1982

Third-country use: Is time running out?

Steven P. Hannes
U.S. Tax Treaties

Third-Country Use: Is Time Running Out?

by STEVEN P. HANNES / Partner, Washington Service Center

The U.S. has had income tax treaties with foreign nations since 1939. The network of U.S. income tax treaties has expanded significantly since then, especially in the last decade. With those that were ratified by the Senate in 1981, the U.S. now has 35 such treaties in force, with two others awaiting ratification overseas.

Now, however, this expansion is threatened by claims that U.S. tax treaties are being improperly used by residents of “third” countries (not the U.S. or its treaty partner) at times with the blessing of the U.S. treaty partner. Claims of such treaty abuse or “treaty shopping” also threaten existing treaty relationships with the Netherlands, the Netherlands Antilles, and Switzerland.

What effect do income tax treaties have on the U.S. economy? In 1978, $3.9 billion of income was paid to residents of tax treaty countries who had U.S. investments. This represented 87 percent of the income earned by foreign persons on U.S. investments. If one assumes a 10 percent return on investment, this means U.S. investments held by or through treaty country residents totaled at least $39 billion in 1978. Thus, the treaties provide protection for significant amounts of cross-border investments. Critics claim, however, that some of these treaties are being used improperly, thereby depriving the U.S. of needed and legitimate tax revenue.

Statistics published in 1981 in a widely publicized U.S. government report, Tax Havens and Their Use by United States Taxpayers—An Overview, suggest that certain jurisdictions with low tax rates which have tax treaties with the United States are vehicles for disproportionately large amounts of both U.S. investment overseas and foreign investment into the United States. According to the report, U.S. gross dividends, interest,
and other payments made in 1978 to inhabitants of Switzerland and the Netherlands Antilles represented 30 percent of all U.S. payments to nonresident aliens. Other data in the report points to a five-fold increase between 1968 and 1976 in the assets of U.S.-controlled corporations formed in tax havens. By 1978, U.S. direct investments overseas in tax haven jurisdictions were more than $23 billion; in 1968, the figure had been approximately $4.7 billion. Several of these tax haven jurisdictions, the British Virgin Islands, Luxembourg, Netherlands Antilles, and Switzerland, have U.S. income tax treaties.

Depending on one's perspective, these published figures merely confirm the best hopes or worst fears of many concerning the use of U.S. income tax treaties. That is, for some time many people have believed that U.S. and foreign taxpayers were using U.S. income tax treaties with tax havens to channel investment from and to the United States and to and from residents in countries without U.S. tax treaties. One of the principal objectives of this pattern of investment through treaty countries has been to reduce income tax in the country where the investment is finally made—the "source"country.

Is the long-range impact of this cross-border investment strategy harmful to U.S. interests? Should the U.S. Treasury proceed with its announced policy of curtailing or ending third-country use of U.S. tax treaties with low-tax jurisdictions? Is the issue really one of lost U.S. tax revenue? This article explores these questions.

How U.S. Tax Treaties Are Used

An April 27, 1982, report on the United States Model Income Tax Convention prepared by the New York State Bar Association illustrates how U.S. tax treaties are used. "It is common knowledge, for example, that Canadian direct investment in the United States almost invariably is made through Netherlands holding companies, since the U.S. withholding tax on dividends and interest paid to a Netherlands corporation (generally 5 percent and zero, respectively) is substantially less than the U.S. withholding tax on interest and dividends paid to Canada (currently 15 percent) and the Netherlands permits holding companies for this purpose in consideration of the payment of a nominal amount of income tax. For the same reasons, Australian direct investment tends to flow through Netherlands Antilles structures; and substantial investments from countries with whom the U.S. has no tax treaties have been channeled through the Netherlands, the Netherlands Antilles, and the British Virgin Islands."

Such third-country use of U.S. tax treaties raises a number of questions and issues. For inbound investments, treaties that are easily used by residents of third countries give a U.S. treaty partner, such as the Netherlands Antilles, the extraordinary right to determine who will receive U.S. tax breaks. Also important, easy and favorable access to the United States through a low-tax U.S. treaty jurisdiction eliminates an incentive for other jurisdictions to create their own direct treaty relationship with the United States.

