to modernize their tax, securities, and accounting laws to remain competitive, and to replicate or emulate the provisions contained in the hub economy's tax treaty. This convergence effect becomes super charged when the new preferential treaty happens to be between two major economic hubs like the United States and Japan.⁶⁷⁷

The phenomenon of competitive liberalization can already be identified in the wake of the Japan-U.S. Tax Treaty's conclusion, particularly in Asia. For example, Japan is now engaged in a major effort to modernize and expand its network of bilateral tax treaties,

674. See C. Fred Bergsten, *Competitive Liberalization and Global Free Trade: A Vision for the Early 21st Century* (Peter G. Peterson Inst. for Int'l Econ., Working Paper No. 96-15, 1996), available at <http://www.peterson-institute.org/publications/wp/wp.cfm?ResearchID=171>; Richard E. Baldwin, *A Domino Theory of Regionalism*, in *TRADING BLOCKS: ALTERNATIVE APPROACHES TO ANALYZING PREFERENTIAL TRADE AGREEMENTS* 479-501 (Jagdish N. Bhagwati, Pravin Krishna, and Arvind Panagariya eds., MIT press, 1999) [hereinafter Baldwin, *Domino Theory*].

675. The classic prisoner's dilemma in game theory is created when countries are compelled to maintain revenue losing rates in order to stay competitive. For a discussion of this dilemma and the OECD's promising initiative to prevent harmful tax competition see *supra* Part XII.A and Part XIII.B.1, respectively.

676. See generally *supra* note 673, see also Baldwin, *supra* note 674.

677. See generally *supra* note 674 and sources cited therein.

and has indicated that it is using its new agreement with the United States as its model in negotiating further tax treaty reforms with other countries.⁶⁷⁸ In 2006, for example, Japan signed a new tax treaty with India, incorporating a modern LOB clause and other sophisticated anti-abuse provisions, as well as reductions in the maximum withholding rates on intercompany dividends (reduced from 15 to 10 percent) and royalties (reduced from 20 to 10 percent).⁶⁷⁹ Japan has also recently signed protocols amending its bilateral tax treaties with the Philippines and the Netherlands, and is presently engaged in negotiations to modernize its tax treaties with Indonesia, Australia, Kuwait, and the United Arab Emirates. Not surprisingly, after the successful conclusion of the Japan-U.S. Tax Treaty, other economic hubs like the United Kingdom and France have been eager to renegotiate their tax treaties with Japan. In 2006, Japan and the UK signed a new tax treaty that includes a modern LOB clause and substantial reductions in the maximum withholding rates.⁶⁸⁰ And in January 2007, Japan and France agreed to further reduce tax barriers to trade by signing a new tax treaty expected to enter into force in 2008.⁶⁸¹

The indirect network effects⁶⁸² of augmenting the OECD bilateral network with a major, new tax treaty are also sure to trigger tax policy reforms. The various provisions in the new Treaty have now become part of the large body of off-the-shelf regulatory standards, treaty articles, and viable income allocation mechanisms—all now available for perusal and possible replication by formal members of the OECD, by non-members with treaties based on the OECD or U.N. Models, and by developing countries that seek better methods of handling the recurrent tax allocation problems. The evolving transgovernmental networks,⁶⁸³ which the Japan-U.S. Tax Treaty encourages, will create increasingly powerful incentives to cooperate, causing weaker jurisdictions to import the legal standards and treaty provisions of more powerful nations like Japan and the United States. Within the context of the informal OECD tax treaty network, this phenomenon of rule convergence is largely self executing.

3. *Just Tweaking Anachronisms? Or Evincing the Continued Dominance of the Nation State in a Globalizing World?*

Undoubtedly, some international tax scholars will contend that the new Japan-U.S. Tax Treaty, far from signaling new norms or inspiring meaningful reforms, merely tweaks fundamental anachronisms in international tax policy—in particular, the construct of allocating income between countries on the basis of the income's source and the taxpayer's residence. This allocation scheme, inherent in the 1920s' Compromise,⁶⁸⁴ was designed in another era when business enterprises were more easily identifiable by the physical buildings that

678. See Thomas, *supra* note 3 (reporting that a high ranking Japanese tax official clearly indicated, without actually using the term model tax treaty, that Japan views its new tax treaty with the U.S. as its new model for future tax treaty negotiations).

679. See Tax Analysts, *India, Japan Sign Tax Treaty*, 2006 WORLDWIDE TAX DAILY, Feb. 27, 2006, at 38–3.

680. See Tax Analysts, *Japan-U.K. Tax Treaty Enters Into Force*, 2006 WORLDWIDE TAX DAILY, Oct. 13, 2006, at 198–1.

681. See Tax Analysts, *Japan, France Sign Revised Tax Treaty*, 2007 WORLDWIDE TAX DAILY, Jan. 16, 2007, at 10–4.

682. See *supra* Part XIII.A.1.

683. See *supra* Part XIII.B.3.b. (explaining how transgovernmental networks can help forge cooperation and rule convergence).

