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# The Quest to Tax Interest Income: Stages in the Development of International Taxation

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# THE QUEST TO TAX INTEREST INCOME IN A GLOBAL ECONOMY: STAGES IN THE DEVELOPMENT OF INTERNATIONAL INCOME TAXATION

*Ilan Benshalom\**

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#### I. INTRODUCTION: WHY INTEREST? A PREFACE

Despite its complexities, inconsistencies, and somewhat chaotic development, the international income tax regime (IITR) has never fulfilled the fire and brimstone prophecies many claimed it would. Imposing only insignificant barriers to trade and investment, the IITR has allowed international commerce among industrialized countries

with inconsequential incidences of double taxation.<sup>1</sup> Because it is premised on the “source rules,” which allocate revenue from different economic activities to different jurisdictions, it is surprising that the IITR has never been fundamentally challenged. These rules are convoluted, detached from the economic concept of income, and devoid of any well theorized normative content.<sup>2</sup> To unfold this apparent inconsistency — between the IITR’s smooth operation and blemished source premise — this article reviews critically the economic and intellectual history of one of the IITR’s most important sourcing conventions: the source tax treatment of interest payments.

Allocation of interest income has always been an important issue because of the business community’s interest in preventing tax obstacles from interfering with the “smooth” flow of international debt investments. Despite its ongoing importance for both capital importing and exporting countries, sourcing rules dealing with interest have been somewhat ambiguous as to the tax owed by the creditor to the debtor’s jurisdiction. Even though they have elicited numerous controversies, these ambiguities have not been fully resolved during the course of the last eighty-five years. One aspect of the article’s contribution is focusing on the very significant interest source rules and tracing their development over a long period of time. However, its main contribution transcends the importance of the interest source rules. Due to their ongoing importance and ambiguity, the sourcing conventions of interest income have been constantly changed through the years, each change subscribing to the different ideological premise of its era. Accordingly, the development of these sourcing conventions serves as an example that reflects the IITR’s development as a whole.

The article traces the historical development of the IITR — a synthesis of two more commonly told 20th century historic processes. The first is the history of globalization — a process induced by Western countries to restore the high pre-WWI levels of market integration. The second is the history of the income tax — and the reliance of Western countries on income tax revenues since WWI. The source rules are the friction point between these two stories. The economic concept of income refers to the net increase in individuals’ wealth during a given period, pooling individuals’ resources to

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<sup>1</sup> Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261, 269 (2001).

<sup>2</sup> H. David Rosenbloom, *U.S. Source Rules: Building Blocks of Cross-Border Taxation*, 60 BULL. INT’L FISCAL DOCUMENTATION 386 (2006) (providing an illuminating analysis over the function of the source rules in the international income tax regime (IITR)).

determine their ability to bear the tax burden. In contrast, the source rules bifurcate individuals' income to different jurisdictions, hence importing a divisional element into income tax administration that is alien to the notion of income as the net gain of individuals' total wealth.<sup>3</sup> The growing levels of economic integration in global markets require increasingly the use of source rules, hence making the tension between the notion of income tax and globalization palpable and inevitable. This article provides readers with an insight into the dynamics by which many international source tax rules and conventions have developed. IITR policy is an extension of foreign policy and fiscal policy, each representing a compromise among multiple considerations. Because of this, the development of IITR policy has always been perceived as somewhat erratic and discontinuous. As a result, with only few exceptions,<sup>4</sup> it has never been adequately researched and theorized.

The article demonstrates that an erratic vision is flawed, and that one may track dominant themes underlying the IITR's development. The article demonstrates how, over the past eighty-five years, these themes were subject to changes that corresponded with the political economy of cross-border businesses and transactions. To illustrate this, it creates three novel chronological stages of development: the Revenue, Trade, and Anti-Avoidance Phases. In each of these phases, the article focuses on the major crossroads in the development of U.S. sourcing rules in the U.S. IITR that, due to the dominant economic position of the United States, are the most influential IITR in the examined era. The article examines U.S. sourcing rules by looking at two different elements that developed in different phases. The first is U.S. double taxation treaty policy and its resonance with other significant treaty policies of international organizations with regard to withholding taxes on interest payments. The second element is the U.S. earnings-stripping regime (USES SR).

The upshot of the article's historical analysis transcends the value of elucidating this specific issue alone. It highlights a more general and multilayered story of source tax erosion that has not yet been told.

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<sup>3</sup> Jugh J. Ault & David F. Brandford, *Taxing International Income: An Analysis of the U.S. System and Its Economic Premises*, in TAXATION IN THE GLOBAL ECONOMY 31 (Assaf Razin & Joel Slemord eds., 1990).

<sup>4</sup> Reuven S. Avi-Yonah, *All of a Piece Throughout: The Four Ages of U.S. International Taxation*, 25 VA. TAX REV. 313 (2005); Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 DUKE L.J. 1021 (1997); Richard Vann, *Tax Treaties: The Secret Agent's Secrets*, 50 BRIT. TAX REV. 345 (2006).

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The thesis that emerges is that the themes that have dominated the IITR debate are fundamentally insufficient for dealing with material changes in an integrated global economy. More specifically, the article argues that fiscal and equitable considerations played too small a role in the development of the IITR. The article suggests that notions of liberalizing cross-border trade and investment have infiltrated the debate in an unbalanced and hazardous way, leading to a severe erosion of the income tax base. It further argues that the anti-avoidance strategy, which sought to balance trade considerations by re-characterizing transactions that might be identified as abusive, was unable to prevent fiscal losses, resulting in immense costs and inefficiencies. In my opinion, such paradigmatic failures explain the present IITR's inadequate performance at the outset of the 21st century. One cannot underestimate the impact of this failure because, as the 21st century begins, residence income taxation is under siege.<sup>5</sup> There is a growing readiness among policymakers in dominant economies to shift to a territorial system that exempts residents' foreign income. This suggests that whether or not one believes that taxation at source is justified, the source rules are the de facto arena in which many future tax battles are going to be won or lost.<sup>6</sup>

The article provides an historical analysis that is necessary for better informed policy research. It urges scholars and policymakers to create a new phase in IITR development that contains new source allocation conventions. It argues that, based on material changes in the world economy and the inadequacy of current sourcing rules to efficiently and equitably deal with the proceeds of financial investments, the sourcing rules of an emerging new phase will have to depart from prevalent source rule classifications of financial investments.

Part II of the article contextualizes the tax environment in which financial transactions are employed. It does so by exploring the legal and economic terrain in which such transactions take place. Afterwards, it carefully defines the scope of the article's inquiry. Part III describes the first phase in the intellectual development of the IITR — the Revenue Phase. During this phase, from the 1920s until the end of WWII, revenue considerations played the major role in IITR formulation. As the article later argues, it is surprising to see

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<sup>5</sup> Ilan Benschalom, *Sourcing the 'Unsourceable': The Cost Sharing Regulations and the Sourcing of Affiliated Intangibles-Related Transactions*, 26 VA. TAX REV. 631, 633–35 (2007).

<sup>6</sup> *Id.*

such revenue considerations abandoned in years to come. Part IV details the rationales behind the second phase — the Trade Phase. It examines the manner through which double taxation treaties (Treaties) and unilateral exemptions eroded U.S. withholding taxes on interest from inbound debt investments — investments made by nonresidents in the (domestic) source jurisdiction — to promote free trade objectives during the Cold War era. The article argues that such rationales severely impaired the U.S. IITR from effectively and equitably levying source taxation on inbound debt investments. Part V discusses the 1990s Anti-Avoidance Phase, which was the knee-jerk reaction to the hegemony of trade and investment considerations during the Trade Phase. The article highlights the premises of this phase, and their underlying problems, through an in depth analysis of the earnings-stripping tax abuse and the paradigm of earnings-stripping regimes designed to counter it. Part VI uses the USESR as a case-study to assess critically whether the anti-avoidance paradigm met any of its feasible objectives. The article contends that the USESR's failure is directly derived from the tottery foundations of the Anti-Avoidance Phase and, as such, is reflective of a more profound systemic failure in the IITR. Part VII presents the epilogue of the analyzed historic processes and a concise prologue to how interest sourcing rules should develop in the future. This Part stresses that the article is the first part of a broader research enterprise dealing with formulating a concrete sourcing paradigm for financial transactions within multinational enterprises (MNE or MNEs, as appropriate). It further suggests that the article's historical analysis lays out a set of underlying principles that may serve as a platform for future reforming of the IITR. Part VIII provides the article's conclusions.

## II. THE TAXATION OF DEBT INVESTMENT: THE ISSUE IN CONTEXT

### A. *The Law and Economics of Inbound Debt Investments*

This Part explains the basic attributes of the (current) interest sourcing rules and conventions in preparation for the next Parts, which analyze the dynamics by which they were created. Although much of the article's discussion is relevant outside the corporate framework, since international commerce is overwhelmingly conducted by corporations, the article limits its analysis to them.<sup>7</sup> It

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<sup>7</sup> Alvin C. Warren, Jr., *Income Tax Discrimination Against International Commerce*, 54 TAX L. REV. 131, 131 (2001).

nevertheless refrains from addressing the possible implications of corporate shareholders' imputation tax regimes on the analysis.<sup>8</sup>

Everyone agrees that the source jurisdiction (where the income is formed through the productive activity of tangible and intangible assets, human capital, and capital investments) has the right to levy corporate tax before the residence jurisdiction (where the individual or corporate investor resides).<sup>9</sup> This, however, is merely a formal recognition in the case of interest income, since the source priority does not provide source jurisdictions with a tangible capability to raise revenues from it.

There are two relevant types of source taxes on foreign corporate investments — the corporate income tax and withholding taxes. Corporate tax is laid on the (net) taxable income of a corporate entity.<sup>10</sup> If the corporation derives income from domestic *and* foreign sources, the corporate tax is applied both as a source tax (on the income raised by the domestic operations) and as a residency tax (on income generated abroad). In the context of this article, which deals primarily with source taxes, the analysis refers to the corporate tax mainly as a source tax. In contrast, withholding taxes are laid on different types of payments (e.g., dividends, royalties, and interest) made by domestic taxpayers to foreign investors and trading partners. Thus, withholding taxes are laid on sources of gross income and not upon (net) taxable income. This division of the source taxing right, reflected in the principles governing treaties, relies on the structure of the classical corporate tax system, which enshrines a distinct tax law treatment of investors and corporations.<sup>11</sup> Accordingly, setting aside issues of tax incidence, while the corporate income tax (when it is imposed as a source tax and not as a residency tax) is a tax on

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<sup>8</sup> This is partly because, with the exception of the European Union (EU), which for the time being is a unique political arrangement, imputation tax regimes do not typically grant any corporate tax relief to foreigners.

<sup>9</sup> Stephen E. Shay, Jr. et al., "What's Source Got to Do With It?" *Source Rules and U.S. International Taxation*, 56 TAX L. REV. 81, 83 (2002). The residence's entitlement is always secondary in the sense that if levied, it offers some type of relief to taxes paid in the source jurisdiction. One can argue that this concurrence is not the byproduct of a normative recognition of the source regime's entitlement to levy tax first but a byproduct of the practice in which source recognition *can* take the first tax bite.

<sup>10</sup> The corporation's net taxable income equals its gross income (profits) minus its expenses.

<sup>11</sup> Hugh J. Ault, *Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practices*, 47 TAX L. REV. 565, 565 (1992).

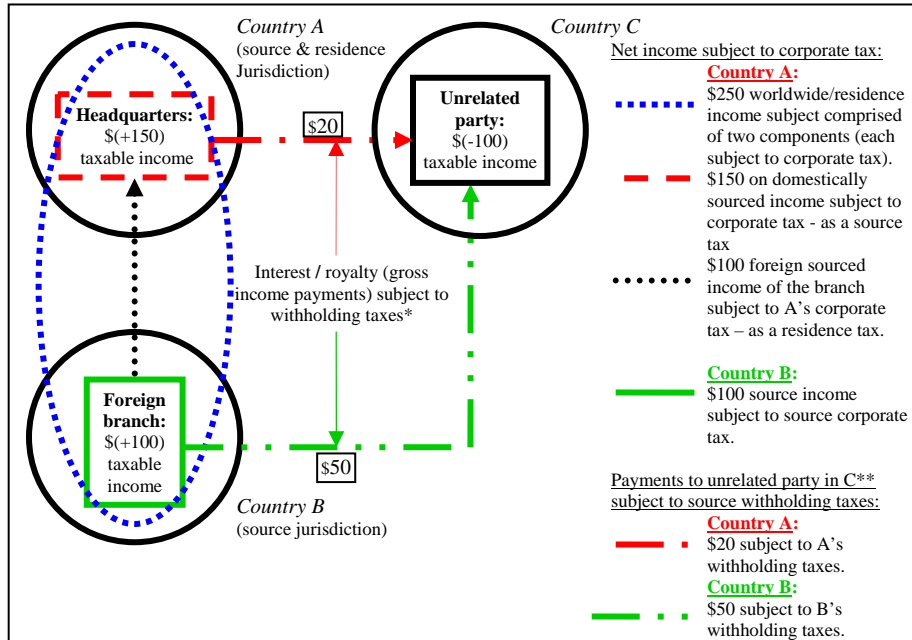


business, withholding taxes are perceived as taxes on foreign investors (e.g., shareholders and creditors).

The following graphic schema (Figure 1) illustrates how these concepts interplay. Assume, for example, there is a corporation that is a tax resident of Country A. It has its headquarters located in Country A and a foreign branch in Country B. In a given year the corporation earned \$150 from its business activities in Country A and \$100 from its business activities in Country B (both figures represent taxable income before taxes). In this example, Country B is solely a source jurisdiction; therefore, it lays its corporate tax (as a source tax) on the \$100 earned by the corporation in it. Country A is both a source and a residence jurisdiction; therefore, it lays its corporate tax on the entire \$250 earned by the corporation in that year. Country A's corporate tax is laid, as a source tax, on the \$150 earned by the corporation in its jurisdiction *and* as residence tax on the foreign sourced income earned by the corporation's foreign branch in Country B. To avoid double taxation, Country A, the residence jurisdiction, will typically grant the corporation tax credits for the corporate income taxes it pays abroad in the source jurisdiction (Country B in our case). All corporate income taxes are laid on taxable income (before taxes) — so if the corporation had been losing money, it would not be exposed to the taxes.

Withholding taxes are laid by the source country on gross income payments. In the above example assume that the corporation's headquarters (located in Country A) took a loan from an unrelated lender in Country C and the foreign branch (in Country B) leased some intellectual property rights from it. In a given year, the corporation's headquarters and foreign branch had to pay USD 20 interest and \$50 royalty payments to the unrelated party, respectively. In this case, Countries A and B could lay withholding taxes on those payments. These taxes, which are nominally imposed on the unrelated party from Country C, are not "real" income taxes since they would have to be paid even if overall the unrelated party incurs losses in a given year and therefore has no economic income.

FIGURE 1. A TAXONOMY OF THE IITR TAXES



\* Withholding taxes may also be laid on dividend payments. Additionally, they will also be laid upon interest and royalty payments made from a foreign subsidiary to its parent.

\*\* The withholding taxes are levied on gross income payments and thus are imposed even though the unrelated party in Country C has a net income loss in the taxable year in which it is receiving the payments.

Legally, source supremacy is limited solely by a sovereign's undertaken treaty obligations for reciprocity and nondiscrimination towards the residents of the other signatory.<sup>12</sup> However, in reality, the actual division of a sovereign's right to tax most frequently adheres to a more refined convention. This convention differentiates between the source jurisdiction's unchallenged primacy to tax active business income and its (de facto) weaker claim on taxing passive (investment) income generated from foreign capital invested in its jurisdiction.<sup>13</sup> The source country retains its corporate tax rate and base when dealing with the taxable income derived by subsidiaries of foreign corporations in its jurisdiction. In contrast, it only has the ability to impose low withholding taxes on deductible payments<sup>14</sup> (and also on

<sup>12</sup> See sections 871(b), 882(a), and 884, which impose a relatively high 30% withholding tax rate on a wide array of payments made by U.S. residents to nonresidents. I.R.C. §§ 871(b), 882(a), 884.

<sup>13</sup> Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301, 1306 (1996).

<sup>14</sup> Ault, *supra* note 11, at 566, 573 (noting that this principle is most notably

nondeductible dividend payments).<sup>15</sup> Source jurisdictions' ability to impose withholding taxes is therefore mere lip service to the notion of source supremacy. For example, federal statutory law prescribes that every interest payment made to nonresidents that is not effectively connected with a trade or business in the United States is subject to a statutory withholding tax rate of 30%.<sup>16</sup> However, as will be demonstrated later in detail, the encompassing nature of the exemptions to this rule makes the exceptions the de facto rule of the land.

The fact that withholding taxes are mostly recognized by their effective erosion suggests that the source jurisdiction's desire to levy taxes is typically reconciled with the broader international consensus that passive income should be taxed primarily in the residence jurisdiction.<sup>17</sup> Startlingly, this artificial division of source taxing rights has by and large been left unchallenged. Perhaps because of deemed truisms regarding the distinctness of corporate-versus-shareholder tax treatments, the debate over sourcing practices has neglected using a combined analysis of the two taxes to determine the appropriateness of source tax practices.<sup>18</sup>

The present article explores how the source tax base has been eroded both on the withholding tax level (Part IV) and on the corporate tax level (Part VI). It is important to recognize that this leniency in a source tax jurisdiction's tax bite has not been tantamount to a stronger fiscal grasp of the residence jurisdiction. Rather, the dynamics described below, which led to erosion of the source tax base, took place as residency taxation was eroded as well.

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followed with respect to income derived from portfolio investments).

<sup>15</sup> Richard L. Umbrecht & Don W. Llewellyn, *Planning Pitfalls and Opportunities for Foreign Owned Corporations Under the Earnings Stripping Rules*, 47 TAX LAW. 641, 646 (1994).

<sup>16</sup> I.R.C. §§ 861(a), 862(a)(1), 871(a), 881(a)(1).

<sup>17</sup> This consensus has been defended on numerous grounds which include (1) benefit principle rationales (which some may consider to assign passive income primarily to the residence jurisdiction), (2) administrative convenience, and (3) the (intra-nation) equitable desirability of taxing passive income on the consolidated progressive resident basis, which best reflects the taxpayer's ability to pay. See Reuven S. Avi-Yonah, *For Haven's Sake: Reflections on Inversion Transactions*, 95 TAX NOTES 1793 (June 17, 2002); Paul D. Reese, *United States Tax Treaty Policy Toward Developing Countries: The China Example*, 35 UCLA L. REV. 369, 373 (1987).

<sup>18</sup> For some of the few exceptions, see Peggy B. Musgrave, *Comments in Session on "Foreign Reaction to U.S. Tax Reform,"* 41 NAT'L TAX J. 365 (1988); John P. Steines, Jr., *Income Tax Implications of Free Trade*, 49 TAX L. REV. 675, 676 (1994).

In an open and competitive global economy, international investors are able to shift a considerable amount of their (source) tax burden on capital. This theme helps explain much of what is described in the following Parts. The tax erosion dynamic was embroiled with the facilitation of certain conditions that allow greater shifting to debtors. These conditions<sup>19</sup> have one common denominator — they undermine the bargaining position of the source jurisdiction in setting its “tax price” for international investments.

Relatively low source taxes laid upon proceeds of debt transactions make their economics lucrative every time there is a jurisdictional mismatch in which a lender is a tax resident of a jurisdiction with lower tax rates than the debtor. This is a combination of two factors. First, the debtor is able to deduct the interest it pays from its otherwise highly taxed income. Second, the lender will only be subject to low (or no) levels of source withholding taxes (on the gross interest payments) and low income taxes (on its taxable income) in its country of residence. From the taxpayer’s perspective, this finance transaction is superior to an equivalent domestic debt transaction (in which the lender may be exposed to high income taxes) and to domestic and foreign equity investments in which shareholders bear at least some of the corporate tax burden and are exposed to higher income and/or withholding tax rates. To understand the historical development of the legal conventions applied to interest from inbound debt investments, one must first understand the unavoidable tension that is bound to arise from this jurisdictional mismatch.

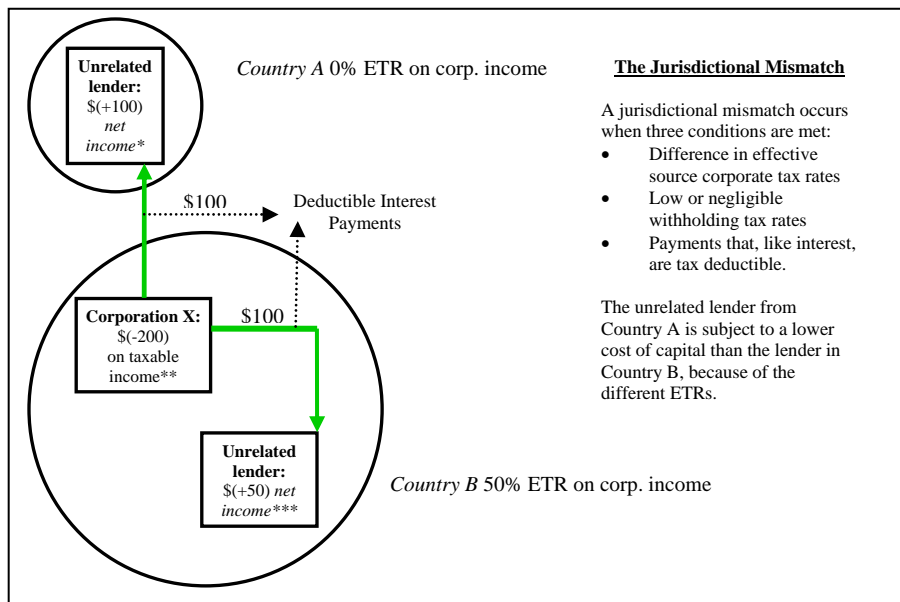
The following graphic schema (Figure 2) illustrates the jurisdictional mismatch. Country A and Country B impose respectively a 0% and 50% effective tax rate (ETR) on all sources of corporate income. Countries A and B entered a double taxation treaty, which eliminates withholding taxes on interest payments. *X* is a corporation located in Country B. *X* took two \$1000 loans each carrying a 10% annual interest rate from two different creditors in Countries A and B. In a given year *X* paid \$200 interest payments. These payments are deductible, so *X* could use them to reduce its corporate income. Because of the different ETRs in Countries A and B, *X*’s creditors will have a different net gain of \$100 and \$50, respectively. Since the payments to both creditors are equally deductible to *X*, it will prefer to take loans from creditors in Country A, from which presumably it will be able to get better terms, than

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<sup>19</sup> See *supra* Part IV.D for a discussion of these conditions in detail.

from creditors in Country B. *X*'s preference to loan from Country A's creditors will come at the expense of Country B's treasury. *X*'s interest payments to the foreign creditor will reduce its taxable income in \$100, which given Country B's 50% ETR, would have resulted in a \$50 tax liability. However, unlike the case of the interest payments made by *X* to its creditor in Country B, Country B's treasury does not tax any of the foreign creditor's interest proceeds.

FIGURE 2. JURISDICTIONAL MISMATCH



\* Comprised of \$100 interest payments received from *X* + \$0 corporate income tax payments.

\*\* Comprised of \$(-200) deductible interest expenses.

\*\*\* Comprised of \$(100) interest payments received from *X* + \$(-50) corporate income tax payments.

### B. Where Do We Go Now?

Tracing the IITR's development highlights a number of its problematic features (e.g., IITR's complexity, which leads to inefficiencies and high compliance and administrative costs).<sup>20</sup> However, as mentioned before, this article spotlights the development of the sourcing conventions of interest payments because they best illustrate the tax erosion dynamic it explores. The next three Parts provide the article's main novel contribution to the construction of the IITR's intellectual history.<sup>21</sup> They identify three thematic phases: the

<sup>20</sup> Benshalom, *supra* note 5.

<sup>21</sup> This article addresses the IITR's intellectual history. It is, therefore, interested

Revenue Phase, the Trade Phase, and the Anti-Avoidance Phase. Each thematic phase represents an era in which a specific set of considerations has dominated policymakers' considerations with regard to sourcing. Each is a benchmark in the process of source tax erosion that the article excavates. The crudeness of the present article's research approach has two virtues. First, by formulating an evolutionary account of the sourcing of income from inbound debt investments, the article is able to provide its novel understanding of IITR development. Second, this approach allows the article to intertwine intimately the IITR's development with material changes in the global political economy. Together, both of these virtues allow the article to extract deeper normative and practical conclusions regarding the future path of the IITR.

The article's attempt to make a rough historical division of tax conventions into chronological phases may unavoidably seem simplistic. However, tracing the historical development of legal norms requires periodization to trace the conventions and interests from which they were molded and the reality of the circumstances from which their contours were forged.<sup>22</sup> This article does not argue that every theme was unique to a designated period in the IITR's evolution.<sup>23</sup> Each period is roughly defined, beginning at the point in which a specific set of considerations begin to gain dominance, up to the point when a new set of considerations arise. Hence, under the

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in how people were explaining, justifying, and theorizing the different sourcing arrangements established. Accordingly, it primarily refers to secondary material from the relevant periods that deal with those questions.

<sup>22</sup> Avi-Yonah, *supra* note 4, at 315 (discussing briefly the necessity of periodization in historic research).

<sup>23</sup> In fact, the scholarship of pioneer policymakers informs us that many of the different issues, tradeoffs, and considerations that we struggle with today were already openly recognized in earlier IITR stages. PAUL DEPERON, *INTERNATIONAL DOUBLE TAXATION* 11–12 (1945) (“The attitude of governments towards the problem of international double-taxation is determined by factors such as the degree and direction of economic development of the country concerned, the commercial and financial relations that the country maintains or seeks to establish with other countries, the amount of public revenue obtained by taxing international business and the technical features of the national tax system.”); Henry S. Bloch & Cyril E. Heilemann, *International Tax Relations*, 55 *YALE L.J.* 1158, 1159, 1166 (1946); H. David Rosenbloom & Stanley I. Langbein, *United States Tax Treaty Policy: An Overview*, 19 *COLUM. J. TRANSNAT'L L.* 359, 362–64 (1981). The article cites to the 1923 and 1925 reports made to the League of Nations, which recognized that source taxation of foreign investment is equivalent to a tariff on capital-importing, infringes with income tax standards of horizontal equity, and is inconsistent with capital-importing countries' desires to attract foreign investments.

article's conception, a period does not end when it loses its dominance — rather, it ends when it is fundamentally challenged.

### III. THE REVENUE PHASE: FROM THE END OF WWI UNTIL THE END OF WWII

In the first phase — the Revenue Phase — the article sets out to demonstrate the original concerns of the different IITR policymakers in the period between the two world wars. I argue that, unlike the periods that follow it, the dominant debate during this phase was about the allocation of revenues between capital-importing and capital-exporting nations.<sup>24</sup> The article's main claim in this Part is that, because of the urgency of reducing double taxation after WWI and the political turbulence in the 1930s and 1940s, the Revenue Phase resulted in incomplete sourcing conventions. Since then, the IITR's sourcing conventions developed as an amiss set of stopgap measures, which did not try to reformulate the IITR's original deficiency. This, as the article demonstrates in its following Parts, contributed to the dynamics of source tax erosion.

To be sure, at the time, the IITR was primarily concerned with alleviating double taxation. As a baseline for discussion, it is important to recognize that Europe had a well established tradition of liberalized foreign trade and capital investments, which flourished in the pre-WWI years.<sup>25</sup> The concern over double taxation originated from the International Chambers of Commerce — an umbrella organization of the business community, which recognized post-war growth potential in continental Europe, especially in new nations that replaced pre-war empires.<sup>26</sup> This concern was later endorsed by the governments yearning for foreign investments to restore their economies. At the same time, coming out from the devastation of

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<sup>24</sup> P. Verloren van Themaat, *Intervention*, VIII CAHIERS DE DROIT FISCAL INTERNATIONAL 47, 48 (1947) (claiming that the pre-war conventions gave more heed to the theoretical underpinnings of allocating the right to tax while the post-WWII Anglo-American treaties were a byproduct of a give and take bargaining process).

<sup>25</sup> Evelyn Kolm, *The Emerging System of Double Taxation Agreements in the Late 19th and 20th Centuries*, FEJLESZTES ES FINANSZIROZAS: Q. HUNGARIAN ECON. REV. 66, 66–67 (2005) (summarizing the social developments that led to the pre-WWI market integration).

<sup>26</sup> DEPERON, *supra* note 23, at 14–16; JOHN G. HERNDON, JR., RELIEF FROM INTERNATIONAL INCOME TAXATION 69–120 (1932); Graetz & O'Hear, *supra* note 4, at 1066–71; Ke Chin Wang, *International Double Taxation of Income: Relief Through International Agreement 1921-1945*, 59 HARV. L. REV. 73, 102–06 (1945).

WWI, governments had dire needs for revenue.<sup>27</sup> In this context, the combination of business ambitions to go global and the (new at the time) income tax based public finance scheme of European countries<sup>28</sup> resulted in a high double taxation exposure for cross-border activities. Given the high tax rates imposed during and after WWI, this risk of double taxation introduced a serious obstacle to re-liberalizing cross-border trade.<sup>29</sup> This Part demonstrates, however, that even though trade considerations triggered policymakers' endeavors to formulate an IITR, the controversies that delineated its course of development, especially with relation to inbound financial investments, were by and large related to the allocation of revenues among sovereigns.

The two decades of the Revenue Phase were a unique period. The process of delineating the IITR as a new doctrine of law and public policy involved a lot of experimentation to create terminology as well as governing principles. This process was simultaneously pursued by nongovernmental parties (International Chambers of Commerce and academics),<sup>30</sup> as well as by national legislators and bilateral treaty negotiators.<sup>31</sup>

At the beginning of the Revenue Phase there were four income tax rules of the land. The first was the United Kingdom's rule which imposed income tax liabilities on the worldwide income of all its residents. The second was the United States' rule, which, to avoid the problem of double taxation, supplemented the residency taxation with credits for income taxes paid to foreign countries.<sup>32</sup> Both the United

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<sup>27</sup> Mitchell B. Carroll, *International Tax Law*, 2 INT'L LAW. 692, 700 (1967-1968).

<sup>28</sup> HERNDON, *supra* note 26, at 261.

<sup>29</sup> *Id.* at 7; Mitchell B. Carroll, *The Development of International Tax Law: Franco-American Treaty on Double Taxation-Draft Convention on Allocation of Business Income*, 29 AM. J. INT'L L. 586, 587 (1935); Burton W. Kanter, *The United States Estate Tax Treaty Program*, 9 TAX L. REV. 401, 402 (1954); Rosenbloom & Langbein, *supra* note 23, at 361 ("During and shortly after World War I, double taxation became a matter of worldwide significance. Rates of direct taxation, particularly income taxation, were increasing, as was the volume of international business.").

<sup>30</sup> EDWIN R.A. SELIGMAN, DOUBLE TAXATION AND INTERNATIONAL FISCAL COOPERATION (1928); Thomas S. Adams, *International and Interstate Aspects of Double Taxation*, 22 NAT'L TAX ASS'N PROC. 192, 193 (1930).

<sup>31</sup> Kolm, *supra* note 25, at 71-74.

<sup>32</sup> In 1918 Congress enacted, unilaterally, a generous statutory double taxation relief measure, which credited taxes paid in foreign jurisdictions by American residents and citizens. George F. James, *The Taxation of Business Income from Foreign Sources*, 13 U. CHI. L. REV. 229, 234-35 (1946); Graetz & O'Hear, *supra* note 4, at 1041-59. In 1936, Congress laid another important tax layer to the U.S. IITR by



Kingdom and the United States, which at the time were the most dominant capital-exporting countries, refrained almost entirely from entering treaties during the Revenue Phase.<sup>33</sup> The third was the rule of Germany and the countries that emerged from the Austro-Hungarian empire, which, to avoid double taxation, supplemented the residency taxation with treaties. These treaties often assigned different sources of income to either the residency or the source jurisdiction.<sup>34</sup> Fourth was the French rule, which had a strong emphasis on taxation only at the source.

At the outbreak of WWII, there were more than sixty treaties intended to relieve double taxation between different countries (mainly in Europe).<sup>35</sup> In general, these treaties, especially those signed during the 1920s, demonstrated a strong preference toward residence allocation.<sup>36</sup> This is not surprising given that most of these treaties were signed between declining empires (e.g., Austria and the United Kingdom) and their former colonies (e.g., Hungary, Czechoslovakia, Yugoslavia, and Ireland). The old empires, likely to be capital exporters to their former colonies, would benefit from residency allocation. This allocation of tax revenues probably mirrored the divergence in bargaining power between the former superpower (even if already in decline) and its previous colony.<sup>37</sup> Additionally, most of

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setting a 10%-15% statutory withholding tax rate on the gross payments of interest (and other payments) to nonresidents (individuals and corporations). *See* Revenue Act of 1936, 74 P.L. 740, §§ 211(a), 231(a), 49 Stat. 1648, 1714, 1717; Ault & Brandford, *supra* note 3, at 22 (noting that the 30% tax rate is a heritage of old times, when the tax rates on net taxable income were much higher — thus the 30% rate was actually considered a redress that was necessary because the withholding taxes were levied on gross income); Marcel Singer, *Some American Discriminations Against Foreign Enterprises*, 11 LAW & CONTEMP. PROB. 776, 779 (1945–1946).

<sup>33</sup> DEPERON, *supra* note 23, at 15; Mitchell B. Carroll, *Tax Inducements to Foreign Trade*, 11 LAW & CONTEMP. PROB. 760, 761 (1945–1946). The only exceptions for this are the U.S.-French double taxation treaty (which was very limited in scope) and the U.K.-Ireland treaty (in which Ireland forfeited its right to levy source tax). The article considers the U.S.-Sweden double taxation treaty signed during WWII also as an exception.

<sup>34</sup> *See* Kolm, *supra* note 25, at 71–73; Wang, *supra* note 26, at 102–07. This was possible because at the time most income taxes employed in Europe were not like the idea of economic income we have today, “but *impôt* reals, an untranslatable expression for a series of separate taxes imposed on different types of income on a source basis, such as a tax on land, a tax on business profits and the like . . . .” *See* John F. Avery Jones, *Are Tax Treaties Necessary?*, 53 TAX L. REV. 1, 12–13 (1999).

<sup>35</sup> DEPERON, *supra* note 23, at 15.

<sup>36</sup> Wang, *supra* note 26, at 102.

<sup>37</sup> The most transparent example for this is the double taxation treaty between

the pre-WWI European colonies shared the income tax system of their former rulers. This meant that questions of source were probably marginal and insignificant. Thus, after the empires were broken, the dynamic of tax administration continuity may have served as a de facto platform for adopting residence taxation.<sup>38</sup>

Early on, policymakers recognized that, unless some multilateral coordination norms were introduced to the IITR, the dynamics of unsystematic legislation and treaty negotiations would produce different arrangements, posing an immense implicit tax of administrative and compliance costs on foreign trade.<sup>39</sup> As a result, the most prominent role of delineating IITR conventions during the Revenue Phase was by and large invested in the League of Nations (the League) — a body in which poor net capital-importing countries had dominant representation. The remainder of this Part describes how these countries tried, unsuccessfully, to counter the inherent difficulty in source taxing mobile capital assets by using the egalitarian, multilateral framework of the League to promote a cartelized arrangement. The open confrontation in the League

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the United Kingdom and Ireland, signed in 1926, in which no taxes were levied on the source level. This arrangement was obviously revenue biased towards Britain, the main capital exporter at the time. *See* Wang, *supra* note 26, at 105–06.

<sup>38</sup> Taxpayers operating in different parts of the empire were subject to a single centralized tax authority and tax rules. Prior to its post-WWI bifurcation, the Austro-Hungarian Monarchy had two sets of different direct tax systems (one for the more agrarian Hungary and one for the more industrialized Austria). In the post war era two things happened: many formerly subordinated vessels became independent, and the Hungarians accepted most of the Austrian direct tax rules. This made the implementation of residency much easier. *See* Kolm, *supra* note 25, at 67–68, 72–73. In the British-Irish scenario, it is useful to compare the Irish arrangement with its arrangement with other, non-European members of the Commonwealth. In those cases, where because of geographic distance there was no single tax administration, double taxation arising from U.K. residency was avoided through a regime that divided the revenues between the United Kingdom and the source jurisdiction. This alternative regime was intended to encourage U.K. residents' foreign investment in the Commonwealth. The United Kingdom deducted source taxes paid up to half of its tax liability and the other (source jurisdiction colony) provided the rest of the relief to the taxpayer so that the taxpayers' tax liability would not exceed the lower of the two taxes. *See* DEPERON, *supra* note 23, at 15 (noting that Britain adopted the splitting arrangements to encourage investments in the commonwealth); James, *supra* note 32, at 231 (describing how Britain's capital-importing colonies (e.g., South Africa, Australia) exempted foreign sourced income earned by their residents altogether); Wang, *supra* note 26, at 74.

<sup>39</sup> HERNDON, *supra* note 26, at 69–171 (providing a description of the different convoluted arrangements produced by national legislators and treaties during the 1920s).

between debtor and creditor countries on the taxation of capital income is the most telling example of the importance of revenue consideration in this era. The prospects of such a cartelized arrangement may have seemed more plausible at the time than they do today. At the time, international investors operated in a less mobile, transparent, and sophisticated business environment, which made it difficult to shift source taxes to debtors.

The League's process of codification was both technically and politically convoluted. On the technical level, the various League committees had to agree on terminology that corresponded well to the various, trailblazer income tax systems, all of which had not yet taken root in a nonwar-crisis environment. The attempt to allocate resources between (what eventually became coined) source and residence jurisdictions was protean and subject to fluctuation.<sup>40</sup> Some practical mechanisms of taxing and auditing businesses with cross-border activities were also discussed, though not resolved fully, during that period of time.<sup>41</sup>

Revealing as the discussions over these technical obstacles are, this article focuses on the political reconciliation that took place in those discussions. Despite the European countries' will to remove income tax barriers that sparked initially the IITR formulation's endeavors, the main issues in the Revenue Phase debates did not deal with how to best facilitate trade. In fact, the bone of contention between sovereigns during the Revenue Phase related to the allocation of the revenue base. The sparring partners on the different sides of the debate<sup>42</sup> were the non-European and continental European debtor countries, on the one hand, and the net capital-

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<sup>40</sup> Wang, *supra* note 26, at 81–88. The article notes that, in the course of shaping the IITR's terminology, alternative criteria were suggested to distinguish between different income sources for the purpose of allocating them to the country of residency/domicile or source/origin (e.g., income derived from tangibles versus intangible assets and personal versus impersonal taxes).

<sup>41</sup> SOL PICCIOTTO, INTERNATIONAL BUSINESS TAXATION: A STUDY IN THE INTERNATIONALIZATION OF BUSINESS REGULATION 27–33 (1992) (describing the Carrol committee's works and findings and the 1935 draft allocation convention); Carroll, *supra* note 27, at 704 (explaining how the arm's-length standard was formulated); Wang, *supra* note 26, at 79 (noting that the League's 1933 draft convention suggested the use of formulary methods based on turnover for permanent establishments when the arm's-length standard did not work adequately).

<sup>42</sup> Wang, *supra* note 26, at 86–89 (describing how the creditor countries opposed suggestions made by the United Kingdom to tax investment income only in investors' country of domicile).

exporting countries (mainly the United Kingdom and, to a lesser degree, the United States) on the other.<sup>43</sup>

At the forefront of the debate was the right to tax the income proceeds of capital investments — namely, interest and dividends.<sup>44</sup> This proved a major issue because of the enormous debts European countries, primarily France, Italy, and Russia, incurred during the War.<sup>45</sup> Settling the right to tax the interest proceeds of debts was therefore tantamount to determining to what extent the debtor countries were to bear these unheard of amounts of sovereign debts by themselves. In allocating the primary sourcing right over capital resources, the United Kingdom, the biggest capital-exporting country at the time, argued vehemently in favor of an exclusively residence-based taxation of such passive income sources.<sup>46</sup> In other words, the British believed that income taxes should only be imposed as direct taxes by the country of residence. The firm opposition posed by the United Kingdom was the source of much of the controversy during the Revenue Phase.<sup>47</sup>

Over the course of the 1920s, the League's position on this issue proved volatile and subject to changes.<sup>48</sup> In 1923, a nominated committee of four professors submitted a report to the League, recommending the right to levy taxes on all intangible wealth (including debt investments but excluding mortgages) to be granted exclusively to the investor-creditors' domicile. This was by and large refuted in a report submitted by a group of Technical Experts to the Financial Committee of the League in 1925.<sup>49</sup> Net capital-exporting countries responded to the debtor countries' 1925 success with much more active participation in the League. Most apparently, the United

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<sup>43</sup> Graetz & O'Hear, *supra* note 4, at 1072 (claiming that the battle lines were drawn as a result of the resolutions made by the 1923 Rome congress, which assigned the right to tax interest and dividends to both source and residence jurisdictions).

<sup>44</sup> *Id.* at 1077.

<sup>45</sup> T.B. Macaulay, *The Allied Debt to the United States*, WASH. STAR, Aug. 27, 1922, at 4–5.

<sup>46</sup> Graetz & O'Hear, *supra* note 4, at 1086–87.

<sup>47</sup> For more details, see Graetz & O'Hear, *supra* note 4, at 1069–73, 1084–86 (describing the role of the prominent United Kingdom in the International Chamber of Commerce 1921–1923 and in the League).

<sup>48</sup> Wang, *supra* note 26, at 81–96.

<sup>49</sup> HERNDON, *supra* note 26, at 58–62 The book notes that the 1925 report, which allocated the right to tax impersonal taxes to source jurisdictions and direct-personal taxes to the domicile jurisdiction, was expected to shift revenues from creditors to debtors countries — this motivated the United States, as a net capital-exporting country, to join the League's fiscal committee discussion.

States, which was not a League member, joined actively in the League's fiscal committee discussions. This resulted in a backlash against source allocation. Article 3 of the draft bilateral convention published by the League in 1927 allowed the source jurisdiction to take the first tax bite on most passive income payments but required it to refund those taxes once evidence showed that taxes were levied in the residence jurisdiction.<sup>50</sup> This strengthening of residency revenue allocation triggered a harsh retaliation from debtor countries. As a result of this struggle, the issue of interest revenues' allocation was not resolved.<sup>51</sup> In 1928, three draft conventions, each of them providing different allocation rules for interest income, were published. These arrangements were: (1) taxation solely at source (convention I-a) or residence (I-b) and (2) a hybrid of source taxation with a residual residence tax (I-c).<sup>52</sup> In a sense, the League's decision to publish the three model conventions reflected a general withdrawal from the strong pro-residency stance in treaties signed during the early 1920s.<sup>53</sup>

The draft convention of 1943, which sealed the Revenue Phase, was a sharp contrast to the League's ambivalent stance during the 1920s. The League's fiscal committee met in Mexico. There, without representatives from war battered Europe, Latin American countries dictated a pro-source agenda. In the context of interest, the pro-source agenda produced article IX, which granted source jurisdictions the exclusive right to tax income from movable capital.<sup>54</sup> This convention best illustrates the centrality of revenue considerations during that period — showing that source countries were not willing to forfeit these considerations for the sake of attracting foreign investments and engendering cross-border trade. It further demonstrates the overall function of the League during the Revenue Phase in strengthening the notion of source taxation. Nevertheless, the limited impact the Mexico convention eventually had is also reflective on capital-importing countries' failure to entrench sufficiently the notion of source taxation so that it would stand the test of time.

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<sup>50</sup> Wang, *supra* note 26, at 89.

<sup>51</sup> DEPERON, *supra* note 23, at 26 (noting that this was one of the few issues on which the League did not take a clear stand).

<sup>52</sup> HERNDON, *supra* note 26, at 185–90, 238–41; Carroll, *supra* note 27, at 699.

<sup>53</sup> DEPERON, *supra* note 23, at 17 (noting that although most pre-war treaties assigned the right to tax financial income to the residence jurisdiction, they did not preclude the possibility of a withholding tax laid on the source level); Carroll, *supra* note 29, at 587.

<sup>54</sup> Carroll, *supra* note 27, at 708–10.

To flesh out the difference between the Revenue Phase and later periods, it is useful to think about the changing discourse in favor of the right to tax at the source. In Revenue Phase discourse, this right was framed as a right to receive revenues from capital investments in source jurisdictions. In sharp contrast, today source jurisdiction supremacy is typically framed as the right of the source jurisdiction to offer foreign investors a genuine reduction in source taxes. Developing source countries argue that these reductions often do not meet their goals of attracting foreign investments because they are (arguably) absorbed by residence taxes laid on investors. While the Revenue Phase's discourse was about source countries' right for revenues, prevalent current discourse is about their right not to collect taxes to induce foreign investments. Although these two positions are not analytically mutually exclusive,<sup>55</sup> the practical gap dividing them illustrates the difference between contemporary and Revenue Phase sourcing conventions.

The formal victory of debtor countries, embodied in the Mexican convention towards the end of the Revenue Phase, turned out to be more marginal than one could have originally expected.<sup>56</sup> The Revenue Phase ended at the end of WWII and the beginning of the Cold War. It had tremendous impact with regard to IITR's terminology and on some of its principles, which still echo in contemporary IITR treaties' discourse. Many of these arrangements, still present today, may be understood as a byproduct of the debtor-versus-creditor country controversy.<sup>57</sup>

The Revenue Phase's actual allocation conventions, overall inclined to support a stronger source entitlement to tax, were severely undermined by the conventions that followed during the subsequent Trade Phase. These trade oriented sourcing conventions were initially developed by capital-exporting countries (e.g., the United States and the United Kingdom). They were later endorsed by the Organisation for Economic Co-Operation and Development (the OECD), which, during the Trade Phase years, was comprised almost solely of Western European and North American countries.

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<sup>55</sup> In theory, source jurisdictions could levy taxes and use them to subsidize (presumably undersupplied) foreign investments.

<sup>56</sup> Bloch & Heilemann, *supra* note 23, at 1166–67.

<sup>57</sup> Rosenbloom & Langbein, *supra* note 23, at 366 (noting that the sourcing model of assigning income based on classification of the sources in which it derived was adopted during the Revenue Phase to enable a compromise between creditor and debtor countries).