684. See *supra* Part II.D.

housed them. In a sense, these critics are right; the new Treaty ostensibly applies only patchwork solutions to the gaping loopholes and absurdities created by attempts to make the economic entitlements theory, upon which both *in rem* and *in personam* jurisdiction are founded, fit the new realities created by the advent of integrated economies, multinational enterprises, digital commerce, and financial engineering. To the extent the Japan-U.S. Tax Treaty manages to plug the resulting holes in the international tax policy dike, it will nonetheless take years, perhaps decades, before these arguably superficial solutions are incorporated into other bilateral tax treaties, perhaps slowing tax policy reforms to a glacial pace. Moreover, the addition of the new Treaty to the OECD bilateral network, these skeptics will argue, tends to further standardize inefficient rules through the lock-in effect, even though superior rules may exist.⁶⁸⁵

Clearly, these are credible contentions. There are obvious reasons to be concerned that the 1920s' Compromise has become an inadequate and inefficient allocation method. As the foregoing Parts of this article have shown,⁶⁸⁶ some scholars now maintain that the Information Age necessitates a whole new supranational institution to replace the present bilateral tax treaty network so that new allocation rules can be administered without reference to income's source and taxpayer's residence.⁶⁸⁷ However, the common solution propounded by these scholars—replacement of the network of bilateral tax treaties with a legally binding multilateral or supranational institution—is illogical because the likelihood that inefficient rules and standards will get locked in is greater in an explicit network (e.g., a binding multilateral treaty or supranational institution like the WTO or the EU) than the risk existing in a nonbinding, virtual network created by the informal OECD consortium where new rules and standards can be tested in one bilateral treaty at a time. Open and informal networks, as opposed to closed and explicit ones, are more likely to provide environments where members have the opportunity to choose among a multiplicity of standards, thus mitigating the risk that an inefficient standard will become dominant, displacing more efficient ones.⁶⁸⁸ Several ingenious provisions of the new Japan-U.S. Tax Treaty—for example, Article 4(6) concerning the treatment of fiscally transparent entities; Article 9 referencing the OECD Transfer Pricing Guidelines; the newly delineated Royalties Article (Article 12); and Article 3(2) granting more interpretive authority to the Contracting States' competent authorities pursuant to the Mutual Agreement Procedure—evince the capacity of the informal OECD tax treaty network to adapt to radically changed circumstances.

Those scholars calling for a paradigm shift in the way tax jurisdiction is allocated also tend to disregard the continued dominance of the Nation State on the international stage, and further discount the extreme reluctance of Nation States to surrender their fiscal sovereignty. As emphasized throughout this article, the concepts of taxpayer residence and income source derive from, and serve to support, the territorial jurisdiction and economic entitlements of the Nation State.⁶⁸⁹ To the extent these concepts are compromised, so too is

685. See *supra* Part XIII.A.1.a (discussing the “lock-in” effect).

686. See *supra* Part XII.B-D.

687. See, e.g., the discussion of formulary apportionment, *supra* Parts XII.B.3, C.2, and D.2-3, and XIII.B.2.b.

688. As earlier described in Part XII.D.3.b., the European Union is arguably being infected by an inefficient standard for allocating income: the ECJ's unbridled application of its nondiscrimination doctrine, which some scholars maintain is causing incoherent results. See Graetz & Warren, *Income Tax Discrimination*, *supra* note 252, at 1219. See discussion *supra* Part XII.D.3.b.

689. See *supra* Part II.D (discussing the economic entitlements theory underlying the 1920s' Compromise).

the power of the Nation State to govern and survive. Not surprisingly, as the experiment in the European Union has shown, there is little evidence to support the theory that Nation States will soon be ready to “engage in a massive surrender of national sovereignty over [their] tax policies.”⁶⁹⁰ Given the continued dominance of the Nation State on the international stage, and the great diversity of political systems, economies, and domestic tax rules among these States, the present system of bilateral income tax treaties, which operate within the informal, multilateral framework provided by the OECD and its Model Treaty, remains the most viable institution for allocating international tax authority. The network’s soft-law, consensus seeking approach is more substantively desirable, procedurally pragmatic, and demonstrably effective than the alternative institutions considered in this article—namely, an explicitly binding multilateral tax treaty, a supranational body similar to the WTO, and regional tax agreements existing within regional trade blocks.⁶⁹¹ The new Japan-U.S. Tax Treaty evinces both the continued dominance of the Nation State on the world stage, as well as the ability of the OECD’s informal tax treaty network to meet the tremendous challenges posed by a rapidly changing economic and technological environment.

XIV. Conclusion

The trade and investment relationship between Japan and the United States—unquestionably one of the global economy’s most critical bilateral economic relationships—will be substantially strengthened by the Japan-U.S. Tax Treaty, which became fully effective on January 1, 2005. Although the future economic effect of the Treaty is incapable of being accurately tallied in dollars or yen, the Treaty’s precedent setting reductions of withholding taxes on investment income, its improved allocation of income derived through partnerships and hybrid entities, and its provisions policing transfer pricing and treaty misuse, will undoubtedly promote more flexible and efficient business structures, and foster higher levels of investment in both countries.

Although the Japan-U.S. Tax Treaty does not break the foundational mold for international tax policy, it does represent a major policy breakthrough on several levels. First, the Treaty signals a fundamental shift in the international trade and tax policies of Japan (historically an isolated country with strong, protectionist tendencies), which comport with Japan’s new open attitude and recent sweeping revision of its company and securities laws aimed at attracting more foreign investment. Second, given Japan’s leadership role in Asia, the Treaty will likely catalyze tax policy reforms in other Asian countries looking to remove unnecessary tax barriers to trade and investment flows. Moreover, the Treaty also reflects and fortifies what appears to be an evolving international consensus on how to most practically resolve, at least for now, some longstanding problems in allocating cross-border income between sovereign states. The Treaty, which sets new standards both for the negotiation and administration of bilateral tax treaties, will cause significant changes in behavior. The triggered changes in investing behavior, both those anticipated and those unforeseen, will undoubtedly impact the development of international tax relationships between sovereign nations for many years to come.

690. McClure, *Globalization, Tax Rules*, *supra* note 393, at 341.

691. See the discussion of these alternatives *supra* Part XII.A-D.