## IV. THE TRADE PHASE: POST-WWII TO 1990S

The Trade Phase is the period of time that roughly overlapped with the Cold War. While the terminology of the IITR was engraved during the Revenue Phase, its dominant allocation conventions took form during this post-WWII era. The article argues that the Trade Phase paradigm, which advocated the removal of tax obstacles from the flow of international investment, was unbalanced and resulted in severe revenue losses and inequities.

The star of the “British position” during the Revenue Phase, which asserted that interest proceeds should be taxed only in the creditor country, was yet to rise. As it turned out, the substantive allocation norms of the IITR were influenced more heavily by events that took place after WWII than by those of the Revenue Phase. The political turbulence in the first half of the 20th century and the radical shifts in geopolitical power, which preceded and followed WWII, limited the substantive impact of the Revenue Phase’s allocation conventions. This limited impact is perhaps best exemplified by the way international, tax base incomes from inbound debt investments were de facto allocated during the post-WWII decades. Most interestingly, while skewing the sourcing of withholding taxes on capital income is by no means revenue neutral, the discourse that eventually led to this erosion focused on trade and investment considerations, allotting less heed to revenue or distributive (let alone redistributive) considerations.

*A. The Rationales of the “Trade Argument”*

The main normative argument of the article is that investment and trade considerations of the Trade Phase have undermined *unduly* the fiscal base of the IITR and its ability to elicit a set of governing equity standards. To fully understand this claim about trade considerations’ inappropriate impact, one must first understand the historical context in which these considerations gained dominance and their underlying rationales.

International trade and investment regimes and the IITR shared a parallel development, with only few (tangential) policy oriented attempts to resolve this gulf<sup>58</sup> (although recently there have been more

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<sup>58</sup> An exception to this is the World Trade Organization (WTO) discussions and rulings with regard to the U.S. income tax export subsidies. See Yariv Brauner, *International Trade and Tax Agreements May Be Coordinated, but Not Reconciled*, 25 VA. TAX REV. 251, 295–97 (2005) (exploring a number of WTO cases in which U.S.

academic attempts to address this issue).<sup>59</sup> An obvious connection could nevertheless be drawn between these regimes' underlying goals. Both regimes facilitate international cooperation through sets of reciprocal restraints that nations undertake, which limit the ability of government actions to disturb transnational commercial activity.<sup>60</sup> While the IITR generally restricted its role to the elimination of double income and capital gain taxation impediments, the international trade and investment regime sought to liberalize trade and investment through the reciprocal and gradual reduction (and eventually even elimination) of tariffs, import quotas, and export subsidies. The pillars of the international trade regime are the General Agreements on Tariffs and Trade (GATT), initially agreed to in 1947. These agreements eventually laid the institutional framework of what is known today as the World Trade Organization. The GATT were a unique set of agreements, since countries undertaking GATT obligations also undertook the obligation to abide by future GATT rules in future negotiations. Besides enforcement mechanisms, the GATT agreements impose three types of reciprocal commitments on their members — tariff limitation, a certain “code of (proper) conduct,” and, most importantly, nondiscrimination.<sup>61</sup>

This Part draws a conceptual connection between the two regimes with reference to the post-WWII period ending with the beginning of the 1990s. The intuitive connection between withholding taxes on the gross income proceeds of foreign investment, essentially tariffs on

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income tax export subsidies were found to be inconsistent with U.S. obligations); 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, 89–95 (1998) (describing the Uruguay talks around these issues in 1993).

<sup>59</sup> Brauner, *supra* note 58; Catherine Brown & Christine Manolakas, *Trade in Technology Within the Free Trade Zone: The Impact of the WTO Agreement, NAFTA, and Tax Treaties on the NAFTA Signatories*, 21 *NW. J. INT'L L. & BUS.* 71 (2000); Green, *supra* note 58, at 88–89 (comparing the substantive obligations of countries under GATT to bind their tariffs and those frequently undertaken under double taxation treaties); Paul R. McDaniel, *The David R. Tillinghast Lecture Trade Agreements and Income Taxation: Interactions, Conflicts, and Resolutions*, 57 *TAX L. REV.* 275 (2004); David B. Oliver, *The David R. Tillinghast Lecture Tax Treaties and the Market-State*, 56 *TAX L. REV.* 587 (2003); Joel Slemrod & Reuven Avi-Yonah, *(How) Should Trade Agreements Deal With Income Tax Issues?*, 55 *TAX L. REV.* 533 (2002); Warren, *supra* note 7, at 147–49; Whitney Whisenhunt, *To Zedillo or not to Zedillo: Why the World Needs an ITO*, 16 *TEMP. INT'L & COMP. L.J.* 541 (2002).

<sup>60</sup> John S. Brown, *Formulary Taxation and NAFTA*, 49 *TAX L. REV.* 759, 799–800 (1994).

<sup>61</sup> KYLE BAGWELL & ROBERT W. STAIGER, *THE ECONOMICS OF THE WORLD TRADING SYSTEM* 48–49 (2003).



foreign lenders and investors, was openly recognized by scholars at the beginning of the Trade Phase.<sup>62</sup> The article argues that there is an ever growing “trade considerations” spillover into the IITR policymaking. The most obvious landslide victory for trade considerations during this period is undoubtedly the colossal reduction of source laid withholding taxes on the gross income proceeds of inbound capital investments. Nevertheless, one should refrain from equating the IITR’s role as a promoter of free trade solely with the reduction of source based withholding taxes. A more profound trade implication of the IITR’s treaties, which typically receives less attention than withholding taxes, is their ability to reduce the tax-related uncertainties of foreign investors. Both are discussed in more detail below.

As mentioned previously, the Trade Phase is signaled not by the fact that trade considerations were accounted for, but for the manner in which trade considerations marginalized more traditional revenue and equity considerations. While some critics have argued against actual reduction in tax barriers on trade<sup>63</sup> and against the plausibility<sup>64</sup>

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<sup>62</sup> Bloch & Heilemann, *supra* note 23, at 1159, 1166, 1173 (arguing that while the effects of taxes on trade are marginal, they can have a significant influence on the profit margin and the investment environment, and observing that debtor nations’ preference for source taxation is counterproductive since “a country in need of capital may be willing to forego taxing the return on that capital . . . [and] willing to enter an exemption type treaty” and concluding by saying that “[if] free flow of trade [is a matter] of international concern . . . then fiscal policies, too, must be a matter for international investigation”); Roy Blough, *Treaties to Eliminate International Double Taxation and Fiscal Evasion*, 5 N.Y.U. ANN. INST. ON FED. TAX’N 208, 208–09 (1947) (“Aside from the question of equity is the economic aspect of international double-taxation. World prosperity is promoted by enlarged world trade and capital movements, free from the restrictions which the operation, often the unintended operation, of tax laws may impose. International double taxation discourages the growth of world economy. The discouragement arises, not only from the taxes themselves, but also from uncertainty as to when they will be imposed.”); James, *supra* note 32, at 231.

<sup>63</sup> Herrick K. Lidstone, *Double Taxation of Foreign Income? Or an Adventure in International Double Talk*, 44 VA. L. REV. 921, 925–26 (1959) (arguing that the mechanisms for relieving double taxation removed trade obstacles only to big American multinational enterprises (MNE or MNEs, as appropriate) that lobbied Congress to obtain generous benefits).

<sup>64</sup> Brauner, *supra* note 58, at 283 (advocating that trade and taxation rationales are in many senses antithetical, and the most visible example for that is the differentiation in withholding tax-rates under double taxation treaties, which violates the “most favorable nation” principle advocated by the WTO).

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and the (analytical<sup>65</sup> and normative)<sup>66</sup> desirability of this fusion of international trade and tax, relatively little attention has been paid to the question of why trade considerations triumphed so dramatically over alternative considerations.

The answer has several layers. First, trade consideration dominated in the first two to three decades of the IITR's post-WWII development because Western capital-exporting countries (namely, the United States and, to a lesser extent, the United Kingdom) desired to re-establish international trade practices following the havoc wreaked by WWII. It is relatively straightforward to point out that this liberalization was necessary to promote U.S. economic interests (and specifically U.S. business sector interests) by creating demand for U.S. capital and production surpluses.<sup>67</sup> Nevertheless, the liberalization objectives also supported a broader notion concerning world public order in the post-WWII era. Following the grief caused by the devastation of WWII, it has been observed that:

Unless statesmen are able to solve the perplexing problems of international double taxation, serious economic and political results may follow. An emerging world system designed to achieve peace through political integration cannot withstand the economic balkanization to which double taxation will contribute.<sup>68</sup>

Simply put, in a world at the verge of an escalation into the Cold War period, free trade was both a carrot and an ideological “common-carrier” of anti-communist Western policy. Just like the Marshall Plan, free trade was a vehicle for rebuilding Europe and acquiring allies (e.g., Japan and Germany). It was a way to make sure that American investors and MNEs would take an active part in a European/Japanese resurrection. Emerging as the dominant winner of WWII, with unmatched industrial capabilities and capital resources, the United States aimed to lead a new capitalistic world order. It is

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<sup>65</sup> H. David Rosenbloom, *What's Trade Got To Do With It?*, 49 TAX L. REV. 593, 597–98 (1994) (arguing that the attempt to equate tariffs and withholding taxes just because both pose barriers on trade and investments is analytically wrong, since there are many attributes that differentiate between these two mechanisms of social policy).

<sup>66</sup> Richard M. Bird, *A View From the North*, 49 TAX L. REV. 745, 748 (1994) (“[T]he trade policy dog should [not] necessarily wag the tax policy tail.”).

<sup>67</sup> ALBERT A. EHRENZWEIG & F.E. KOCH, *INCOME TAX TREATIES: THE INCOME TAX CONVENTIONS OF THE UNITED STATES WITH GREAT BRITAIN, CANADA AND OTHER COUNTRIES* 5 (1949); James, *supra* note 32, at 229.

<sup>68</sup> Wang, *supra* note 26, at 73.

easy, therefore, to see why the United States revered trade considerations as a major component of its foreign (tax) policy.

Second, in the perspective of many countries at the beginning of the Trade Phase, there was no clear distinction between trade and revenue considerations. Capital-exporting countries, which taxed worldwide income of corporate and individuals residents (most notably, the United States and, to a lesser extent, the United Kingdom), could have expected a net increase in their revenues as a result of reciprocal reductions in withholding taxes on capital income on the source country level.<sup>69</sup> One should bear in mind that, when trade considerations took form, the international tax planning industry and offshore tax havens were not firmly established.<sup>70</sup>

From the perspective of many net capital-importing countries, the need to prioritize trade over revenue considerations may be explained by their acute need for foreign investment to re-establish post-war economies,<sup>71</sup> compounded by the U.S. monopoly over capital resources at the end of WWII. Additionally, one may assume, the remission of the withholding tax base was made easier because it was never a solid source of revenue for many capital-importing countries. Erosion of the withholding tax base was thus erosion of a marginal source of tax revenues. These reductions in withholding taxes in the early stages of the Trade Phase could be perceived as the beginnings of a vicious tax-competitive practice cycle among source jurisdictions for the taxation of nonresidents' passive income.

The analysis becomes much more complicated in the later stages of the Trade Phase (during the late 1970s–1990s), when the sharp distinction between capital-importing and capital-exporting countries gets somewhat blurred. Hence, in the U.S. case, reducing investment barriers for U.S. investors is still the objective of reciprocal reductions on withholding taxes. However, this treaty policy also eases the tax burden over the inflow of capital investments, particularly bond investments, into the United States. This inflow plays a crucial role in light of the U.S. mounting trade and fiscal deficits.<sup>72</sup> In this context,

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<sup>69</sup> Robert J. Patrick, Jr., *United States Negotiating Objectives and Model Treaties*, in 1977 TAX TREATIES AND COMPETENT AUTHORITY 12–13 (Virginia di Francesco & Nicolas Liakas eds., 1977).

<sup>70</sup> This was not a coincidence. Both these phenomena gradually matured in response to the tax-arbitrage possibilities that residents from capital-exporting countries have in an ITR characterized by low source taxes in some jurisdictions.

<sup>71</sup> Wang, *supra* note 26, at 115.

<sup>72</sup> Diane Renfroe et al., *Earnings Stripping: An Analysis of the Proposed Regulations Under Section 163(j)*, 91 TNI 43-46 (Oct. 23, 1991).

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the article examines the intriguing metamorphosis of U.S. IITR policies during the Trade Phase as a case study. The United States started the Trade Phase as the only major capital-exporting country. As a result, while all other capital-importing countries surrendered fiscal needs to compete for U.S. investments, the United States sought reciprocal withholding tax reductions to ease its residents' foreign investment experiences, while adhering to the notion of capital-export neutrality to retrieve some of its fiscal losses in its resident revenue base. This capital-export neutrality emphasis changed over the course of the Trade Phase as the United States became a debtor nation. To successfully attract for foreign investments, the U.S. ideal of capital export neutrality had to shuffle off its mortal coil with regards to inbound debt investments. This was necessary for the United States to compete, like any other country, for foreign capital.

The article demonstrates the applicability of the above analysis to the source income tax treatment of inbound debt investments. While the present article's analysis focuses mainly on U.S. treaty law, it also addresses other important representative examples. As mentioned, the baseline for the discussion, established during the Revenue Phase, is the 30% withholding tax rate imposed by federal statutory law on interest payment made to nonresidents.<sup>73</sup> This Part discusses how the effect of withholding source taxes on interest is eroded through three major exemptions: (1) the reduction/exemption of interest payments made by treaties, (2) the bank deposit exemption, and (3) the portfolio interest exemption.<sup>74</sup>

### *B. U.S. Treaty Law*

With few exceptions,<sup>75</sup> scholars generally agree that treaties are one of the core income tax policy stimulants of transnational investments and, as such, an avenue for economic development.<sup>76</sup>

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<sup>73</sup> See *supra* note 16.

<sup>74</sup> MICHAEL J. MCINTYRE, INTERNATIONAL INCOME TAX RULES OF THE UNITED STATES 2-47, 2-54 (2002).

<sup>75</sup> See, e.g., Allison D. Christians, *Tax Treaties for Investment and Aid to Sub-Saharan Africa: A Case Study*, 71 BROOK. L. REV. 639, 644 (2005) (arguing that treaties have a limited impact on reducing trade barriers to developing countries).

<sup>76</sup> PHILIP BAKER, DOUBLE TAXATION CONVENTIONS: A MANUAL ON THE OECD MODEL TAX CONVENTION ON INCOME AND ON CAPITAL A-5-A-7 (2001) (noting that both the United Nations (U.N.) and the Organisation for Economic Co-operation and Development (OECD) model treaties recognize the attempts to reduce double taxation as motivated by trade and development objectives); Jeffrey M. Colon, *Financial Products and Source Basis Taxation: U.S. International Tax Policy at the*

Leaving aside treaties' compliance cost reductions<sup>77</sup> and signaling benefits,<sup>78</sup> treaties induce transnational trade between signatory sovereigns mainly through a mutual relaxation of (source and residence) tax rules.<sup>79</sup>

Thus, with the exception of information sharing initiatives directed to counter tax evasion, treaties are a more useful policy tool to limit taxation than to solve problems of untaxed (or under-taxed) income.<sup>80</sup> This relaxation of tax rules has two prongs. The country of residence must modify income taxes to grant its taxpayers' (at least partial) relief for taxes paid in the source jurisdiction. In return, source jurisdictions must reduce withholding taxes on investments and leases and avoid imposing discriminatory income tax rules on active income generating activities that are controlled by foreign residents.<sup>81</sup>

From a perspective that seeks to liberalize international investments, withholding taxes have an undisputable negative effect.

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*Crossroads*, 1999 U. ILL. L. REV. 775, 786 (1999); William P. Streng, *U.S. Tax Treaties: Trends, Issues, & Policies in 2006 and Beyond*, 59 SMU L. REV. 853, 856–58 (2006).

<sup>77</sup> JOSEPH ISENERGH, *INTERNATIONAL TAXATION* 197 (2000) (noting that an additional trade enhancing aspect of treaties is reducing the compliance uncertainties faced by foreign investors); Blough, *supra* note 62, at 208; Paul D. Reese, *United States Tax Treaty Policy Toward Developing Countries: The China Example*, 35 UCLA L. REV. 369, 375 (1987) (noting that, especially with regards to permanent establishments, the compliance burdens of dealing with a foreign tax system may make the entire investment unattractive).

<sup>78</sup> David H. Rosenbloom, *Current Developments in Regard To Tax Treaties*, 40 N.Y.U. ANN. INST. ON FED. TAX'N 31, 31–52 (1982); Miranda Stewart, *Global Trajectories of Tax Reform: The Discourse of Tax Reform in Developing and Transition Countries*, 44 HARV. INT'L L.J. 139, 148 (2003) (“Bilateral tax treaties seem to serve largely to ‘signal that a country is willing to adopt the international norms’ regarding trade and investment, and hence, that the country is a safe place to invest . . . . The signing of a tax treaty is often presented as an important symbol of international capitalist engagement.”).

<sup>79</sup> DEPERON, *supra* note 23, at 2 (describing the contribution of treaties to the “development of international trade” as “render[ing] more acceptable to national treasuries the sacrifices involved in the elimination of double-taxation”); Richard L. Doernberg, *Overriding Tax Treaties: The U.S. Perspective*, 9 EMORY INT'L L. REV. 71, 71 (1995).

<sup>80</sup> Michael S. Lebovitz & Theodore P. Seto, *The Fundamental Problem of International Taxation*, 23 LOY. L.A. INT'L & COMP. L. REV. 529, 532 (2001).

<sup>81</sup> U.N. Dept. of Econ. & Soc. Affairs, *United Nations Model Double Taxation Convention Between Developed and Developing Countries* 8 (2001) [hereinafter U.N. Treaty]; Green, *supra* note 58, at 113–14; Julie Roin, *Rethinking Tax Treaties in a Strategic World with Disparate Tax Systems*, 81 VA. L. REV. 1753, 1764 (1995) (providing a good summary of the way treaties reduce source tax rates); David R. Tillinghast, *Tax Treaty Issues*, 50 U. MIAMI L. REV. 455, 459 (1996).

As is most evident in the case of capital-intensive sectors, withholding taxes are imposed on gross income<sup>82</sup> and therefore do not correspond to similar (possibly progressive) income taxes imposed on domestic investors, which take into account their (net) ability to pay. In the financial industry, laying high withholding tax rates over interest may have severe effects due to high volumes of interest payments and relatively small margins of profit.<sup>83</sup> The article shows that the tendency of treaties to impose lower tax rates on interest payments than on returns to equity facilitated a (de facto) acknowledgment that source country entitlement on income derived from debt investments is weaker than from equity investments.

Treaties are also constructed to help countries protect residents' foreign investment interests from falling prey to the fiscal needs of host countries.<sup>84</sup> Although it is now widely believed that the discipline of the international financial markets and the dynamic of tax competition effectively counter some of these tendencies, that is not necessarily how the issue was perceived at the end of WWII. As mentioned, at the beginning of the Revenue Phase, nonresidents were susceptible to abusive tax treatment by countries eager for revenue. In light of this, and in light of foreign investors' inability to move many types of investments in response to changes in tax policy created by a political process over which they held no control, treaties had a prominent role in easing investor concerns over foreign investments. Thus, countries' obligations to limit withholding taxes and, even more imperatively, to adhere to nondiscrimination norms, played a pivotal role in alleviating tax-related uncertainties associated with foreign investing during the first years of the Trade Phase.<sup>85</sup> This is especially true with respect to the ability to deduct payments made to foreign parties, as discussed in greater detail in the next Part.<sup>86</sup>

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<sup>82</sup> STEF VAN WEEGHEL, *THE IMPROPER USE OF TAX TREATIES: WITH PARTICULAR REFERENCE TO THE NETHERLANDS AND THE UNITED STATES* 16–17 (Kluwer Law International 1998).

<sup>83</sup> Ault, *supra* note 11, at 570.

<sup>84</sup> F.E. KOCH, *THE DOUBLE TAXATION CONVENTIONS* 4–5 (Stevens & Sons Limited 1947).

<sup>85</sup> THE AMERICAN LAW INSTITUTE, *FEDERAL INCOME TAX PROJECT, TAX ADVISORY GROUP DRAFT NO. 21 REPORTER'S STUDY* 141 (1992).

<sup>86</sup> Slemrod & Avi-Yonah, *supra* note 59, at 546 (“With certain exceptions, [the anti-discrimination provision in treaties usually requires that] payments of interest, royalties and other disbursements to foreign residents, for the purposes of determining taxable income, are to be deductible under the same conditions as payments to domestic residents.”).

This Part describes the manner by which the United States, through its treaty network, has facilitated a significant (reciprocal) reduction in the withholding tax rates with all of its major trading partners.<sup>87</sup> The reduction has fatally eroded the fiscal viability of withholding taxes (especially on interest payments) as a source of revenue. Devoid of any substantive fiscal content, statutory withholding taxes mainly operate today as a measure to induce double taxation treaty negotiations with the United States.<sup>88</sup>

The article identifies and analyzes two constitutive moments in the history of U.S. treaty policy: the completion of the U.S.-U.K. tax convention in 1945 and the promulgation of the U.S. Model Treaty in 1976.

#### 1. The U.S.-U.K. Double Taxation Treaty, 1945

The importance of the U.S.-U.K. double taxation treaty (the Treaty) results from the fact that it was signed by the two dominant Western capitalist powers who won the war immediately after WWII, as the Western and Eastern blocks of the Cold War era were beginning to form. Given the dominant position of the United States and the United Kingdom in the post-WWII global economy, the conventions the Treaty introduced during the course of the Trade Phase have become the unchallenged core of the IITR.

With regard to the tax treatment of transnational capital income, and specifically to the taxation of interest payments, the Treaty introduced the following prominent notions. First, it separated tax treatment of dividends and interest payments. As mentioned previously, this separation has been vindicated on the grounds of a “real difference” doctrine, which detached interest earnings from the debtor’s jurisdiction because, unlike dividends, they were not considered to be derived from the source.<sup>89</sup>

Second, the Treaty exempted interest payments from any withholding source taxes.<sup>90</sup> In this respect, the Treaty endorsed the

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<sup>87</sup> MCINTYRE, *supra* note 74, at 2-37–2-38.

<sup>88</sup> *Id.* at 2-47; Jones, *supra* note 34, at 3 (“The more outrageous the provisions of internal law, the better the starting position for negotiating treaties.”); Roin, *supra* note 81, at 1765 (noting that reducing withholding taxes on passive income may result in a revenue gain because of more taxes resulting from more foreign investments).

<sup>89</sup> EHRENZWEIG & KOCH, *supra* note 67, at 44–45.

<sup>90</sup> Income Tax Treaty, art. VII, Apr. 16, 1945, U.S.-U.K., 4 Tax Treaties (CCH) ¶ 10,962 (expired) [hereinafter The Treaty].

long standing “British position” of the Revenue Phase,<sup>91</sup> which, as noted in the previous Part, assigned the right to impose direct personal taxes solely to the domicile/residence jurisdiction.<sup>92</sup>

The Treaty went beyond the elimination of double taxation and left a longstanding, eminent mark on international tax legislation and policy of both the United States and the United Kingdom.<sup>93</sup> Furthermore, although rarely recognized as such, the completion of the Treaty comprised the major and most fundamental building block of the IITR during the Trade Phase. It laid the foundation for the IITR’s distinction between the source tax treatment of active and passive income and the treatment of dividends and interest payments. This had a prominent effect on the income tax allocation of proceeds from transnational investments. Particularly with debt investments, the Treaty’s determination that passive income should be taxed only by the residence jurisdiction had a major impact on revenue allocation. This was the League’s original determination from 1923, which capital-importing countries tried so fiercely to overturn during the course of the Revenue Phase. Given the exceptionally strong position of both (capital-exporting) economies at the time (the United States commanding the lion’s share of capital resources and the United Kingdom standing in a leading financial and trading position), the Treaty’s terms and concepts were internalized into customary practices of double taxation treaties. The article points out that the Treaty predated the League’s final London convention from 1946. It was therefore the first to articulate and adopt many of the IITR’s sourcing conventions.<sup>94</sup> These conventions were by and large

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<sup>91</sup> PICCIOTTO, *supra* note 41, at 5 (noting that the residence principle was adopted in the United Kingdom in 1909 as part of an effort to legitimize the income tax).

<sup>92</sup> KOCH, *supra* note 84, at 10.

<sup>93</sup> PICCIOTTO, *supra* note 41, at 45 (suggesting that following the adoption of the Treaty, the United Kingdom adopt a foreign tax credit relief legislation); HERMON M. WELLS, UNITED STATES POLICIES IN INTERNATIONAL DOUBLE TAXATION OF INCOME 170–71 (1950) (noting that prior to the Treaty, the United States refrained from substantially reducing its 30% withholding tax rates through treaties); Carroll, *supra* note 33, at 772.

<sup>94</sup> The Treaty was the first to adopt the notion of source primacy (discussed on page 7), which is supplemented by residence jurisdiction obligation, to relieve double taxation. This comes in contrast to most of the pre-WWII treaties, which typically assigned the right to tax a specific source of income either to the source *or* to the residence jurisdiction. See P. Verloren van Themaat, *The Anglo-American Group of Tax Conventions, Concluded Since 1939, Compared with Pre-War Treaties*, III CAHIERS DE DROIT FISCAL INTERNATIONAL 1, 6 (1947).



incorporated into the League's London Convention<sup>95</sup> and later picked up by the OECD Model Treaty discussed below. Furthermore, both the United States and, even more so the United Kingdom,<sup>96</sup> entered into a series of treaties with Western European countries shortly after signing the Treaty. The series of treaties, all based on the Treaty,<sup>97</sup> comprise the pillars of the post-WWII treaties network. Hence, the Revenue Phase's sourcing conventions were not emphasized, partially because the United States and the United Kingdom did not endorse them by refraining from entering treaties. By the same token, the Treaty's Trade Phase sourcing conventions were absorbed so profoundly into the IITR because these two Goliaths used the Treaty as a model for their following treaties. Accordingly, the Treaty is the (self-crowned) codification of the piecemeal legacy created by the League.

A careful analysis of the balance struck by the Treaty with regards to source tax treatment of interest payments reveals two important insights about the premises of the Trade Phase it initiated. First, the United States accepted exemption of interest from withholding taxes despite net revenue loss.<sup>98</sup> This merits clarification, since the United

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<sup>95</sup> Like the Treaty, the 1946 London convention prioritizes the residence jurisdiction. Its allocation arrangements greatly resemble those of the Treaty. For example, the articles in the 1946 London convention — IV (business enterprises), V (shipping income), VII (compensation for services), VIII and IX (the income from movable capital: dividends and interest payments), and X(2) (royalties from intangibles) — have allocation arrangements that correspond better with the Treaty arrangements (III, V, XI(3), VI and VII, VIII), than with Mexico's 1943 convention source allocation arrangements. *See London and Mexico Model Tax Conventions: Commentary and Text*, League of Nations Doc. C.88.M.88 1946 II.A. (1946); Carroll, *supra* note 27, at 709–20 (making a comparison between the OECD Model Treaty and the Mexico and London draft conventions and concluding that the OECD model incorporated most of the London convention's arrangements, which with respect to interest, followed the Treaty's arrangement).

<sup>96</sup> Jones, *supra* note 34, at 1–3 (noting that out of the 100 in force, comprehensive treaties the United Kingdom had entered into by 1999, the first fifty were entered into between the years of 1945–1951, the Treaty being the first of those agreements).

<sup>97</sup> John G. Archibald, *U.K.-U.S.A. Double Taxation Convention*, VIII CAHIERS DE DROIT FISCAL INTERNATIONAL 1, 18–25 (1947) (discussing the eminent effect of the Treaty on the treaties the United Kingdom entered into in subsequent years with certain Commonwealth members); Mitchell B. Carroll, *Double Taxation Convention of The United States since 1939*, V CAHIERS DE DROIT FISCAL INTERNATIONAL 25, 26 (1947); Mitchell B. Carroll, *Evolution of U.S. Treaties to Avoid Double Taxation of Income, Part II*, 3 INT'L LAW. 129, 139–40 (1968–1969) [hereinafter Carroll, *Evolution*].

<sup>98</sup> EHRENZWEIG & KOCH, *supra* note 67, at 139.

States was by no means in an inferior bargaining position. There are a number of tactical<sup>99</sup> and cynical<sup>100</sup> explanations for the United States' acceptance of the interest withholding exemption rule. The article, however, points out that this endorsement represents an acknowledgment by U.S. tax policymakers that source tax exemptions on investment income are justified, despite revenue loss consequences of the Treaty, because of their positive effect on the free flow of capital. U.S. policymakers were able to look beyond the net bilateral revenue impact of the Treaty to promote an arrangement that, in the long run, would advance U.S. objectives.<sup>101</sup> Soon after its completion, the United States entered into a series of treaties with Western European countries that followed the same interest allocation arrangement. In all of these cases, countries desiring access to New York money markets waived most rights to levy source withholding taxes on gross interest payments made to Americans,<sup>102</sup> leading to U.S. revenue gains.

Second, the Treaty's unofficial "codification" of the policy behind double taxation treaties engraved the writing on the wall with regard to the IITR's future development during the Trade Phase. That the IITR was founded on a contractual agreement between the two richest nations demonstrates that rather than promoting a *vox populorum vox Dei* (the voice of peoples is the voice of God/the law), the reign of capital intensive countries triumphed. Additionally, it demonstrates that it was pro-investment, rather than fiscal or source tax equity considerations, that laid down the law in the IITR. In this respect, the profoundness of the Treaty transcends the manner in

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<sup>99</sup> *Id.* (noting that this compromise was easy to swallow from an American perspective, since 75% of British investors' holdings in the United States were in the form of equity rather than debt).

<sup>100</sup> U.S. treaty negotiators could assume reasonably that due to its high level of accumulated capital resources at the end of WWII, the long-term net fiscal effects of the exemption were likely to even out and perhaps even reverse after a short while.

<sup>101</sup> Clarence Castimore, *Income Tax Treaties with France, Sweden and Canada and the Convention with Great Britain and Northern Ireland*, 4 N.Y.U. ANN. INST. ON FED. TAX'N 537, 547 (1946) (asserting that the Treaty, and the treaties that followed it, had a pronounced objective of alleviating double taxation to foster foreign trade and investments that would result in more revenues).

<sup>102</sup> Carroll, *Evolution*, *supra* note 97, at 139; Charles R. Irish, *International Double Taxation Agreements and Income Taxation at Source*, 23 INT'L & COMP. L.Q. 292, 294-95 (1974) (describing how the United States used its favorable bargaining position at the end of WWII to induce Western European countries to deemphasize their source tax rights upon entering into treaties with it).

which its actual mechanisms and principles echo in current treaty practices.

## 2. The Promulgation of the U.S. Model Treaty, 1976

The U.S. Model Treaty can be understood as the second in a sequence of three model tax treaties: the OECD, the U.S., and the United Nations (U.N.) Model Treaties. The underlying theme behind the first in that series, the OECD Model Treaty published initially in 1963, was to provide potential double taxation treaty signatories with a contractual and interpretational anchor through which they could reduce the transactional costs of reaching an agreement.<sup>103</sup> In the context of withholding taxes, the OECD provided a number of focal tax rates. These tax rates represented a “reasonable” equilibrium, from which it was implicitly understood that signatories would not deviate substantially.

The OECD Model Treaty followed the London convention, which, as mentioned, was inspired by the Treaty. It refuted the conclusions of the Model Bilateral Convention agreed upon by the League in Mexico in 1943. It accepted the Treaty’s distinction between passive and active income and, similarly to the Treaty, assigned a stronger claim in the former to the country of residency. It was, therefore, anything but ideologically neutral. The institutionalization of the OECD Model Treaty and its ancillary commentary as the official cornerstone of the IITR motivated other bodies to codify model tax treaties. Most notably, the U.N. Model Treaty published initially in 1980 tried to offer an alternative to the OECD tax hegemony by stressing the need for a fair return on foreign investments in developing countries through fortifying and broadening the applicability of the source principle.<sup>104</sup> However, as demonstrated below, with regard to the withholding tax treatment of interest payments arising from inbound investments, the U.N.’s

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<sup>103</sup> OECD, Model Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital, June 30, 1963.

<sup>104</sup> U.N. Treaty, *supra* note 81, at vii, xi–xii (noting that the reasonableness of reciprocal measures should be questioned when there is great disparity between the initial negotiating positions of parties to treaties); Rosenbloom & Langbein, *supra* note 23, at 393; Donald R. Whittaker, *An Examination of the O.E.C.D. and U.N. Model Tax Treaties: History Provisions and Application to U.S. Foreign Policy*, 8 N.C.J. INT’L L. & COM. REG. 39, 46 (1982) (attempting to solidify the U.N.’s arguments in favor of source allocation); Irish, *supra* note 102, at 298–314 (providing an illuminating analysis regarding the dynamics that lead countries to waive their source taxing rights).

professed ambition of creating a viable practical (or even conceptual) alternative to the OECD model was met only on the margins.<sup>105</sup> This failure, in my opinion, is a direct result of the U.N. Model Treaty's attempt to attain redistributive objectives without first articulating a coherent set of development goals that international taxation should aspire to promote.<sup>106</sup>

In 1976 the United States published its first model treaty, which, as a matter of intentional design, followed the structure and wording of the OECD model.<sup>107</sup> The ambition to create a model treaty can be explained as: (1) part of a longstanding U.S. trade policy to avoid favoritism,<sup>108</sup> (2) an expression of its disagreement with aspects of various other model tax treaties (e.g., on the proper withholding tax rate on interest and worldwide taxation of citizens), and (3) a way to introduce its opinions on issues insufficiently addressed by the OECD Model Treaty (e.g., treaty-shopping).<sup>109</sup>

A comparison of section 11 of all three treaties, which deals with the imposition of withholding taxes on interest, reveals that, besides the recommended rate each treaty prescribes, there is little difference in much of their wording and structure.<sup>110</sup> While the OECD Model Treaty prescribes a 10% withholding tax rate on interest payments, the U.S. Model Treaty prescribes an interest exemption regime for taxes at the source level. This is one of the few material differences between the U.S. Model Treaty and the OECD benchmark.<sup>111</sup> The

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<sup>105</sup> Willem F.G. Wijnen, *Towards a New UN Model?*, 52 BULL. INT'L FISCAL DOCUMENTATION 135, 143 (1998) (raising the question of whether it makes sense to maintain a separate U.N. Model Treaty project when only eight of its provisions were actually embraced by a significant number of treaties).

<sup>106</sup> U.N. Treaty, *supra* note 81, at xx-xxiii (2001) (failing to articulate the distributive role international taxation should play in promoting and/or conceptualizing international justice).

<sup>107</sup> Rosenbloom & Langbein, *supra* note 23, at 398 ("The most important decision that has been made in designing the U.S. model was to adhere as closely as possible to the OECD model. . . . [which] offers the best chance of achieving the maximum degree of international tax harmonization, [and] the reduction of tax-based barriers to the free movement of goods . . .").

<sup>108</sup> Reese, *supra* note 77, at 392 (drawing a connecting policy rationale between the U.S. Model Treaty and its trade-treaty policies — suggesting that in both cases the United States seeks to reach a uniform treaty agreement with a broad range of nations rather than entering into particular and diversified agreements with each nation).

<sup>109</sup> Rosenbloom & Langbein, *supra* note 23, at 396.

<sup>110</sup> KEES VAN RAAD, MODEL INCOME TAX TREATIES 38-42 (1990).

<sup>111</sup> Rosenbloom & Langbein, *supra* note 23, at 399.

OECD Model Treaty's recommended rate is relatively low, in comparison to current prevalent statutory rates.<sup>112</sup> It illustrates the vigor of the notion that the main objective of the IITR during the Trade Phase period was to remove tax obstacles to foreign debt investments among developed countries. Such a low level of withholding taxes on gross payments may still prove substantial in highly leveraged sectors (e.g., the financial sector and, to a lesser extent, the manufacturing sector) where gross interest flows are large. One must remember that, unlike equity investment, the proceeds of debt investment avoid the source (corporate) income tax completely. The leniency in interest taxation is particularly evident with regards to the United States, since its model treaty's interest source exemption does not provide even minimal support to the notion of source country precedence.<sup>113</sup>

The U.N. Model Treaty takes a somewhat awkward position and does not recommend a specific withholding tax rate on interest (or on dividend and royalty payments). This seems antithetical to its stated ambition — to strengthen developing nations' interests as source countries. The U.N. group of experts recently reaffirmed this original commitment "even in light of the global economy's pressures."<sup>114</sup> Due to gaps in bargaining power among developed (capital-exporting) and developing (capital-importing) countries, one wonders why U.N. Model Treaty drafters believed that leaving rate determinations to parties' negotiation would skew more revenue to the source jurisdictions. Even in recent commentary, the U.N. failed to provide a detailed account of what an equitable income tax source return for inbound debt investment is.<sup>115</sup> As previously mentioned,<sup>116</sup> high withholding taxes may have substantial negative externalities on the inflow of debt investment. Given that the incidences of withholding

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<sup>112</sup> A few examples of OECD members: France has a 16% withholding tax that may go up to 60% when the location of the creditor is not disclosed. C.G.I. art. 125-A-III, 990A-C. Germany and the United Kingdom impose a 20% withholding tax on interest. EStG § 50 (7); Income and Corporation Taxes Act, 1988, c. 1, § 349 (2).

<sup>113</sup> The OECD and U.S. Model treaties both exempt royalty payments from withholding taxes. VAN RAAD, *supra* note 110, at 42–47. They both impose a 5%/15% withholding tax rate on dividend payments to related/unrelated parties. *Id.* at 36–38.

<sup>114</sup> U.N. Treaty, *supra* note 81, at xi–xii.

<sup>115</sup> *Id.* at 168. The commentary claims that there are good reasons for reducing the withholding tax costs on debt financing since the identity of the parties that bear the tax is not clear. Combined with withholding taxes' negative externalities on investment inflow, the unclear incidence of the tax may indeed make it unworthy to maintain for a developing country.

<sup>116</sup> See *supra* Part IV.A.

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taxes' burden may frequently be shifted to the debtors, it could well be the case that higher than 10% withholding tax rates are not worth maintaining. The problem with the U.N.'s position is its failure to offer developing countries a robust analysis that provides the analytical tools to determine the optimal withholding tax rate on interest for their jurisdiction. Thus, in its decision to leave the determination of actual rates to the parties, the U.N. Model Treaty failed to provide developing countries with adequate guidance.<sup>117</sup>

The manner by which all the abovementioned model treaties, specifically the U.S. Model Treaty, tax lightly (or fail to tax) inbound debt investments, is the best example of the manner in which trade considerations erode the source tax base. The national need to attract debt capital led nations to lower withholding tax rates on interest. The thoroughgoing reduction is particularly troublesome because it makes international debt investments appear much more lucrative from a tax perspective. Since interest payments are deductible in the source country, the exemption of interest payments from source taxes opened a significant loophole for tax planners. As discussed below, the fiscal losses and inequities of this loophole are particularly problematic in the case of debt investments made by related parties, which offer an easy and costless substitution for equity investments.

### *C. The Bank Deposit and Foreign Portfolio Income Statutory Exemptions*

Reciprocal treaty-based reductions in withholding tax rates do not solely account for the erosion of the source income tax base regarding interest payments from inbound investments. There are two exemptions to U.S. sourced income that were "unilaterally" incorporated by the United States into the Internal Revenue Code (Code): the banking deposit and the foreign portfolio income withholding tax exemptions. These unilateral tax reductions have three common characteristics: (1) both appeal to interests of powerful commercial lobbies, (2) both involve capital-elastic and, therefore, tax-sensitive<sup>118</sup> resources, which, in the absence of multinational

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<sup>117</sup> In practice, the major representative developing economies (e.g., China, India, Indonesia, Venezuela, Kazakhstan, South Africa, and Russia) maintain a model double taxation treaty withholding tax rate on interest of about 10% or slightly lower, with some rare exceptions (e.g., Argentina, Brazil, and Egypt) that maintain a model rate between 10% and 15%. See Tax Analysts, Worldwide Tax Treaties Database, <http://services.taxanalysts.com/taxbase/nav.nsf/WWTTFrame?Open&login>.

<sup>118</sup> Michael J. Graetz & Itai Grinberg, *Taxing International Portfolio Income*, 56

coordination among sovereigns, are the most natural candidates for fierce tax competition, and (3) neither require that residence taxes be laid on the source exempted income.

First, the bank deposit exemption: From its original enactment in 1936<sup>119</sup> to the present,<sup>120</sup> in order “not unduly to hamper foreign investments . . . of money and services [in the United States],” withholding taxes excluded interest payments arising from foreigners’ bank deposits not effectively connected to a U.S. business’ income.<sup>121</sup> Through the years, such an exemption became prevalent among practically all developed countries.<sup>122</sup>

Second, the foreign portfolio income exemption: As part of the Deficit Reduction Act of 1984, a wide withholding taxes exemption applied to interest income arising from inbound portfolio investments, including bonds issued by the U.S. government, U.S. corporations, and financial institutions.<sup>123</sup> This exemption was part of an attempt to facilitate better access by the U.S. public and private sectors to the Eurobond market by reducing the burden on U.S. debtors via decreased interest rates.<sup>124</sup> The exemption also helped U.S. debtors

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TAX L. REV. 537, 547–54 (2003) (providing the key distinctions between direct and portfolio investments, and arguing that the latter are more volatile, short-term, and responsive to bottom line returns and to financial markets).

<sup>119</sup> See *supra* note 32.

<sup>120</sup> I.R.C. § 871(i).

<sup>121</sup> EHRENZWEIG & KOCH, *supra* note 67, ¶ 19.

<sup>122</sup> Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573, 1581 tbl.1 (2000) (demonstrating that with few exceptions all developing countries were exempting interest arising from bank deposits in the 1990s).

<sup>123</sup> I.R.C. § 881(c). The portfolio income exemption had one major exception: section 881(c)(3)(A) excludes interest payments made to foreign banks from the exemption. I.R.C. § 881(c)(3)(A); see also Avi-Yonah, *supra* note 122, at 1580 n.5 (arguing that this exclusion was made to protect the competitiveness of U.S. banks); Bruce A. Elvin, *The Recharacterization of Cross-Border Interest Rate Swaps: Tax Consequences and Beyond*, 2 FLA. TAX REV. 631, 643–44 (1995) (suggesting that swap transactions open a wide array of options for bypassing the exclusion of interest paid to foreign banks from the portfolio income exemptions).

<sup>124</sup> DORON HERMAN, TAXING PORTFOLIO INCOME IN GLOBAL FINANCIAL MARKETS — A POSITIVE AND NORMATIVE EXPLORATION OF POSSIBLE SOLUTIONS 38 (2002) (suggesting that the comparative advantage of Eurobond lenders over their domestic competitors is their ability to reduce tax liabilities and regulatory costs); Avi-Yonah, *supra* note 122, at 1580 (describing how the exemption resulted from a fortuitous combination of (1) the U.S. deficit following the 1981 Reagan administration tax reform, and (2) the shutdown of the Netherlands Antilles finance subsidiaries tax planning avenues); James P. Holden, Jr., *Repeal of the Withholding*

meet the anonymity and net-return obligations of those markets.<sup>125</sup> Put differently, the high demand for portfolio bond investment supplied by the Eurobond markets allowed bond issuers operating in them to shift the withholding tax burden to the debtors. The tax exemption should therefore be understood as the U.S. government's response to domestic business (and deficit reduction) pressures by accepting the "net interest rate standard" of the Eurobond markets to better compete for these capital resources.

However, enactment of the portfolio income (source) tax exemption regime resulted in a myriad of unwanted avoidance and evasion complexities, both associated with a need to identify the true fiscal residency of the bond holder.<sup>126</sup> Furthermore, the U.S.'s unilateral exemption led to a tax-competitive chain reaction by which all major economies abolished withholding taxes on interest arising from inbound portfolio investments to avoid migration of capital resources to the United States.<sup>127</sup>

The withholding tax exemption granted to interest income originating from inbound portfolio investments is perhaps the best example of source tax harmonization that is enforced by a tax-competitive dynamic. To date, the exemption of portfolio income has diminished the revenue generation of the U.S. withholding tax on interest so profoundly that serious doubts have arisen as to whether maintaining the withholding tax on foreign investments is a worthwhile endeavor.<sup>128</sup>

In examining the foreign portfolio income exemption, it is important to recognize the pivotal role that double taxation treaty principles played in paving the way. As one commentator put it: "[The

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*Tax on Portfolio Debt Interest Paid to Foreigners: Tax and Fiscal Policies in the Context of Eurobond Financing*, 5 VA. TAX REV. 375, 393 (1985) ("First, but not necessarily foremost, Congress wanted U.S. business and the U.S. Treasury to have efficient access to foreign capital. Second, Congress wanted to assure such access without creating any significant tax compliance problems.").

<sup>125</sup> Holden, *supra* note 124, at 383.

<sup>126</sup> Marilyn D. Franson, *The Repeal of the Thirty Percent Withholding Tax on Portfolio Interest Paid to Foreign Investors*, 6 NW. J. INT'L L. & BUS. 930 (1984) (discussing the problems of limiting the exemption only to portfolio interest and to nonresidents); Holden, *supra* note 124, at 415 (claiming that Congress enacted the exemption without fully accepting the avoidance costs that broad access to the Eurobond market would entail).

<sup>127</sup> Avi-Yonah, *supra* note 122, at 1581; Franson, *supra* note 126, at 976 (describing how France and West Germany repealed their withholding taxes on interest to compete successfully with the United States).

<sup>128</sup> Colon, *supra* note 76, at 843-44.



portfolio income exemption] legislation supports the longstanding principle of international taxation that portfolio investors should be subject to taxation on interest income [only] in their own country of residence or nationality.”<sup>129</sup>

*D. The Trade Phase: Some Final Observations*

One has to recognize that international trade and IITR considerations coincided during the Trade Phase to promote liberalization of international markets and international commerce. This fusion resulted in a conceptual spillover of international trade considerations into the realm of IITR — one that was not balanced by coherent source tax equity standards. As IITR revenues comprised a relatively small fraction of developed countries’ tax mix during the Trade Phase, the trade liberalization considerations had tremendous impact on the development of the IITR during that crucial era.

This spillover would have been less disturbing to some countries if reductions in withholding taxes on interest were compensated for by higher taxation on the residence frontier (in which it is assumed that the worldwide income of residents is taxed).<sup>130</sup> However, revenue reciprocity seems to be impaired beyond rescue<sup>131</sup> in light of the current flourish of loosely taxed and regulated financial offshore centers along with the development of sophisticated deferral, inversion, and tax avoidance techniques by tax planners. These phenomena are related to taxpayer ability to shift and manipulate holdings of mobile financial (and intangible) assets to foreign jurisdictions. The accelerating mobility of assets during the last fifty years is an inevitable byproduct of a number of overall positive developments, including the overall pro-capitalist political stability in Western countries, technological and telecommunication

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<sup>129</sup> Franson, *supra* note 126, at 972.

<sup>130</sup> Julie A. Roin, *Adding Insult to Injury: The “Enhancement” of § 163(j) and the Tax Treatment of Foreign Investors in the United States*, 49 TAX L. REV. 269, 283–84 (1994) (noting that the United States refrained from entering tax treaties with jurisdictions that will not adequately tax the proceeds of passive income on a residence basis).

<sup>131</sup> Perhaps most indicative of the reciprocity notion’s conceptual deficiency is the growing readiness of policymakers to favorably consider the shift to a territorial system. HARRY GRUBERT & JOHN MUTTI, TAXING INTERNATIONAL BUSINESS INCOME (2001) (concluding that exempting repatriated income would greatly simplify the Internal Revenue Code (Code) and may even yield more revenues than the current regime); *see also* FINAL REPORT OF THE PRESIDENT’S ADVISORY PANEL ON FEDERAL TAX REFORM 103–04, 133–35 (2005).

advancements, and the expansion of international financial markets and intermediaries, which allowed taxpayers to locate intangible assets in one jurisdiction while controlling them from another. Accordingly, tax-motivated inversion techniques involve changes in citizenship or residency status by wealthy individuals or corporations from high-tax rate jurisdictions to those with lower effective rates.<sup>132</sup> Deferral techniques involve sheltering income in foreign subsidiaries thus avoiding taxation until realization based repatriation.<sup>133</sup> Tax evasion arises from taxpayer ability to invest financial holdings in source jurisdictions that impose null or negligible tax rates, without reporting earnings to residence jurisdictions.<sup>134</sup> Avoidance techniques typically involve related party dealings to shift income to low-tax jurisdictions, the use of hybrid entities to repatriate excessive foreign tax credits,<sup>135</sup> and/or the manipulation of financial and intangible asset holdings in an effort to create artificial losses in high-tax jurisdictions.<sup>136</sup> While solutions have been conceptually established, and partially employed, to redress problems of evasion (through information sharing), inversion (through re-characterization rules), and deferral (through anti-deferral CFC legislation),<sup>137</sup> the problem of avoidance remains an open wound within the IITR.

Reduction of withholding taxes is not unique to the United States; to the contrary, it is probably more significant in the European Union (EU).<sup>138</sup> The United States, however, is an interesting example

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<sup>132</sup> Mihir A. Desai & James R. Hines, Jr., *Expectations and Expatriations: Tracing the Causes and Consequences of Corporate Inversions*, 55 NAT'L TAX J. 409, 415 (2002).

<sup>133</sup> See generally Robert J. Peroni, *A Hitchhiker's Guide to Reform of the Foreign Tax Credit Limitation*, 56 SMU L. REV. 391 (2003).

<sup>134</sup> See HERMAN, *supra* note 124, at 275–77, 428; Graetz & Grinberg, *supra* note 118, at 578–82.

<sup>135</sup> See Lawrence Lokken, *Territorial Taxation: Why Some U.S. Multinationals May Be Less Than Enthusiastic About the Idea (and Some Ideas They Really Dislike)*, 59 SMU L. REV. 751, 759–63 (2006) (showing how MNEs use hybrid entities for importing tax-credits).

<sup>136</sup> See, e.g., Alvin C. Warren, Jr., *Understanding Long Term Capital*, 106 TAX NOTES 681 (Feb. 7, 2005) (providing an elaborate example of such manipulation).

<sup>137</sup> But see Yesim Yilmaz, *Tax Havens, Tax Competition, and Economic Performance*, 43 TAX NOTES INT'L 587, 590 (Aug. 14, 2006) (challenging the effectiveness of this anti-deferral regime and claiming that holding hybrid entities in tax havens are used by U.S. MNEs to reduce the tax liabilities of their foreign subsidiaries while avoiding exposure to subpart F liabilities).

<sup>138</sup> To promote the four freedoms of people, goods, services, and capital mobility, the EU enacted directives that disallow the imposition of withholding taxes between related parties in Member States. See, e.g., Council Directive 03/49, Common System

because it illustrates the different techniques through which (stable) trade conventions were pursued under changing circumstances. Looking at U.S. IITR policy during the Trade Phase, one could break down reductions of source withholding taxes on inbound debt investments as a gradual shift from the notion of neutrality to the notion of competition.<sup>139</sup> At the beginning of the Trade Phase, the United States acted in the capacity of a creditor country. Thus, as mentioned, it promoted a capital-export neutrality policy, which assumed that proceeds from financial investments are taxed by residence jurisdictions. The capital-export neutrality was thus good, not only for liberalizing international trade and investment markets, but for the Treasury as well. At the end of the Trade Phase, the United States, in its capacity as a debtor and later as a net-debtor,<sup>140</sup> unilaterally reduced its withholding taxes to attract investment. In sharp contrast with notions of capital-export neutrality, the competitive process of converting foreign investors from a source of revenue to a source of credit did not require reciprocal tax reductions on behalf of other tax regimes. Paradoxically, as the United States shifted from being “the” net capital-exporting country to a major net-capital-importing country, it was motivated by the same considerations that led net capital-importing countries at the beginning of the Trade Phase to swim along the withholding tax erosion current, despite subsequent fiscal loss.

The shift in the United States’ position flags an important distinction between the beginning and the end of the Trade Phase: the role of tax-competition. In a sense, the initial decision of net capital-importing countries to comply with the Treaty’s norms, which dictated erosion of withholding taxes, was a form of tax-competition intended

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of Taxation Applicable to Interest and Royalty Payments Made Between Associated Companies of Different Member States, 2003 O.J. (L 157) 49 (EC); Council Directive 90/435, Common System of Taxation Applicable in the Case of Parent Companies and Subsidiaries of Different Member States, 1990 O.J. (L 225) 6 (EEC).

<sup>139</sup> Avi-Yonah, *supra* note 4, at 324–34 (arguing that U.S. international tax policy should be divided into four periods and identifying two post-WWII periods; the first lasting until the beginning of the 1980s, which emphasized capital export neutrality, and the second lasting from the beginning of the 1980s until the late 1990s, which was dominated by competition considerations).

<sup>140</sup> During the second half of the 1970s, the United States maintained a net-debt exporting balance (around USD 16 billion). It became a net-debtor in 1984 (USD 32 billion). Its position as a net-debtor increased dramatically in 1985 (USD 151 billion) and 1989 (USD 281 billion). To date, the United States is a net-debtor of USD 1,993 billion. See Bureau of Economic Analysis, International Investment Position of the United States at Yearend, 1976-2005 (2005), [http://bea.gov/bea/di/intinv05\\_t2.xls](http://bea.gov/bea/di/intinv05_t2.xls).

to attract foreign direct investments (FDI). FDIs are typically strategic, long-term investments by corporations in a line of business in a certain country.<sup>141</sup> Thus, from a capital-importing country's perspective, attracting FDIs by signing a double taxation treaty with a capital-exporting country was a cautious way to maximize investment in its jurisdiction without completely eroding its withholding tax base. Although the volume and magnitude of FDIs are increasing significantly and constantly as the global economy continues to integrate, this growth has been overshadowed by the meteoric growth of portfolio investment in modern global financial markets.<sup>142</sup> Portfolio investments are made by individuals and corporations seeking a diversified portfolio of financial assets and a high (net) return on their investments — not control of a specific entity. These investments are volatile, mobile, and dispersed among various types of investors originating from different countries.<sup>143</sup> All of the above attributes make portfolio investments more sensitive to tax than FDIs. Accordingly, as portfolio investors and markets grew in size and sophistication, portfolio investors were able to utilize capital mobility to shift the withholding tax burden to their debtors. To tax-compete successfully for these investments, the United States had to make a strong commitment to broad foreign portfolio income exemptions. This change in strategy is a direct result of material changes in international investment markets. Nevertheless, thematically, both strategies ascribe to Trade Phase rationales.

At the beginning of the Trade Phase one commentator wrote:

[A]ny special provisions for the promotion of trade . . . would entail some loss of revenue in certain cases and, in certain other cases, it might permit [sic] manipulation. . . . [However, s]ave in cases of abuse, if this country wants foreign trade, it should be prepared to pay some reasonable premium to get it.<sup>144</sup>

This commentator was correct. He failed to foresee, however, that in the absence of an IITR source equity paradigm, there was no indication as to what “reasonable premium” meant in terms of

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<sup>141</sup> See Graetz & Grinberg, *supra* note 118, at 549–52 (discussing the ambiguous empirical evidence for portfolio investments' tax sensitivity).

<sup>142</sup> See *id.* at 542–45 (detailing the growth of U.S. taxpayers' outbound portfolio investments since the beginning of the 1990s).

<sup>143</sup> *Id.* at 549.

<sup>144</sup> James, *supra* note 32, at 246.

revenues. On a conceptual level, the absence of such a paradigm disabled tax policymakers from discerning when trade considerations infringed key normative tax considerations. The subsequent Anti-Avoidance Phase represents a convoluted and, to a large extent, unsuccessful attempt to identify those principles.

#### V. THE EARNINGS-STRIPPING LOOPHOLE AND THE ANTI-AVOIDANCE PHASE: LATE 1980S TO 2000S

The third era this article defines, the Anti-Avoidance Phase, marks an attempt by IITR policymakers to balance considerations emphasized during the Trade Phase by developing mechanisms to re-characterize the tax consequences of tax abusive transactions. The article argues that this attempt failed because it was conceptually inapt to deal with sourcing difficulties that arise from an integrated global market reality. During the Anti-Avoidance Phase, evasion opportunities associated with the growth of the international portfolio investment markets and the availability of loosely taxed and regulated financial centers<sup>145</sup> also emerged as a major avenue of revenue loss. The main difference between the avoidance and evasion topics is that, in the case of tax evasion, policymakers conceptually resolved the proper methods for dealing with it (e.g., information sharing)<sup>146</sup> — therefore making it a problem of incomplete implementation.<sup>147</sup> This

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<sup>145</sup> See generally Yilmaz, *supra* note 137.

<sup>146</sup> MITCHELL B. CARROLL, PREVENTION OF INTERNATIONAL DOUBLE TAXATION AND FISCAL EVASION: TWO DECADES OF PROGRESS UNDER THE LEAGUE OF NATIONS 37 (1939) (exemplifying that the solution was already known in the 1930s).

<sup>147</sup> The OECD took measures to establish these methods by threatening to implement a set of multilateral sanctions against tax-havens (through bank and corporate secrecy laws, noninformation sharing policies, etc.) that jeopardized its Members' residency taxation. See OECD, HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE (1998); OECD, THE OECD'S PROJECT ON HARMFUL TAX PRACTICES: THE 2001 PROGRESS REPORT (2001); OECD, TOWARDS GLOBAL TAX CO-OPERATION: REPORT TO THE 2000 MINISTERIAL COUNCIL MEETING AND RECOMMENDATIONS BY THE COMMITTEE ON FISCAL AFFAIRS (2000); see also DONALD L. BARLETT & JAMES B. STEELE, THE GREAT AMERICAN TAX DODGE 51–117 (2000) (giving a detailed account of how American taxpayers use offshore facilities to evade taxation and how the use of the internet made it difficult for the Internal Revenue Service (Service) to prevent this abuse); Abadan Jasmon & Junaid M. Shaikh, *Underreporting Income: Should Financial Institutions Disclose Customers' Income to Tax Authorities?*, 15 J. INT'L TAX'N 36, 40–42 (2004) (suggesting options for effective enforcement); David E. Spencer, *OECD Project on Tax Havens and Harmful Tax Practices: An Update (Part 2)*, 13 J. INT'L TAX'N 32, 41–45 (2002); Suzanne Walsh, Note, *Taxation of Cross-Border Interest Flows: The Promises and*

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Part focuses on the topic of tax avoidance because countering the problems associated with it requires first a more profound conceptualization of the issues at stake.

In the previous Part, the article presented how the Trade Phase assumption (that lower source taxation would result in more residence taxation) failed because the economics of investment markets enabled the tax planning industry to develop deferral and avoidance techniques. By the same token, the article argues that the assumption underlying the Anti-Avoidance Phase, which contemplates that abusive tax-motivated transactions could be separated from ordinary business transactions, is nullified by high volumes of affiliated transactions within MNEs. The following Part makes this point by examining the manner in which the USESR failed to adequately source affiliated-party inbound debt investments.

In the 1990s, on the verge of entering the post-Cold War period, which was characterized by a lack of any serious anti-capitalist political competition, fiscal regimes in the developed world faced the following two issues: (1) free trade cross-border practices (including liberalization of monetary and financial policies and omission of protectionist barriers to investment) had, as a matter of course, become so prevalent that they could almost be taken for granted and (2) the increasing integration and accessibility of international markets entailed considerable tax avoidance costs. Tax avoidance opportunities were most frequently associated with MNEs. Given the slowdown in the growth of post-WWII economies and the growing role of MNEs in the global economy,<sup>148</sup> policymakers feared that the tax avoidance costs of promoting free trade would eventually jeopardize the core expenditure programs of liberal democracies' welfare states.<sup>149</sup>

In the aftermath of the Cold War, there was a focus on the attainment of Trade Phase political objectives, thus increasing concerns regarding the solidity of public finance schemes as an indispensable component of a stable (capitalist) world order.<sup>150</sup> Such

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*Failures of the European Union Approach*, 37 GEO. WASH. INT'L L. REV. 251 (2005); Douglas J. Workman, Comment, *The Use of Offshore Tax Havens for the Purpose of Criminally Evading Income Taxes*, 73 J. CRIM. L. & CRIMINOLOGY 675, 686–706 (1982) (demonstrating that incomplete implementation is not a new phenomenon).

<sup>148</sup> Vito Tanzi, *Globalization, Technological Developments, and the Work of Fiscal Termites*, 26 BROOK J. INT'L L. 1261, 1269–71 (2001).

<sup>149</sup> See Avi-Yonah, *supra* note 122, at 1632–39.

<sup>150</sup> See Emilio Cencerrado, *Controlled Foreign Company and Thin Capitalization Rules Are Not Applicable in Spain to Entities Resident in the European Union*, 13 EC

changes in the global political economy dimmed the then unchallenged brightness of the notion that trade considerations were supreme. The notion that trade considerations should be limited in certain cases is a mark of the Anti-Avoidance Phase paradigm. It thus prioritizes the need to counter tax avoidance options open to taxpayers with international operations, mainly MNEs.

Fiscal avoidance is possible whenever legal form is inconsistent with economic substance. In the course of looking for ways to retrieve the integrity of their fiscal regimes, IITR policymakers recognized that the inherent complexities of financial transactions, as well as the possibility of using numerous different contractual avenues to attain similar results, make it very difficult to create and implement precise rules. However, tax authorities' efforts to delineate broad anti-avoidance rules have often been successfully challenged, politically and legally, by taxpayers on the basis that the rules are arbitrary.

There are many mechanisms that are consistent with the anti-avoidance paradigm's premise. Unlike the previous, broader discussions of the Trade and Revenue Phases, the Anti-Avoidance Phase requires a narrower discussion focused on an examination of only one representative example. Accordingly, after briefly explaining the difficulties of sourcing debt investments and their susceptibility to avoidance schemes, the article's next Part focuses on what it considers to be the best representative example: MNEs' ability to shift income by related party lending — a phenomenon known as “earnings-stripping.” More specifically, the article focuses on the USESR as a case study that demonstrates the problems of the Anti-Avoidance Phase. Dealing with the attempt to prevent abusive intra-group finance transactions within MNEs, the USESR example epitomizes the difficulties associated with the anti-avoidance paradigm's premises.

*A. The Difficulty of Sourcing Interest and the Earnings-Stripping Practice*

The international tax terrain, which entails the difficulty of formulating robust interest allocation rules, can be understood as consisting of two different components: (1) the different tax rates and sourcing techniques that apply to debt and equity instruments and (2) the tax-competitive global environment in which tax policymakers operate.

First, the proceeds from equity investments are typically subject to two layers of taxation (corporate and shareholder). In contrast, proceeds from debt investments are subject to one tax only — on the creditor level (due to the deductibility of interest expenses on the corporate level). In addition, the bilateral treaty network has facilitated a (de facto) acknowledgment that source countries should enjoy a much stronger claim on income derived from equity than from debt investments.<sup>151</sup> The combination of these two factors reveals the prima facie appeal of related-debt financing due to potential jurisdictional mismatches between the locations where interest deductions and proceeds are recognized. By leveraging operations in high-tax jurisdictions and borrowing from low-taxed lenders, taxpayers may take advantage of interest expense deductibility and negligible withholding tax on interest to reduce finance costs. This possibility is especially lucrative for MNEs, which can engage in related-debt transactions to finance subsidiaries in high-tax jurisdictions while retaining corporate control. This practice is called earnings-stripping.

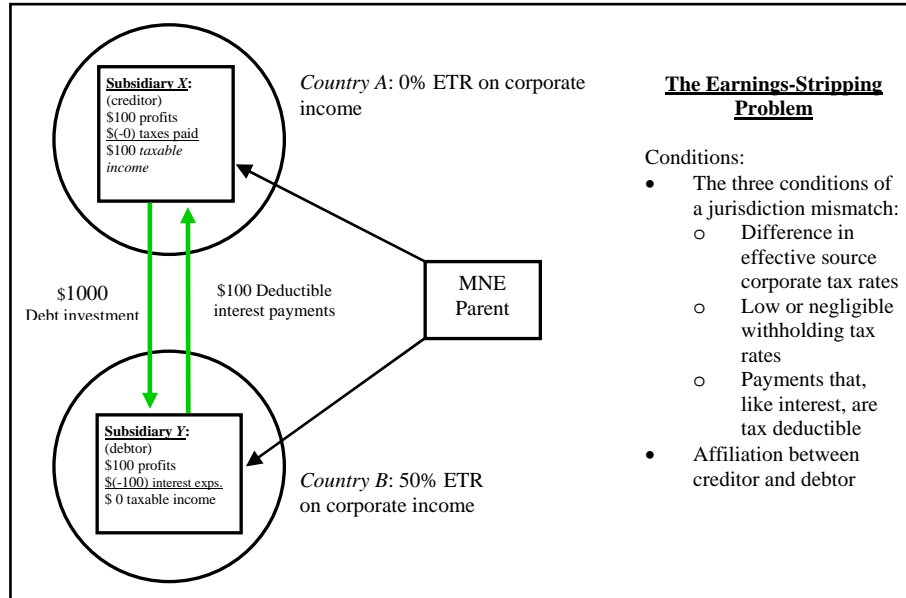
This loophole is central to this Part's analysis and therefore an example with a graphic schema (Figure 3) may help to better illustrate it. Country A and Country B impose respectively a 0% and 50% ETR on all sources of corporate income. Country A and Country B then enter a double taxation treaty, which eliminates withholding taxes on interest payments. *X* and *Y* are two subsidiaries of a single MNE that are located in Country A and Country B, respectively. In a given year, *Y* earned \$100 from its business activities in Country B, which would be subject to a 50% tax rate leading to a tax liability of \$50. The MNE has a clear incentive to reduce its overall tax expenses. This could easily be done by financing *Y*'s activities with *X*'s debt instruments. For instance, subsidiary *X* loans subsidiary *Y* \$1000 carrying the appropriate market rate of 10% annual interest. *Y* deducts the \$100 interest payments from its income and *X*, which is tax indifferent because of Country A's low ETR, will report them as income. This way *Y*'s income for that year would be \$0 and the MNE would avoid \$50 of source tax costs that would have been laid on *Y* by Country B.

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<sup>151</sup> Axel Cordewener, *Company Taxation, Cross-Border Financing and Thin Capitalization in the EU Internal Market: Some Comments on Lankhorst-Hohorst GmbH*, 43 EUR. TAX'N 102, 113 (2003); see also Umbrecht & Llewellyn, *supra* note 15, at 646 (noting that under some treaties the withholding tax on dividends and corporate distributions is usually not eliminated but only reduced to 5%-15%, while passive interest income is usually exempt).



FIGURE 3. THE EARNINGS-STRIPPING TECHNIQUE



Second, sovereigns, conflicted between attracting foreign investments and protecting revenue streams, try to reduce the effective tax burden on capital without piercing their tax nets too severely. In this context, the fact that the Anti-Avoidance Phase took place after all major developed countries reduced effective tax rates to create more competitive economies reveals an interesting insight.<sup>152</sup> Anti-avoidance measures could be encapsulated as supplementary mechanisms intended to keep the tax rate reductions of the mid-1980s to 1990s (that were accompanied by tax base broadening) within the original intended framework of revenue neutrality. Through their crude and somewhat arbitrary nature, anti-avoidance measures were intended to cap losses from revenue. Using anti-avoidance mechanisms, tax authorities aspired to balance revenue losses arising from deliberate tax reductions, including withholding taxes on capital income, with the political necessity of adhering to the unsound foundations of transfer-pricing and treaty based sourcing regimes.

<sup>152</sup> Jacques Sasseville, *Current Issues in International Tax Policy*, in *TAX TREATIES: LINKAGES BETWEEN OECD MEMBER COUNTRIES AND DYNAMIC NON-MEMBER ECONOMIES 9* (Richard Vann ed., 1997) (arguing that in the 1980s and 1990s Western countries changed their strategies for attracting investments; instead of offering tax breaks they tried to make their tax systems more neutral and competitive through tax rate reductions and tax base broadenings).

Treaty sourcing mechanisms were explained at great length in the previous Part. The next Part will critically describe some key aspects of the transfer-pricing sourcing regime.

*B. The Inadequacy of Sourcing Mechanisms in Protecting the Tax Base's Integrity from Earnings-Stripping Practices*

It is crucial to first understand what earnings-stripping practice is and why ordinary sourcing conventions provide unsatisfactory results when dealing with it.

At their core, the problems associated with interest sourcing and earnings-stripping are a byproduct of the following two notions. The first notion is that MNEs should have the freedom to arrange their capital structure. A derivative of this is that related party debt is a completely legitimate finance option in pursuing various business objectives.<sup>153</sup> The reluctance of MNEs to disclose sensitive information to creditors or to tie capital to specific locations are only two of an array of legitimate business reasons for MNEs to engage in related-debt (rather than equity) financing for any related entity, regardless of its creditworthiness. The second notion stresses the idea that, from an economic perspective, a debt transaction between entities under common control “is ultimately just a piece of paper”<sup>154</sup> — very different from debt obligations issued to unrelated parties.<sup>155</sup> The core of the anti-avoidance problem in the earnings-stripping case is about how to reconcile the two notions. The underlying theme of the Anti-Avoidance Phase is that tax authorities could attain the institutional competence to separate related finance transactions with legitimate tax consequences from those with illegitimate ones.

Unsurprisingly, many of the ordinary sourcing rules developed during the Trade Phase have limited capacity to protect the integrity of the interest tax base in light of the abovementioned pressures. As a prologue to its detailed discussion of the U.S. earnings-stripping regime as a case study, this article briefly examines the sourcing difficulties arising from two mechanisms that directly relate to source interest tax base erosion: (1) the arm’s-length standard and (2) limitation-of-benefits clauses (in treaties) and anti-conduit legislation.

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<sup>153</sup> T. James Brooks, *Why It Would Be Premature to Tighten U.S. Earnings Stripping Rules*, 33 TAX NOTES INT’L 1017, 1023 (Mar. 15, 2004).

<sup>154</sup> H. David Rosenbloom, *Banes of an Income Tax: Legal Fictions, Elections, Hypothetical Determinations, Related Party Debt*, 26 SYDNEY L. REV. 17, 17 (2004).

<sup>155</sup> *Id.* (“The hallmark of debt is an unconditional promise to pay a sum certain on demand or at a fixed maturity in the reasonably foreseeable future . . .”).

First, the arm's-length standard is the key sourcing technique through which tax authorities source related party transactions. Generally, the arm's-length standard is a transaction-based approach employing a hypothetical inquiry<sup>156</sup> as to how unrelated parties would price a certain transaction, requiring each corporate entity within a MNE group to report accordingly.<sup>157</sup> However, the arm's-length standard, as it is currently enshrined in a plethora of transfer-pricing regulations, is a mechanism that is conceptually flawed,<sup>158</sup> practically inept,<sup>159</sup> and extremely inefficient and burdensome<sup>160</sup> for sourcing many complex affiliated transactions.

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<sup>156</sup> *Id.* at 27 (arguing that hypothetical tests are needed for any operational income tax system because contractual fictions allow many situations in which transactions cannot be accepted at face value).

<sup>157</sup> Robert A. Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 CORNELL L. REV. 18, 46–47 (1993); Joann M. Weiner, *U.S. Treasury Office of Tax Analysis Paper Considers States' Experience Regarding Formula Apportionment*, 1999 WTD 182-23 (Sept. 21, 1999).

<sup>158</sup> As a business structure, MNEs flourish in those industries where the integrated multi-jurisdictional group structure enables them to internalize efficiently a variety of the group's (collective) costs — such as transaction costs, research and development costs, information obtaining costs, and management costs. Hence, tax authorities find it difficult to directly assign MNEs' collective costs and profits to any specific corporate entity operating in a certain jurisdiction. See Reuven S. Avi-Yonah, *The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation*, 15 VA. TAX REV. 89, 149–50 (1995); Kojo Yelapaala, *In Search of Effective Policies for Foreign Direct Investment: Alternatives to Tax Incentive Policies*, 7 NW. J. INT'L L. & BUS. 208, 221 (1985); James R. Hines, Jr., *Tax Policy and the Activities of Multinational Corporations* 34–38 (Nat'l Bureau of Econ. Research, Working Paper No. 5589, 1996), available at <http://econpapers.hhs.se/paper/nbrnberwo/5589.htm>.

<sup>159</sup> The arm's-length standard's endorsement by all tax regimes motivates MNEs to restructure their affiliated transactions' contractual prices to report profits in corporations located in low-tax jurisdictions (MNEs may also be motivated to report profits in high-tax corporations, which have generated deductible losses about to expire). This tax reduction opportunity, open to MNEs through their range of international entities, enables them to curtail their tax expenses without instituting any fundamental alteration in the economic nature of their activities.

<sup>160</sup> In an attempt to prevent the possibilities for abuse that arise from these conceptual deficiencies, transfer-pricing regulations often oblige MNEs to meet superficial (yet burdensome and rigorous) documentation standards in relation to their intra-group pricing methods. However, because of their incongruence with economic reality of integrated MNEs, transfer-pricing rules have a penumbra of abuse possibilities and uncertainties, which breed litigation and embroil the arm's-length standard with inherent inequities. See *Towards and Internal Market Without Tax Obstacles, A Strategy for Providing Companies with a Consolidated Corporate Tax Base for their EU-Wide Activities*, at 40, COM (2001) 582 final (Oct. 23, 2001), available at [http://eur-lex.europa.eu/LexUriServ/site/en/com/2001/com2001\\_](http://eur-lex.europa.eu/LexUriServ/site/en/com/2001/com2001_)

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In the related party finance realm, it is virtually impossible for tax authorities to unveil and systemize MNEs' financial structures according to the arm's-length standard. Pricing the "proper" interest rate of a specific related-debt transaction is a feasible task for the tax authorities of developed countries. However, tax authorities have no conceptual benchmark to determine whether the debt form of the transaction is proper, given the numerous alternatives available to taxpayers for mobilizing and repackaging fungible capital assets. This sourcing difficulty is compounded by the general difficulty of overly formalistic tax rules in dealing with sophisticated financial instruments according to obsolete debt versus equity distinctions. In light of these factors, it is evident that the arm's-length standard is incapable of coherently sourcing affiliated financial transactions because there is no one "correct" and objective standard for allocating financial risks.<sup>161</sup> Since it may be both analytically and practically difficult to retrieve the true economic substance of many affiliated financial transactions, MNEs may, through contractual machinations, skew the risks associated with those transactions (and their correlative returns) to favorable tax jurisdictions, even when no real economic risks are undertaken in those jurisdictions. As one prominent scholar has put it, the arm's-length standard's prima facie endorsement of affiliated transactions' risk allocation schemes resulted in a "tax-planning free for all [regime]."<sup>162</sup>

Second, in what has become known as treaty-shopping, sophisticated taxpayers are able to avoid unfavorable withholding taxes levied upon payments to nonresidents by channeling financial flows through conduit entities in jurisdictions with a favorable treaty

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0582en01.pdf (stating that there is evidence for aggressive transfer-pricing practices of both MNEs and tax authorities); *Company Taxation in the Internal Market*, at 261, 268 SEC (2001) 1681 (Oct. 23, 2001), available at [http://ec.europa.eu/taxation\\_customs/resources/documents/company\\_tax\\_study\\_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/company_tax_study_en.pdf) (noting that business sector representatives claim that the compliance burden of transfer-pricing and its ongoing incidents of double taxation are major ITR obstacles).

<sup>161</sup> Gary D. Sprague, *Application of Transfer Pricing Rules to Branches and Permanent Establishments — Electronic Commerce and Intangible Property Aspects*, 10 GEO. MASON L. REV. 971, 988 (2002).

<sup>162</sup> Richard J. Vann, *Reflections on Business Profits and the Arm's-Length Principle*, in THE TAXATION OF BUSINESS PROFITS UNDER TAX TREATIES 142 (Brian J. Arnold, Jacques Sasseville & Erick M. Zolt eds., 2003) (arguing, brilliantly, that the embedment of functional value creating factors within the transfer-pricing regimes, which was meant to retrieve economic substance, resulted in providing MNEs with great latitude to contractually allocate risks to low-tax jurisdictions to reduce their tax liability).

network.<sup>163</sup> This way, taxpayers are able to extend withholding tax reductions, attained through such “treaty-havens,” to entities in jurisdictions with more conservative treaty policies.<sup>164</sup> In response to these perceived abuses of the treaty network, it has become a common practice for some nations, most notably the United States, to include in their treaties a limitation-of-benefits clause.<sup>165</sup> These clauses deal with situations in which nonresidents of the other signatory to the double taxation treaty disguise themselves as residents to attain treaty benefits.<sup>166</sup> The United States has supplemented its treaty-shopping treaties’ provisions with an anti-conduit statutory legislation intended to counter conduit transactions that do not require creating a related entity.<sup>167</sup> While both policies have been integrated in U.S.

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<sup>163</sup> These practices are facilitated mainly through developed countries with extensive treaty-networks (e.g., the United Kingdom and the Netherlands). MNEs and other international equity and debt investors may create a conduit entity in such “treaty-havens” to transfer funds through them.

<sup>164</sup> For example, assume *X* is a corporation that resides in a country that has a double taxation treaty with the United Kingdom that eliminates withholding taxes. *X*’s country of residence does not have a double taxation treaty with the United States. *X* wants to provide a loan to an American corporation. If interest payments are paid directly to *X* from the American corporation, they will be subject to 30% withholding tax. However, if *X* establishes a U.K. subsidiary, invests the proceeds from the loan in that subsidiary, and then lends the money to the American corporation, interest payments made to the U.K. subsidiary by the American corporations would, absent an anti-treaty-shopping provision, be exempt from withholding tax rates under the 2003 version of the Treaty — even though they would eventually be redirected to *X*. More sophisticated versions of treaty-shopping are executed typically through the use of conduit companies, agency or trust arrangements, or the use of swap financial instruments, which divert the benefits of the payments from the resident (eligible for the reduced withholding tax rate) to a nonresident.

<sup>165</sup> See, e.g., Treasury Dep’t, United States Model Income Tax Convention, art. 22, Sept. 20, 1996, 1 Tax Treaties (CCH) ¶ 212.22; ISENBERGH, *supra* note 77, at 245–46; Tillinghast, *supra* note 81, at 465–66 (noting that having a limitation of benefits provision has become “an inflexible U.S. demand in negotiation of any treaty”).

<sup>166</sup> Limitation-of-benefits provisions are directed to counter conduit transactions made through corporate entities as well as agency and trust relationships. These provisions rely on ownership benchmarks, the nature of the business activity undertaken by the entities, and the tax avoidance purpose of the transactions. See United States Model Income Tax Convention, *supra* note 165, art. 22.

<sup>167</sup> I.R.C. § 7701(l); Treas. Reg. § 1.881-3 (1995); Timothy S. Guenther, *Tax Treaties and Overrides: The Multiple-Party Financing Dilemma*, 16 VA. TAX REV. 645, 661–63 (1997) (explaining the main attributes of the conduit regulations); Tillinghast, *supra* note 81, at 463. The regulations counter financing transactions, which are part of a tax avoidance plan to reduce withholding taxes through intermediated entities even if those entities are not related to either the financing or financed entities. The

international tax policy, doubt has risen over their effective enforcement in light of high negotiation costs,<sup>168</sup> complexity,<sup>169</sup> and enormous information-finding and litigation costs not available to tax authorities.<sup>170</sup> Although the problems associated with conduit transactions apply to all taxpayers, the mechanisms developed to counter them are less effective when dealing with MNEs. Large MNEs typically have real economic activities in many treaty-havens and a difficult to trace transactional network with various financial institutions.

### C. *The (Counter) Earnings-Stripping Regimes*

#### 1. Two Approaches for Filtering Abusive Related Debt

In discussing earnings-stripping (or thin-capitalization as it is called outside the United States) the OECD has emphasized two common approaches to uncover inappropriate related-debt transactions.<sup>171</sup> The first is an arm's-length standard approach, in which the earnings-stripping regime's interest deduction limitation is triggered when it is determined that a specific related-debt transaction would not have been undertaken by unrelated parties. This approach confronts potentially inappropriate transactions through cumbersome, case-by-case evidentiary inquiries. The multifactor, hypothetical

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simplest example of such transaction would be a back-to-back loan. *See id.* at 463. In this scenario a foreign lender passes funds to a (related or unrelated) borrower through a financial institution that is a resident of the jurisdiction that has favorable treaties with both the lender and borrower's jurisdictions. The financial institution receives a deposit of a certain amount from the lender and shortly after lends a similar amount to the depositor. The interest rate and duration of both debt contracts are similar and the financial institution will typically have some type of recourse against the lender to insure against the debtor's credit risk. This allows the lender and the debtor to avoid withholding taxes and leaves the financial institution with a relatively small, yet costless, profit. In the absence of a smoking gun, it is doubtful whether back-to-back transactions could be spotted effectively by tax authorities.

<sup>168</sup> Colon, *supra* note 76, at 821–22, 829 (noting that the treaty-shopping problem was only settled in the extremely long limitation of benefits provision in the United States' double taxation treaty with the Netherlands; it took the countries twelve years of negotiation to resolve the controversies arising from the ambiguity of the limitation of treaty benefits provision).

<sup>169</sup> ISENBERGH, *supra* note 77, at 254 (noting that the most primitive practice of earnings-stripping tax planning survives the anti-conduit legislation).

<sup>170</sup> Tillinghast, *supra* note 81, at 461.

<sup>171</sup> OECD, THIN CAPITALISATION, TAXATION OF ENTERTAINERS, ARTISTES AND SPORTSMEN 29–31 (1987).

nature of this inquiry narrows significantly the idea of inappropriate debt to include, exclusively, related-debt transactions with terms inconsistent with a debtor's credit rating.<sup>172</sup>

Under the second "ratio approach," the interest deduction limitation is triggered once a relevant party fails to meet a certain debt-equity safe-harbor ratio. This ratio could be designed to focus on the debtor's total indebtedness or its indebtedness against a specific related shareholder's portfolio.<sup>173</sup>

The OECD's absolute adherence to the arm's-length standard, as the sole sourcing methodology of affiliated transactions,<sup>174</sup> could be understood, in part, by its concern that anti-avoidance sourcing mechanisms will pave the way for discriminatory tax treatment of foreign inbound debt investments and investors. As discussed earlier, a key objective of treaties is to prevent tax discrimination of source jurisdictions against foreigners.<sup>175</sup> In the earnings-stripping context, there is an almost-explicit invalidation of this norm, since the heavier tax burden is directly targeted at domestic entities with foreign shareholder-creditors.<sup>176</sup>

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<sup>172</sup> See generally Tim Edgar, *The Thin Capitalization Rules: Role and Reform*, 40 CAN. TAX J. 1, 30 (1992).

<sup>173</sup> Ruud A. Sommerhalder, *Approaches to Thin Capitalization*, 36 EUR. TAX'N 82, 83 (1996) (providing some examples of countries implementing this type of debt-ratio).

<sup>174</sup> OECD, *supra* note 171, at 29–32.

<sup>175</sup> OECD, Model Tax Convention on Income and on Capital, art. 24, Jan. 28, 2003 (prohibiting a number of scenarios in which the source country may discriminate against nationals of another country that reside in it, permanent establishments, and enterprises owned by foreigners).

<sup>176</sup> The OECD's position on earnings-stripping aligns with its general aversion to any sourcing arrangement that may grant the source jurisdiction the right to differentiate enterprises related to foreign investors from domestic investors. It is feared that if the source states will be granted the right to make such differentiation, it would allow them to expropriate taxes in an unaccountable and inequitable manner. One other important aspect of this aversion is the adherence of the OECD to the arm's-length standard principle. To a large extent, this is driven by the fear that source jurisdictions will misuse formulary systems to allocate income in an unjust manner. Fred C. de Hosson & Geerten M.M. Michielse, *Treaty Aspects of the 'Thin Capitalisation' Issue — A Review of the OECD Report*, 11 INTERTAX 476, 484 (1989) (criticizing the earnings-stripping regimes as violating anti-discrimination treaty obligations); Jack M. Mintz, *Globalization of the Corporate Income Tax: The Role of Allocation*, 56 FINANZARCHIV 388, 393–94 (1999) (discussing the issue of tax expropriation through formulary allocation methods).

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Whether specific earnings-stripping regimes violate treaty anti-discrimination norms is a complicated discussion.<sup>177</sup> That discussion is not covered in detail here because it is relevant primarily to questions dealing with the hierarchy of treaty law and national legislation.<sup>178</sup> Thus, it contributes less to the inquiry of this article regarding the intellectual undercurrents affecting interest taxation.<sup>179</sup>

## 2. The Nature of the Interest Deduction Limitation

The first form of limitation, often criticized as being most likely to result in double taxation,<sup>180</sup> is disallowance of interest deductions. Interest deduction disallowance results in the recognition of more income on the source (corporate) level while interest payments are presumably subject to tax on the foreign shareholder-creditor's level as well. A more lenient version of this form is to defer the deduction of disallowed interest. The second option is the re-characterization of interest payments to related parties as dividends. Under this system, payments are subject to source (corporate) tax. Double taxation is thus avoided only if tax authorities in the shareholder-creditor's country of residence endorse the re-characterization<sup>181</sup> by granting relief for extra taxes paid on the source level. The shareholder-

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<sup>177</sup> It involves questions of legislative versus treaty priority and questions of legislative interpretation.

<sup>178</sup> See discussion *infra* note 223.

<sup>179</sup> Forceful arguments that (for tax purposes) foreign (debt) investors are differently situated from domestic investors could be made. See Shay et al., *supra* note 9, at 115. Nevertheless, the fact that (almost) by definition earnings-stripping regimes signal and penalize foreign investment strengthens the OECD's position. These institutional considerations could serve as a partial explanation for the endorsement of the arm's-length approach by many earnings-stripping regimes. This endorsement is frequently manifested through exceptions provided to related-debt transactions that are proven to be made on an arm's-length basis (e.g., the case of Australia and Germany earnings-stripping regimes), or by the incorporation of arm's-length benchmarks into the ratio formula (e.g., the U.S. earnings-stripping regime (USESR)), as discussed below.

<sup>180</sup> Nathan Boidman, *Inversions, Earnings Stripping — Thin Capitalization and Related Matters — An International Perspective*, 29 TAX NOTES INT'L 879, 895–96, 904 (Feb. 24, 2003); Robert J. Misesy, Jr., *An Unsatisfactory Response to the International Problem of Thin Capitalization: Can Regulations Save the Earnings Stripping Provision?*, 81 INT'L TAX & BUS. LAW. 171, 202 (1990) (bringing to attention the impact of re-characterization on related matters such as the computation of E&P in the case of the United States).

<sup>181</sup> Lars-Erik Wenehed, *Thin Capitalization and EC Law*, 30 TAX NOTES INT'L 1145, 1149 (May 26, 2003).



creditor's tax consequences under this approach, however, depend on a number of additional factors.<sup>182</sup> Assuming a constant limitation amount, and putting aside differences arising from different withholding tax rates on debt and equity, the tax consequences for the debtor-corporate entity are similar under the disallowance and re-characterization regimes. In cases where there is more than one shareholder, the burden of the additional source corporate tax liability is borne not only by the shareholder providing the "illegitimate" loan, but by all shareholders.<sup>183</sup>

#### VI. THE USESR AS A CASE-STUDY: A CRITIQUE OF THE ANTI-AVOIDANCE PHASE

A critical analysis of the USESR, as a case study, dovetails nicely with the article's historical analysis. First, the USESR subscribes to the anti-avoidance paradigm in the sense that it tries to define, and differentiate between, "illegitimate" (motivated by abusive tax avoidance) and legitimate (debt) transactions. Second, it deals with the primary problem manifested during the Anti-Avoidance Phase — taxpayer ability to manipulate tax consequences through related party transactions. Third, it deals with the source allocation consequences of interest. Finally, the article maintains that the USESR is a reflection of the anti-avoidance paradigm as a whole. It incorporates the notion that the core difficulty with the IITR sourcing conventions is their inability to deal with the transactional abusiveness associated with cross-border related party activities. As the article demonstrates, this notion is too narrowly framed and, paradoxically, even insufficient to attain its own goals of coherently and equitably sourcing related party

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<sup>182</sup> These factors include, for example, the disparity between withholding taxes laid on interest and dividends, the treatment of foreign sourced dividend by the shareholder's country of residence, the level of shareholder corporate integration, and the classification of re-characterized related-debt transactions in which the lender is the subsidiary.

<sup>183</sup> In both cases, a similarly higher corporate tax is levied on the source level, thus reducing the relative net worth of the holdings of (all) the debtor's shareholders (including those who are not considered related parties), rather than recouping the revenue lost only from those shareholders engaged in the earnings-stripping. For example, assume a corporation with two foreign shareholders each holding 50% of its equity. One of the shareholders provides the corporation with a loan. Assume further that some interest payments made under the shareholder's loan are re-characterized as dividends (or denied a deductions) under the earnings-stripping rules of the corporation's source jurisdiction. This will deny the deduction of those interest payments and is thus likely to result in a higher corporate income tax liability that will affect both shareholders.

debt-finance transactions. The article's focus on the IITR necessarily dictates that the USESR's implications on domestic tax-exempt organizations be left out of the article's discussion.

### A. *The USESR: Some Basic Operational Attributes*

The 1945 U.S.-U.K. double taxation treaty was the first to delineate an earnings-stripping regime.<sup>184</sup> The current USESR is defined in section 163(j) enacted in 1989. To fully understand the inadequacies of the Anti-Avoidance Phase embedded in the USESR, it is first important to understand its three main attributes.

#### 1. Types of Debt Contracts Subject to the USESR

The USESR only limits the deductibility of what it defines as "disqualified interest."<sup>185</sup> Disqualified interest is interest arising from inbound debt investments made by controlling shareholders, which, in the Code, are referred to as related parties.<sup>186</sup> The income is "disqualified" only if the shareholders are exempt — in whole or in part — from U.S. income taxation (including withholding taxes).<sup>187</sup>

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<sup>184</sup> The Treaty established a basic earnings-stripping regime because its negotiators acknowledged taxpayers' ability to manipulate the discontinuity between the withholding tax it laid on dividends and the exemption from withholding taxes on interest. This earnings-stripping regime allowed both jurisdictions to limit the exemption from withholding source taxes on interest in cases of affiliated lending when the foreign creditor had a 50% voting interest in the debtor corporation. *See* The Treaty, *supra* note 90, art. VII.

<sup>185</sup> I.R.C. § 163(j)(1)(A).

<sup>186</sup> I.R.C. § 163(j)(4)(A) (defining related parties as parties with at least 50% ownership stake in the corporate (debtor) taxpayer); I.R.C. § 163(j)(4)(B) (determining that while only corporations (and branches of corporate entities) could be subjected as debtors to the USESR, partners could be considered as related lenders); I.R.C. § 163(j)(5)(A) (containing rules for determining whether the interest was subject to tax on the partner level); I.R.C. § 163(j)(4)(B)(i) (providing a de minimis rule that does not disqualify a partnership that otherwise would be considered a related person if less than 10% of the profits and capital interests are held by a taxpayer not subject to U.S. tax); I.R.C. § 163(j)(6)(C) (affiliated groups are treated as a single taxpayer).

<sup>187</sup> I.R.C. § 163(j)(3)(A). In cases in which treaties reduce but do not eliminate withholding taxes, these reductions are treated as partial tax-exemptions. *See* I.R.C. § 163(j)(5)(B). Thus, the proportion of interest which is disqualified equals the proportional reduction from the 30% withholding tax statutory rate. For example, if through a double taxation treaty the withholding tax rate on interest was reduced to 10%, then two-thirds of the interest payments made by an American corporation to a related foreign taxpayer would be disqualified.

The USESR also covers interest arising from some related-debt equivalents (e.g., debt guaranteed by related parties).<sup>188</sup> It is important to recognize that operating within this mandate limits the scope of the USESR to consider only the appropriateness of intra-group debt-finance transactions. Therefore, it does not cover those cases in which MNEs disproportionately<sup>189</sup> leverage activities of (presumably highly-taxed) American subsidiaries with unrelated debt.

## 2. Defining (Fiscally) Inappropriate Debt Payments

To filter inappropriate related party debt transactions, the USESR employs two safe-harbors: the debt-equity ratio and the permissibility of interest deductions of up to 50% of adjusted taxable income (the ATI Standard). Such a dual filtering system, of employing ratio and (quasi) arm's-length scrutiny standards jointly, situates the USESR in the middle path between the two extremes.<sup>190</sup> Interestingly, both standards use corporate unrelated-debt or interest payments

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<sup>188</sup> The USESR is not restricted to apply only to direct related-debt transactions but also extends to what may be coined "related-debt equivalents." The relative broadness by which the concept of relatedness is defined under the USESR is manifested in the following respects: First, the benchmark of 50% ownership interest, which lenders must have in order to be considered as related to the corporation, is computed according to the related party rules. I.R.C. § 163(j)(4) (making a cross-reference to sections 267(b) and 707(b)(1)). Second, the USESR recognizes indirect (conduit) interest payments as disqualified interest. I.R.C. § 163(j)(3)(A) (using the wording of "any interest paid or accrued by the taxpayer (directly or indirectly)," this provision seems to be attentive to the ability to bypass the USESR by simple back-to-back transactions (emphasis added)). In the absence of guiding earnings-stripping regulations, this seems to be the only statutory anchor within section 163(j) to refute the earnings-stripping potential of these types of transactions. Third, with a small exception, the 1993 amendment of the USESR recognized interest payments arising from debt guaranteed by a foreign related party as disqualified interest. I.R.C. § 163(j)(3)(B), (6)(D); I.R.C. § 163(j)(6)(D)(ii) (contending that if the debtor has a 80%+ interest in the foreign guarantor then interest paid under the debt contract is not disqualified). In my opinion, granting the section 163(j)(6)(D)(ii) exception is wrong since it disregards the ability of a MNE to obtain deferral benefits and/or to obtain stripping benefits through double stripping transactions. *See also* Sanford H. Goldberg & Charles E. Valliere, *Selected US Tax Developments: US Earnings-Stripping Rules Extended to Loans Guaranteed by Related Parties*, 41 CAN. TAX J. 828, 831 (1993).

<sup>189</sup> In comparison to the leverage applied to entities located in low-tax jurisdictions.

<sup>190</sup> Robert E. Culbertson & Jaime E. King, *U.S. Rules on Earnings Stripping: Background, Structure, and Treaty Interaction*, 29 TAX NOTES INT'L 1161, 1169 (Mar. 24, 2003).

(that typically enjoy per se legitimacy) as indicators to determine whether the disqualified interest disallowance should be triggered.

First, deductions of any disqualified interest are unlimited so long as taxpayer debt-equity ratios do not exceed a ratio of 1.5:1.<sup>191</sup> This comparatively low debt-equity ratio standard<sup>192</sup> means that only companies from typically low-leveraged industries fall within the safe-harbor provision.<sup>193</sup> Thus, the safe-harbor allows taxpayers operating in traditionally low-leveraged sectors (e.g., start-ups and retailers), that are solely indebted to related parties, to fly well below the USESR's radar. On the other hand, the USESR may penalize other taxpayers with relatively low percentages of related debt operating in highly leveraged industries (e.g., manufacturing). As discussed later, this blunts the USESR's anti-abusive scrutiny blade.

Second, the deduction of disqualified interest is only limited to the excess amount by which *net* interest expenses<sup>194</sup> exceed 50% of the

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<sup>191</sup> I.R.C. § 163(j)(2)(A)(ii), (C). The equity is computed with reference to the tax base of corporate assets. I.R.C. § 163(j)(2)(C)(i). Because of accelerated tax depreciation, the emphasis on tax base reduces the value of the equity figure. Umbrecht & Llewellyn, *supra* note 15, at 654 (arguing that the safe-harbor would apply mainly to corporations that are constantly engaged in purchasing assets).

<sup>192</sup> Grant Richardson, Dean Hanlon & Les Nethercott, *Thin Capitalization Rules: An Anglo American Comparison*, 24 INT'L TAX J. 36, 59 (1998).

<sup>193</sup> For example, assume there are two corporations, both with a foreign shareholder. The first corporation is a start-up in the internet communication technology field. Since start-ups have the tendency of failing without leaving any tangible assets for their creditors to claim, ordinary commercial lenders will be reluctant to provide the start-up corporation with loans due to the enormous credit risk it would involve. Any investor in the start-up will wish to compensate the risk it is incurring with high rates of return, which are typically attained through equity or hybrid financial investments and not through loans. The second corporation is an industrial one operating in a well-established traditional sector. It requires substantial preliminary investments, which in part would be financed by loans, since lenders can better estimate its credit risk and could issue it recourse loans relying on its tangible holdings. Thus, if the start-up corporation had a debt-equity ratio of 1.4:1, its interest deductions would not be deferred under the USESR even if all of its loans were made by related parties, though this would be considered a high leverage level for a start-up. Additionally, if the industrial corporation had a 1.6:1 debt-equity ratio, it would not fall under the safe-harbor even though this would be considered a low level of leverage for this type of corporation. Furthermore, the industrial corporation will fail to enter the safe-harbor even if only a small fraction of its debt was made by its shareholders.

<sup>194</sup> I.R.C. § 163(j)(6)(B) (defining the term net interest expense as the excess of interest expenses accrued during the fiscal year over the interest payments includable in the taxpayer's gross income in that year).

adjusted taxable income (ATI).<sup>195</sup> This link between the ATI and the permissible level of interest deductions arises because the ATI is considered a rough approximation of cash flow.<sup>196</sup> Cash flow is widely held to be the primary criterion by which unrelated lenders determine the ability of potential debtors to service debt.<sup>197</sup> Accordingly, the ATI Standard is an indirect attempt to create a filtering mechanism that, while using objective measurements, is sensitive to the type of considerations taken by unrelated parties entering into debt transactions.<sup>198</sup> Since many taxpayers fail to meet the debt-equity safe-harbor, much of the USESR's ability to delineate a robust conception of inappropriate related-debt financing practices hinges on the ATI Standard's operation.<sup>199</sup>

### 3. Treatment of Inappropriate Debt Payments

The USESR limitation on the deduction of interest payments may not exceed the lower of (1) the interest excess over the ATI Standard or (2) the amount of recognized disqualified interest. Attentive to business cycle volatility, the USESR employs a carryover provision with no time limits. Thus, the USESR does not disallow interest deductions but only *defers* them to future periods in which its net interest deductions are less than the ATI Standard's prescribed amount.<sup>200</sup>

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<sup>195</sup> I.R.C. § 163(j)(2)(A)(i), (B). To avoid penalizing corporations with temporary decline in revenues, the excess in interest expense may be reduced by offsetting it with unused existing excess limitation carryforwards from three previous fiscal years. *See also* I.R.C. § 163(j)(2)(B)(iii) (the excess limitation is computed in a manner that mirrors essentially the computation of excess interest expenses).

<sup>196</sup> James E. Croker, Jr. & Henry J. Birnkrant, *Earnings-Stripping Prop. Regs. Raise the Level of Complexity for Related-Party Debt*, 75 J. TAX'N 244, 245 (1991); Harry L. Gutman, Thomas A. Stout, Jr., Paul M. Schmidt & Katherine Breaks, *KPMG Urges Reconsideration of Proposals Regarding Earnings-Stripping Provision*, 2003 TNT 84-13 (2003). To entrench this approximation empirically, the USESR provides a number of significant modifications to the way in which the adjusted taxable income (ATI) is to be calculated by taxpayers (namely the add-backs of depreciation amortization and depletion expenses). *See* I.R.C. § 163(j)(6)(A).

<sup>197</sup> Croker, *supra* note 196, at 245–47.

<sup>198</sup> Culbertson & King, *supra* note 190, at 1169.

<sup>199</sup> Umbrecht & Llewellyn, *supra* note 15, at 653–56.

<sup>200</sup> I.R.C. § 163(j)(1)(B). Along with the excess limitation, this interest deduction deferment (until the taxpayer's ATI justifies the deduction) provides taxpayers with an averaging mechanism for USESR purposes.

### B. A Critical Analysis of the USESR

This Part engages in a critical assessment of the USESR's performance, through which it demonstrates that the anti-avoidance paradigm's objectives are a stopgap measure. As the result of its failure to effectively define transactional legitimacy, the paradigm offers no institutional salvage to the difficulties of sourcing affiliated financial transactions in the face of complexity and abuse. I carve the performance question into two analyses: (1) the effectiveness of the USESR in protecting the corporate tax base from erosion and (2) its ability to detect (and, as a byproduct, deter) abusive debt-finance practices.

#### 1. Lack of Effectiveness in Preventing the Tax Base Erosion

The ineffectiveness of the USESR in preventing corporate tax base erosion arises from the carryover provisions and the ATI Standard. First, as mentioned above, many believed that the ATI (as an indicator of cash flow) provides a measure that correlates with the corporate capacity to incur periodic interest payments.<sup>201</sup> However, the imperfections of the ATI Standard,<sup>202</sup> along with taxpayer ability to artificially maximize the ATI (without increasing taxable income),<sup>203</sup> reduced the protective aptitude of this criterion. By allowing corporations to deduct *net* interest expenses up to 50% of ATI, the USESR permits profitable corporations to engage in high levels of related leverage without being affected. Additionally, the USESR's emphasis on the ATI prescribes that corporations with high levels of interest income, mainly financial institutions, are also practically exempt from the USESR.<sup>204</sup> The USESR's impact on loss

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<sup>201</sup> Misey, *supra* note 180, at 199.

<sup>202</sup> These imperfections, to a certain extent, could be attributed to the lack of precise regulations.

<sup>203</sup> Andrea Shaham-Mendell, *Planning Alternatives to the Earnings Stripping Provisions of Section 163(j)*, 70 TAXES 696, 700-01 (1992) (providing a number of examples for how this may be attained such as buying an asset entitled to large depreciation/amortization that will not only offset the income it produces but also artificially increase the ATI, or investment in a diversified portfolio in which the taxpayers will enjoy components that will be included in its ATI but not in its taxable income (dividends subjected to dividend exemptions)); Umbrecht & Llewellyn, *supra* note 15, at 688-92 (providing a number of examples such as the purchase of assets producing interest income as a technique that will provide the corporation with more equity and more ATI — and which would allow it to reduce its net interest expenses).

<sup>204</sup> Diana L. Wollman, *Recent U.S. Earning Stripping Proposals: Why Were the*

corporations, which defer much of their interest deductions anyway, is already limited. However, the USESR's carryover arrangement also severely limits its impact on companies with fluctuating ATIs, which are able to deduct the differed disqualified interest deductions in future years. All this essentially implies that the USESR has a very limited scope and that it affects only a narrow group of mildly profitable corporate taxpayers failing chronically to meet up to the ATI Standard.

Second, the idea that the USESR was intended sincerely to provide a buffer against U.S. corporate tax avoidance through high leverage is in variance with the restrictive definition of disqualified interest. By restricting its scrutiny to related debt (and debt guaranteed by related parties) only, the USESR fails to respond to major concerns over earnings-stripping practices involving disproportionately high levels of leverage of MNEs' American subsidiaries. If one accepts that, economically, all the debt incurred by an integrated MNE's entities is supported jointly by all of its assets,<sup>205</sup> then the USESR does little to prevent MNEs from financing U.S. operations through unrelated debt while financing operations in low-tax jurisdictions through equity investments.<sup>206</sup> This problem of disproportionate leverage has been identified as a major source of concern by other tax regimes,<sup>207</sup> as well as by recent bills that sought to amend the USESR.<sup>208</sup>

Discussions over the USESR erupted recently, in 2002, in light of the relatively high number of corporate inversion transactions. These involved replacements of American parent corporations with foreign surrogates located in tax-havens with little or no impact on inverting MNEs' actual business.<sup>209</sup>

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*Doctors Called and Is the Medicine Worse than the Disease?*, 30 TAX NOTES INT'L 483, 493 (May 5, 2003).

<sup>205</sup> This premise is already supported by some Code sections. See *infra* note 226.

<sup>206</sup> There is one significant exception to this, see *supra* note 188. The USESR counters foreign disproportionate leverage when the American corporation's debt to an unrelated party is guaranteed by a foreign related person.

<sup>207</sup> This is namely a concern of the Australian and New Zealand earnings-stripping regimes. See Andrew M.C. Smith & Paul V. Dunmore, *New Zealand's Thin Capitalization Rules and the Arm's Length Principle*, 57 BULL. INT'L FISCAL DOCUMENTATION 503 (2003); Michael Wachtel, *Australia's New Thin Capitalization Regime*, 55 BULL. INT'L FISCAL DOCUMENTATION 380 (2003).

<sup>208</sup> Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals*, 2003 TNT 23-11 (Feb. 3, 2003).

<sup>209</sup> Desai & Hines, *supra* note 132 (analyzing the types and magnitudes of the tax savings sought by inverting corporations); Hal Hicks, *Overview of Inversion*

Inverting corporations sought long-term tax saving by avoiding subpart F anti-deferral legislation and engaging in earnings-stripping through injection of related party debt into former U.S. parents and their subsidiaries.<sup>210</sup> Inverted MNEs thus admitted openly (in SEC filings and communications with shareholders) that they intended to utilize the inversions not only to avoid paying U.S. taxes on foreign earnings, but also to use earnings-stripping practices to avoid paying taxes on U.S. source incomes. Moreover, it became evident that invertors were trying to attain tax advantages blatantly possessed by all (genuinely) foreign MNEs doing business in the United States through subsidiaries.<sup>211</sup>

In sum, the USESR does not alter incentives available to foreign MNEs for leveraging U.S. subsidiary financing.<sup>212</sup> Additionally, it is incomplete, since it grants MNEs the ability to substitute related-debt transactions with other types of related-capital funding transactions to attain the same stripping effect.<sup>213</sup> Most notably, the USESR fails to address the issue of disproportionate leverage. In view of these shortcomings, the USESR is an inadequate measure to prevent corporate tax base erosion due to interest deductions.

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*Transactions: Selected Historical, Contemporary, and Transactional Perspectives*, 30 TAX NOTES INT'L 899 (June 2, 2003) (providing an analysis of the main features of the last wave of inversions).

<sup>210</sup> Desai & Hines, *supra* note 132; *Drawing Lines Around Corporate Inversion*, 118 HARV. L. REV. 2270, 2278 (2005) (suggesting that the biannual revenue loss in fiscal year 2002–2003 as a result of earnings-stripping by four inverting corporations was estimated to be 700 million USD); Hicks, *supra* note 209, at 907, 915–16.

<sup>211</sup> This initiated legislative proposals that eventually did not materialize into legislation. STAFF OF JOINT COMM. ON TAXATION, 108TH CONG., TECHNICAL EXPLANATION OF H.R. 2896, THE “AMERICAN JOBS CREATION ACT OF 2003” 76–78 (Joint Comm. Print 2003), *available at* <http://www.house.gov/jct/x-72-03.pdf>; STAFF OF JOINT COMM. ON TAXATION, 108TH CONG., MODIFICATION FO THE CHAIRMAN’S MARK ON THE “JUMPSTART OUR BUSINESS STRENGTH (JOBS) ACT” 48 (Joint Comm. Print 2003), *available at* <http://www.house.gov/jct/x-85-03.pdf>; Andrew N. Berg, *NYSBA Comments on Proposals to Modify Earnings-Stripping Rules*, 2003 TNT 178-49 (Sept. 12, 2003) (providing a thorough discussion on the various legislatives proposals to amend the USESR).

<sup>212</sup> Umbrecht & Llewellyn, *supra* note 15, at 675–76 (suggesting a model that analyzes the incentives of different corporations to engage in related-debt financing and demonstrating that the USESR really “hits” firms only in very remote scenarios).

<sup>213</sup> *Id.* at 686 (discussing a number of examples (e.g., replacement of debt with third party leases) and stressing that tax authorities will find it much more difficult to challenge earnings-stripping techniques that do not depend on interest payments).



## 2. The USESR's Failure in Deterring Abusive Related-Debt Transactions

Since tax base erosion is often a byproduct of successful avoidance schemes, the article's differentiation between the notions of anti-avoidance and anti-erosion merits explanation. Although these two topics are indivisible in many senses, there is a qualitative difference of emphasis between them. While anti-erosion effects are measured in terms of bottom-line revenue outcomes, the performance of anti-avoidance mechanisms is measured by the USESR's ability to signal out technical attributes of transactions, which are structured in a manner indicative of inappropriate tax avoidance motivations. This distinction is useful because it explains why tax authorities often combat certain types of practices while openly allowing others that may have similar revenue effects.<sup>214</sup>

Thus, the Anti-Avoidance Phase paradigm aimed to set a behavioral standard for tax professionals regarding the limits of using ITR's incongruence for tax planning purposes. This type of principled behavioral message is necessary, as a tax policy tool, because of the infinite number of abuse and manipulation possibilities contained in the Code. More specifically, in the context of related transactions, this behavioral message is necessary to counter abuse possibilities spawned by the inadequacies of the arm's-length

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<sup>214</sup> For example, the Service has tried for many years to block treaty-shopping practices through litigation and diplomacy. In 1987, the United States unilaterally canceled its double taxation treaty with the Netherlands-Antilles, which for many years was used as a loophole by American corporations that were trying to reduce withholding taxes on their Eurobond borrowings. Convention Between the United States and the Kingdom of the Netherlands in Respect of the Netherlands Antilles for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-Neth., Aug. 8, 1986, 3 Tax Treaties (CCH) ¶ 6657 (expired June 29, 1987). The double taxation treaty was revoked three years after the portfolio tax exemption was made available to all U.S. corporations that wished to issue bonds on the Eurobond markets. The distinction between anti-avoidance and anti-erosion could explain the apparent policy inconsistency. While anti-erosion rationales would have probably dictated the revocation of the double taxation treaty and the denial of the exemption, anti-avoidance rationales would have only dictated the former. Anti-avoidance rationales prescribe that the Netherlands-Antilles loophole should be closed because it provided inverse incentives to engage in "dodgy" tax planning and benefited those taxpayers willing to engage in manipulative conduit transactions. A similar scenario may well be on its way right now. The Treasury and Congress have spent considerable resources trying to counter corporate inversions, at precisely the same time as there is a growing readiness to shift to a territorial tax system. I.R.C. § 7874.

standard. By and large, the validity of the distinction between anti-avoidance and anti-erosion rationales depends on one's view as to whether preventing taxpayer "self help" is a legitimate tax authority objective. Anti-avoidance rationales aim to deter taxpayers from exploiting certain tax reduction opportunities. Although some (legitimate) tax reduction opportunities are available to all taxpayers, the anti-avoidance paradigm seeks to deter and de-legitimize, yet not criminalize, certain tax reduction opportunities. These opportunities are distinguished by their availability only to well-advised and affluent taxpayers. This provides a strong policy ground for supporting anti-avoidance objectives, independent of anti-erosion rationales. Anti-avoidance policy rationales may include democratic considerations regarding the equitable distribution of the tax burden. More profoundly, those policy rationales raise concerns with regard to the prospects of yielding good tax policies through the democratic process. Once tax avoidance practices afford affluent taxpayers a lower tax burden, they have low incentives to mobilize or support a tax reform process to yield superior alternatives.<sup>215</sup>

The inquiry whether the USESR has successfully targeted abusive related-debt finance transactions is rendered difficult by the amorphousness of the anti-avoidance paradigm's "inappropriateness" standard. However, the article argues that the two safe-harbors through which the USESR filters related-debt transactions provide an unintuitive notion of "inappropriateness."

First, the debt-equity safe-harbor is an arbitrary "golden panoply" applied across the board to all industries. Derivatively, this prescribes insensitivity to any "inappropriateness" in the tax avoidance motivation of taxpayers operating in low-leveraged industries. Some of these taxpayers can fall within the safe-harbor's ambit, even though, solely for tax reasons, a significant portion of their financing is made through related party debts. One must note that tax administration considerations may justify adopting a universal (rather than an industry-specific) ratio.<sup>216</sup> Despite these considerations, the USESR debt-equity ratio still seems ill-suited to identify tax avoidance motivation because of its reliance on both related and unrelated debt. An attempt to root out transactions motivated by tax

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<sup>215</sup> Once most of the wealthy taxpayers are de facto exempt from a burdensome tax arrangement (because of avoidance opportunities they can afford to employ), there is likely to be less effective pressure on the political system to reform the burdensome arrangement for the benefit of all taxpayers.

<sup>216</sup> An industry-specific ratio will require defining different industry classifications and will be more susceptible to lobby groups' influence.

avoidance mandates fixing a shareholder-specific (related) debt-equity ratio. This ratio, which examines each related shareholders' relative debt and equity interests in the debtor corporation, resonates with specific (controlling) shareholder motivation to engage in earnings-stripping much more so than a general debt-equity ratio.

Second, the ATI Standard's operation as a filtering mechanism mandates that highly profitable corporations, corporations with high-gross interest income, and/or corporations operating in noncapital-intensive sectors, are in most cases beyond the reach of USESR penalty.<sup>217</sup> This is true even with corporations in which related debt is a main avenue for finance. Furthermore, in many cases, the impact of the USESR interest deduction limitation is determined according to factors of profitability and cash flow (to the extent that both are represented by the ATI). Both cash flow and profitability are highly volatile, unpredictable, and dependent on many factors. Accordingly, the linkage between the ATI Standard and abusive financing is in many senses unclear. If a subsidiary is under-capitalized with respect to equity-capital from its parent, there appears to be no policy objective mandating that the interest deduction limitation be implemented primarily in those periods when that corporation has a low ATI.

An alternative line of criticism is that if the USESR intended to deter tax avoidance transactions, it has done so in an over-inclusive manner. As a crude unilateral mechanism applied across the board against all related-debt transactions, the USESR may result in double taxation of interest payments even if those payments lack avoidance motivation, since they are made to high-tax jurisdiction creditors.<sup>218</sup> If the USESR genuinely intended to detect inappropriate avoidance schemes, it would have probably taken into account the effective tax rate on outbound interest payments in creditors' residence jurisdictions (thus imitating treaty base solutions that involve limitation of withholding tax reductions).<sup>219</sup> This argument is strengthened by the under representation of factors considered as proxies for tax abusive intentions in the USESR. It leads to the conclusion that the USESR fails to signal out, and therefore deter, many avoidance motivated, inbound affiliated debt transactions.

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<sup>217</sup> Umbrecht & Llewellyn, *supra* note 15, at 659–61.

<sup>218</sup> Boidman, *supra* note 180, at 903–04; Derek A. Burgess & James B. Penlington, *Earnings-Stripping Trap*, 35 TAX ADVISER 545, 545 (2004).

<sup>219</sup> Renfroe et al., *supra* note 72.

*C. The USESR's Failure and the Limitations of the Anti-Avoidance Paradigm*

The analysis above suggests that the USESR's quandaries arise from the manner through which it perceives the problematic nature of the earnings-stripping phenomenon. By exclusively associating the earnings-stripping problem with narrowly defined related finance transactions, the USESR exhibits much of the analytical flaws and harmful consequences of the Anti-Avoidance Phase paradigm. As mentioned previously, related debt is a legal fiction. Accordingly, the USESR is problematic because of the constrained set of hypothetical inquiries, limited by the arm's-length standard, through which it addresses this fiction (e.g., the ATI Standard).<sup>220</sup>

Paradoxically, even if the arm's-length standard could discern what an unrelated party would have done, it is unclear whether that would be sufficient to provide a normative framework upon which inappropriate related debt should be defined. The idea that something carried out by unrelated parties is per se appropriate when carried out by related parties is undermined by the fact that many unrelated parties prefer (for purely tax reasons) to package investments as debt rather than equity.<sup>221</sup> While this tendency may not be a problem in itself, it begs the question whether the conduct of unrelated parties is an adequate benchmark for assessing related transaction validity. While affiliated-debt and unrelated transactions are subject to the same favorable tax consequences, affiliated-debt transactions are not truly subject to the high risks, especially credit risks, faced by unrelated creditors.

This latter argument suggests that the attempt to dissect related-debt earnings-stripping practices with arm's-length standard scalpels misses more than just the integrated manner by which financial decisions are carried out within MNEs. It suggests that the fundamental problem with the USESR, and the anti-avoidance paradigm as a whole, is that it superficially distinguishes the issue of how to deal with tax avoidance transactions from the broader question of what the fair source return for (debt) investments should be. It assumes wrongly that preventing avoidance schemes would be sufficient to counter the harsh revenue impact of trade considerations on IITR's sourcing conventions.

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<sup>220</sup> Rosenbloom, *supra* note 154, at 27 (providing an elaborated upon discussion regarding the role of hypothetical inquiries — with particular interest in the arm's-length standard).

<sup>221</sup> Culbertson & King, *supra* note 190, at 1170.

It is first important to recognize that affiliated transactions do not fundamentally alter the question of what should be the fair source return for investments. Taxpayers' attempts to run with the hares and hunt with the hounds by retaining corporate control over subsidiaries in high-tax jurisdictions while stripping their earnings into low-tax jurisdictions through debt finance just highlight the fact that the question remains unanswered. From the very beginning of the IITR, the issue of source jurisdictions' adequate return for debt investments has never been resolved. As the article has demonstrated, this vagueness is reflected in many sourcing arrangements. Earnings-stripping practices are signaled out by the simple and lucrative manner in which MNEs' abuse this vagueness. This is one of the article's main points. It goes against the common wisdom among tax scholars that the problem of sourcing related transactions is insulated from other pending sourcing difficulties in the IITR. The article acknowledges that the growing volumes of affiliated transactions in the last quarter century have altered materially the economic infrastructure to which the IITR relates, but points out that the origins of the difficulty in sourcing affiliated transactions are rooted more deeply in the historical development of sourcing conventions.

It is noteworthy that MNEs' ability to disproportionately leverage business activities in high-taxed jurisdictions proves that the potential of corporate income tax base erosion lies in affiliated settings — not exclusively in the tendency to shift income through affiliated transactions.<sup>222</sup> Any future policy aiming to counter source base erosion tendencies should, therefore, go beyond the issue of pricing affiliated financial transactions and aim to provide a comprehensive solution of sourcing affiliated financial settings.

On a more abstract level, MNEs' ability to utilize tax-competitive environments to report income in low-tax jurisdictions eradicates the fig leaf covering the reciprocal nature of withholding tax reductions. The theory behind those reductions assumes that they help residence jurisdictions collect more revenues. However, the tax sensitive finance structures of MNEs refute the idea that reducing withholding taxes on debt financing results in a win-win situation for all nations (and taxpayers) involved. Such tax structures vindicate the Revenue

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<sup>222</sup> Evidence of the importance of this issue can be observed by some of the recent changes in the new anti-earnings-stripping regimes (in Australia, New Zealand, and Germany), as well as the recent attempt of the Bush administration to change the USESR (which also targeted the problem of disproportionate leverage). *See supra* note 207 and 208.

Phase's initial insight: that allocation of tax is, to a large extent, a zero sum game among different nations and investors.

In many respects, the nonoptimal operation of the USESR could be attributed to its design as a crude backup to an amalgam of Trade Phase loopholes. Thus, rather than theorizing a legitimacy benchmark for affiliated-debt investments, the USESR's cumbersome operation sought a crude (and remote) last line of defense against: (1) the difficulties in distinguishing between debt and equity in light of their often similar economic function and materially different tax consequences; (2) the imperfections of anti-treaty-shopping treaty arrangements; and, most importantly, (3) the practical and theoretical deficiencies of the arm's-length standard in sourcing affiliated financial transactions. If one accepts this account, then one can only wonder why arm's-length proxies were embedded in the USESR in the first place.

The anti-avoidance paradigm of the USESR is subject to criticism not only for its low revenue yields, but also for infringing fundamental institutional constraints undertaken by the treaty network.<sup>223</sup> Some of its critics consider the USESR to be inherently unfair, since it (1) unilaterally alters U.S. treaty obligations to address a problem that could have been addressed properly through treaty negotiations, and, in the case of more than one shareholder, (2) lays a tax burden on parties other than shareholders engaged in earnings-stripping tax avoidance practices.<sup>224</sup>

I respectfully disagree with the above line of criticism. In my opinion, there is a qualitative difference between the earnings-stripping regimes' attempt to cap tax reduction by limiting abusive affiliated transactions and the overriding of treaty obligations. Treaties' main objective is to facilitate a tax environment supportive of a broad array of cross-border transactions, not to prevent specific tax avoidance transactions. Accordingly, as a matter of public policy and treaty interpretation, it seems most plausible to argue that specific anti-avoidance arrangements should be left to national legislators.

It is nevertheless important to recognize that the incorporation of the anti-avoidance rationale within the USESR positioned it in the

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<sup>223</sup> Throughout the different stages of its development, the USESR was criticized for being a "cheating" mechanism intended to override U.S. treaty obligations. See Anthony C. Infanti, *Curtailing Tax Treaty Overrides: A Call to Action*, 62 U. PITT. L. REV. 677, 682, 687-88 (2001) (claiming that the USESR is one of many overrides that are unfair, creates uncertainty, and harms U.S. reputation, thereby deterring other countries from entering into treaties with it); Roin, *supra* note 130, at 275-78.

<sup>224</sup> Roin, *supra* note 130, at 289, 295.

crossfire of criticism from both sides of the barricade. Failing to restore effective fiscal sovereignty over mobile resources, the USESR is rumored to be wasteful, complicated, arbitrary, and ineffective. On the other hand, traversing the twilight zone of breaching treaties' (Trade Phase) anti-discrimination obligations, others criticize the USESR for its discriminatory nature.<sup>225</sup> Perhaps more than anything, the position of tax authorities, situated between the devil and the deep blue sea in the earnings-stripping context, is the prime example of the Anti-Avoidance Phase moral. The quest pursued by policymakers in the Anti-Avoidance Phase, to remedy Trade Phase tax erosion by identifying transactional attributes that render tax schemes inequitable, is futile. Mired in its practical and conceptual drawbacks, the anti-avoidance theme was (and still is) unable to offer a viable alternative to the (Trade Phase's) status quo, let alone to dispel it.

## VII. AN EPILOGUE AND A PROLOGUE

### A. *An Epilogue*

The story of the IITR has not yet been articulated. To the extent that it has, it was often portrayed (simplistically) as sagas of the north disinvesting the south of revenues, or as a story of policymakers' capture. Through the example of the erosion of source taxes on inbound interest income, the article offers a profound and novel view suggesting that the history of sourcing is a history contoured by dominant business interests and policymakers' myopia.

As the developed world emerged from WWI into the Revenue Phase, the major problem, requiring the establishment of the IITR, was how to assure credible double taxation reduction in the face of mounting national needs for both tax revenue and foreign investment. The finalization of the League's three draft conventions in 1928, each pursuing different sourcing doctrines, marks the capital-importing countries' failure to establish a cartelized arrangement that guaranteed a minimal level of source return. The League's failure to elicit a set of allocation — rather than coordination — IITR sourcing norms sparked the tax-competitive harmonization of source taxes. This process was most visible with regard to the reductions of source withholding tax rates on interest income during the Trade Phase.

The Trade Phase began at the end of WWII when the main problem facing Western countries was how to structure an IITR that

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<sup>225</sup> George B. Delta, *The New Earning Stripping Provision*, 31 TAX MGMT MEM. 87, 91–92 (1990).

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did not get in the way of inducing foreign trade. This stipulated objective aligned well with the broader political agenda of the time — to strengthen Western economies. This trade agenda endorsed the harmonization of withholding tax reduction. However, what began as a set of cautious treaty-based, reciprocal reductions in withholding taxes in the early days of the Trade Phase became, towards the mid-1980s, a tooth and nail tax-competitive war for foreign investment (as exemplified in portfolio income exemptions). If, at the beginning of this process, it was believed that lower source taxation resulted in higher residency revenues, that conviction proved a false promise. It further became evident that even dominantly positioned countries such as the United States were not immune from the displeasing revenue consequences of a source tax-competitive battle for foreign investment.

During the Anti-Avoidance Phase — to date, the last episode in this saga — nations recognized that (in light of growing obligations) the ongoing erosion of their income tax base was the major problem for the IITR. More specifically, they recognized that new dominant MNE actors in the global economy are able to exploit many of the IITR's imperfections and incongruence to reduce tax liabilities. In response, governments attempted to amend the IITR to reverse tax erosion by promoting the concept of anti-avoidance, which aimed to filter legitimate from illegitimate transactions. The anti-avoidance paradigm was, nevertheless, a failure. Divisible, tax authorities do not have the enforcement resources to comprehensively audit the many Goliaths of an integrating global economy; nor do they have the conceptual foundations needed to coherently identify illegitimate transactions.

The IITR was able to perform relatively well as long as cross-border investments were FDIs made by foreign investors that were operationally distinguishable from the foreign corporations in which they invested. This also has to do with the imposition of residual residence taxes on foreign investors, which limited the rewards of source manipulation abuse. These premises acutely contrast with contemporary international cross-border investments, which involve increasing volumes of portfolio and affiliated investments, MNEs' enhanced integration, and sovereigns' growing inability and unwillingness to enforce residence taxation on MNEs. An aching fiscal void is therefore bound to materialize.

Upon scrutiny, another pattern that emerges from this problem-and-reaction history is an ongoing shift of the institutional frameworks in search of solutions. During the Revenue Phase, delineation of IITR



sourcing conventions took place, primarily, on a multilateral level as the League attempted to establish agreed upon sourcing conventions. By the Trade Phase, the center of gravity shifted from multilateral to bilateral settings. This phase was marked by the impact of the Treaty, and the treaties that followed it, which attenuated the importance of multilateral arrangements (e.g., the model treaties). Though still significant for coordinating IITR norms, such multilateral institutional arrangements no longer serve as the trailblazers of the IITR. To some, it may seem as if, in many cases, the international arrangements have tended to follow the footsteps of norms established on the bilateral treaty network level, rather than originating these norms themselves. Towards the end of the Trade Phase and the beginning of the Anti-Avoidance Phase, the center of gravity shifted again from the bilateral to the unilateral level, as nations began to both unilaterally compete for investments by reducing taxes and to prevent erosion by establishing unilateral anti-avoidance mechanisms.

This change in the IITR's institutional framework reflects a profounder development in the underlying tax allocation conflict that mobilized IITR policymakers in the different Phases. During the Revenue Phase and the beginning of the Trade Phase the underlying conflict was the allocation of revenues between capital-exporting countries and capital-importing countries. However, towards the end of the Trade Phase this distinction between capital-exporting and capital-importing countries became obscure. Hence, by the end of the Trade Phase the allocation problem transformed from being a problem of allocating revenues between different countries to an allocation conflict between sovereigns and international investors, primarily MNEs. Uncoordinated, countries tried, unilaterally and unsuccessfully, to advance a multi-objective tax policy of attracting foreign investments and countering avoidance.

To the extent that this is the end of the story, then the ending is not a happy one. Divided, nations are ruled by sourcing conventions that originated years ago in response to business sector pressures. During the last eight decades, policymakers and scholars failed to anchor these conventions to any normative content that allowed sovereigns to structure durable IITR sourcing regimes. This is a major reason for concern due to the growing readiness among policymakers, in different jurisdictions, to shift to territorial tax regimes. If such a change indeed occurs, an alteration or elimination will likely occur to many of the residency safeguards on source stripping.<sup>226</sup> This will bring

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<sup>226</sup> Section 864(e), (f) allocates some of the U.S. corporation's interest deductions

IITR's sourcing conventions to the fore, forcing policymakers to deal directly with the challenges of allocating income between sovereigns. The article's analysis questions whether these conventions are apt to meet such a heavy burden.

### *B. A Prologue*

Some indicators suggest new movements in the IITR policymaking regarding interest income sourcing conventions. Recent proposals to change the USESR,<sup>227</sup> and changes in other earnings-stripping regimes around the world,<sup>228</sup> indicate that the IITR may be on the edge of a new Allocation Phase with regard to sourcing interest income. While no allocation doctrine has yet been delineated, those indicators suggest policymakers' growing readiness to re-conceptualize earnings-stripping regimes to disregard some of the fundamental cornerstones of the anti-avoidance approach. These earnings-stripping regimes base their interest disallowance rules on criteria that fail to distinguish between related and unrelated debt and foreign and domestic debt.

A thorough discussion of these changes and the delineation of an alternative IITR sourcing regime are beyond the scope of this article. The need for a re-conceptualization of sourcing conventions is not self-evident. It may be the case that other tax bases (e.g., consumption or wage) will replace eventually the income base over the course of the 21st century. However, to the extent one believes in the maintenance of the income tax base, then in an integrating global economy, this requires a more robust set of sourcing conventions. A different study dealing with the principle features to which the Allocation Phase should evolve will address whether these developments do indeed mark a new phase in IITR sourcing

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against its foreign income to determine its maximum credit through an asset based formula. The effectiveness of this safeguard over the ability of U.S. tax resident MNEs to deduct interest payments against their U.S. sourced income may be reduced significantly in the case of a shift to a territorial system. This is because more of the income repatriating will take the form of exempt dividends rather than sale, royalty, and interest transactions that would still be subject to U.S. tax.

<sup>227</sup> Boidman, *supra* note 180.

<sup>228</sup> Markus Ernst, *Toward a Level Playing Field for Thin Capitalization: German and U.S. Approaches*, 43 TAX NOTES INT'L 657 (Aug. 21, 2006) (discussing section 8a of the German Corporate Income Tax Code (*Körperschaftsteuergesetz* — KStG)); Richardson, Hanlon & Nethercott, *supra* note 192, at 50 (discussing the Australian and New Zealand earnings-stripping regimes); Smith & Dunmore, *supra* note 207 (discussing the 1996 New Zealand earnings-stripping regime).

conventions. To efficiently source the proceeds of mobile financial investments, the sourcing conventions of this emerging phase will have to depart from the current prevalent classifications. Most notably, IITR conventions should depart from correlating the distinction between the abuse potential of affiliated and nonaffiliated transactions with that between tax avoidance and tax evasion. Instead, the sourcing conventions should distinguish between evasion prevention measures and a much more comprehensive set of formulary sourcing measures for assuring proper allocations of income derived by MNEs from (related and unrelated) financial transactions and assets.

The article elaborates briefly on the principled axis of such a regime.<sup>229</sup> Creating this principled basis is the first step in offering a viable alternative to the current amalgam of IITR's arrangements (during its formulation in the Anti-Avoidance and Trade Phases). Others should view this principled basis as the inevitable conclusion of the article's criticism of the IITR's historical development presented throughout the analysis.

The first theme that emerges from the article's historical analysis is that one of the major challenges facing the Allocation Phase will be to delineate the institutional framework in which the IITR sourcing conventions should develop. Such a comprehensive framework should seek to provide better sourcing arrangements on the unilateral, multilateral, *and* (most importantly) bilateral levels. Since unilateral arrangements seem almost categorically insufficient and robust multilateral IITR sourcing arrangements considered almost utopian, the first principle of reform would have to address the substantive features of treaties and the manner by which they are formulated. This is not a simple task since, as the article has shown, the treaties' decentralized network and flexible evolution came at the cost of a very cumbersome, over formalistic, obsolete, and incoherent body of law — one that is extremely difficult to negotiate and amend.<sup>230</sup>

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<sup>229</sup> Bird, *supra* note 66, at 756.

<sup>230</sup> Tillinghast, *supra* note 81, at 455–57. The article mentions the following key points: (1) Treaties “are incredibly slow-moving creatures. They are time-consuming to negotiate and impossible to update on a regular basis”; (2) “The concepts embodied in the existing tax treaties . . . were largely conceived in the days of a ‘brick-and-mortar’ industrial economy. . . . [for example] [r]ules designed to apply to the physical delivery of tangible goods or the provision of physical labor . . . do not always work well when applied to the delivery of software or on-line services. . . . the use of derivative financial instruments to bundle or unbundled economic interests, synthesize securities or confer the economic equivalent of the ownership of property

Furthermore, the treaties' bilateral framework created many of the IITR's structural anomalies because of its inability to encompass the multi-jurisdictional aspects of many transactions.<sup>231</sup> This is most evident in the taxation of MNEs, in which the treaties' bilateral solution spawns numerous tax avoidance opportunities.<sup>232</sup> Moreover, lacking any normative base, the patchwork of treaties seemed to encourage and even legitimize trends of taxpayers' tax avoidance and sovereigns' tax competition. However, the article's analysis also stresses that treaties may, nevertheless, be a wise policy alternative in a reality in which no multilateral tax agreement is foreseeable.<sup>233</sup> In a world of low international tax cooperation, the outcomes of coherent and "correct" unilateral policies are likely to be turbulent and unpredictable, even if framed by competent and benevolent policymakers.<sup>234</sup> Accordingly, at least in the short run, policymakers and academics should internalize "proper" sourcing arrangements in the treaty practice so as to make use of this powerful policymaking tool.

The second and third principles emerge from the analysis of the USESR and its operation in post Trade Phase circumstances of low withholding taxes and weak notions of residency taxation. The second principle hence requires a change in the IITR's emphasis from the classical shareholder corporate distinction to a related (transaction)

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without actually transferring that ownership raises treaty issues that require resolution"; and (3) Treaties' distinction between debt and equity, for the purposes of withholding source taxes, is somewhat inconsistent with the exemption of income arising from derivative financial instruments. *Id.* These instruments could be used to create financial positions, which are equivalent to ownership over debt and equity resources.

<sup>231</sup> Since it affects states that are not contracting parties to the bilateral treaty as well as other bilateral treaty obligations of the contracting states, no bilaterally-agreed MNE taxation policy is likely to be systematically and comprehensively applied. This is true for the following reasons: First, no bilateral agreement can retroactively control provisions of former agreements made by either state, nor can one state adequately constrain the ability of another state from later entering into different treaty obligations. Second, a bilateral treaty cannot constrain the actions of third party states that, in a tax competitive environment, are likely to try to undercut any bilateral MNE tax policy in order to improve their own revenue collection.

<sup>232</sup> Victor Thuronyi, *International Tax Cooperation and a Multilateral Treaty*, 26 BROOKLYN J. INT'L L. 1641, 1641-43 (2001); Whisenhunt, *supra* note 59, at 546-47.

<sup>233</sup> Lebovitz & Seto, *supra* note 80, at 530.

<sup>234</sup> Daniel N. Shaviro, *Does More Sophisticated Mean Better? A Critique of Alternative Approaches to Sourcing the Interest Expense of U.S. Multinationals*, 54 TAX L. REV. 353, 408 (2001).

and nonrelated (transactions/corporate-setting) emphasis.<sup>235</sup> This new emphasis should not aim to offer different anti-avoidance standards for related transactions. It should rather try to offer a categorical shift in how tax authorities perceive and tax MNEs. The emphasis on the distinction between affiliated and nonaffiliated transactions is a practical, rather than a conceptual, distinction. It is triggered by the harsh revenue implications of failing to tax MNEs and is therefore a natural upshot of the arm's-length standard's deficiencies. This article highlights this by questioning the validity of debt financing in affiliated settings where there is no "natural rivalry" between contractual parties to assure the integrity of the underlying transactions.

The third, and perhaps most imperative, principle stresses that any sourcing regime of financial income will have to bridge some of the USESR's discontinuities that emerge from capital's fungibility. As in other cases involving the taxation of financial instruments, discontinuities in the tax treatment of similar transactions arise because MNEs control the tax consequences of their financial flows within affiliated settings by engaging in financial engineering techniques to break, synthesize, re-package, and hybridize the legal form of their financial assets. They make use of this ability to manipulate between economically equivalent transactions to attain the most favorable tax result. Thus, MNEs are able to skew, contractually, the risks from the income and deductions associated with the holdings of their financial assets between their various subsidiaries. By stripping the earnings of their subsidiaries located in high-tax jurisdictions, MNEs erode the source corporate tax base in those jurisdictions. In an era where international commerce and the role of MNEs in it are steadily growing, MNEs' avoidance of source corporate income taxes is a serious threat to the integrity of the income tax. To deal with this problem, policymakers are required to disregard the legal form of MNEs' internal financial flows. This requires tax authorities to establish alternative methods to allocate MNEs' financial income on a *net* basis of the MNE as a whole and not to try and allocate the financial income of every one of its subsidiaries. Put differently, MNEs' resiliency in re-classifying and re-assigning financial assets between their subsidiaries requires tax authorities to

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<sup>235</sup> Ault, *supra* note 11, at 569 ("[The OECD Model Treaty] recognizes the separate right of the source state to tax dividend income in the hands of the investor after imposing a corporate level tax on the profits from which the dividend is paid, as well as the right of the residence country to tax, after giving the appropriate double tax relief for the shareholder-level tax.").

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compute their “financial income” only with regard to financial contracts with unaffiliated parties. More specifically, this prescribes (1) a combined encapsulation of the earnings-stripping and the disproportionate leverage phenomena, (2) the elimination of the distinction between foreign and domestic debt, and (3) the elimination of any discontinuity in the tax treatment of debt/equity. This essentially entails some type of quasi-unitary consolidation of MNEs’ financial earnings and an appropriation formula to source them.

The fourth principle emerges from the article’s emphasis on the growing tendencies of tax evasion associated with portfolio investment. This principle suggests the need for more robust and efficient information sharing measures to assure residence tax on the proceeds of these investments.

The present article lays out the platform for this advanced assessment, along with the treaty and statutory reform proposals it entails.

#### VIII. CONCLUSIONS

The interest income sourcing problem is both intriguing and important because it unfolds many core issues that influenced the development of the IITR. The original sin was the differential (domestic) tax treatment of debt and equity investments under classical corporate taxation. That problem was magnified as the income tax techniques used to tax and allocate the proceeds of international transactions employed different source tax treatments for debt and equity investments. In terms of revenues, and because MNEs may exploit jurisdictional mismatches through related setting manipulations, leaving these problems unsolved entails high stakes. Moreover, formulating a robust and well theorized set of sourcing conventions for financial investments is an acute necessity as the winds of change calling for territoriality develop.

The derivative of this article’s analysis is the following: tax policymakers and academics face two important tasks with regard to the source tax treatment of income from financial investments. First, on the conceptual level, a well theorized notion of source precedent in levying income taxes, as well as an inquiry as to what comprises a “fair (source) return” for debt investments, must be established.

Second, on a more practical level, a mechanism that re-imposes national fiscal sovereignty on MNEs using affiliated settings to exploit jurisdictional mismatches, as well as to avoid source taxation, must be devised.

Addressing both objectives is feasible and should be pursued as the IITR advances into a novel Allocation Phase in the coming decades.