Similarly, a country with a tax treaty relationship with the United States may be unwilling to revise that treaty to make a tax concession to United States investors if its own nationals already can achieve low United States taxation by using other treaties. For example, if Canadian or German investors can reduce United States tax by going through the Netherlands Antilles, then Canada or West Germany may think it unnecessary to revise downward the tax burden in the Canada-United States or Germany-United States income tax treaties. In such circumstances, Canada or West Germany might think (correctly) it would be making a unilateral concession by reducing the tax burden in its treaty with the United States.

Thus, from the perspective of the United States government, the third-country-use issue involves (1) having the United States regain control over who receives U.S. tax benefits, (2) expanding the U.S. treaty network to cover developing countries, and (3) having better leverage to improve current U.S. tax treaties, particularly those with a few developed countries. The issue of "better leverage"cannot be overemphasized. For example, West Germany continues to refuse to agree to tax treaty modifications to ameliorate the recently enacted West German tax that discriminates against U.S. investment in West Germany. Many believe that the German government would be more willing to renegotiate the U.S.-Germany treaty if West German residents with U.S. investments could not continue to reduce unilaterally their U.S. taxes by going through third countries with more favorable U.S. tax treaties.

Use Once Tolerated by Treasury

At the same time, it is widely recognized that third-country use of treaties brings needed capital into the U.S. and that prior policies and practices of the Treasury tolerated if not encouraged third-country use of tax treaties. For example, significant Eurodollar debt offerings have been and continue to be placed by U.S. companies through the Netherlands Antilles to reduce their interest costs and bring down the U.S. tax cost of such financing. Until recently, the IRS blessed or ignored this situation. Moreover, the Treasury recognized the economic advantage of the Eurodollar source of capital when it supported legislation last year (H.R. 4618) that would amend the Internal Revenue Code to unilaterally allow tax-free Eurodollar financings that otherwise might be placed through the Netherlands Antilles.

Similarly, U.S. companies with foreign subsidiaries want to reduce their foreign taxes and have used other treaty networks, such as the Netherlands network, to accomplish this objective for investments in countries not having U.S. treaties. This objective generally has not been criticized from tax policy grounds. Indeed, the Treasury and IRS believe that reducing foreign tax
liability is a valid business goal from the U.S. perspective. The Treasury has tried to conclude income tax treaties with countries such as Brazil and Indonesia that are important areas of investment for U.S. persons. One objective of these treaties would be to reduce Brazilian and Indonesian tax on U.S. investment there. Similarly, the Treasury's interest in attracting capital from third-country users of U.S. tax treaties has been reflected in its often expressed desire to conclude tax reducing treaties with countries such as Saudi Arabia that are important sources for capital investment into the U.S. and thought to be heavy third-country users of U.S. tax treaties.

In the end, modifications to the Internal Revenue Code and new direct treaty relationships could protect much of the U.S. tax savings currently enjoyed by those using a treaty country as intermediary. From the U.S. government's perspective, the issue of is not U.S. tax revenue per se. Through an expanded U.S. treaty network, a U.S. investment overseas might, in fact, bear less foreign tax than this investment bears today by going through an intermediary treaty jurisdiction. Thus, the issue is not, from a U.S. perspective, whether a few treaties encourage an outflow of U.S. capital. The issues are, as explained above, ones of regaining control over U.S. tax benefits, expanding the treaty network, and obtaining leverage to improve current U.S. tax treaties.

Origin of Current Focus
The current focus on third-country use of tax treaties can be traced to a favorable 1975 IRS ruling concerning the third-country-use issue. That is, third-country use of U.S. income tax treaties was officially and favorably highlighted when the IRS published Rev. Rul. 75-23, 1975-1 C.B. 290, which involved a Netherlands Antilles corporation organized "primarily to invest foreign capital" in a major commercial real estate project in the U.S. This ruling held that U.S. taxes were reduced by reason of the U.S.-Netherlands Income Tax Convention as extended to the Netherlands Antilles. The ruling surprised many and was widely perceived as a roadmap, acceptable to the IRS, for third-country investment in the U.S. through the Netherlands Antilles.

While the Treasury apparently believed that the Netherlands Antilles Convention authorized third-country investment, Rev. Rul. 75-23 highlighted a general issue that the Treasury decided warranted action. Shortly after publication of this ruling, the Treasury announced that at least certain types of third-country use of U.S. income tax treaties were unacceptable as a matter of policy. This announcement came in 1976, when the Treasury Department published the first U.S. Model Income Tax Convention. The 1976 model contained a provision, Article 16, designed to curtail certain forms of third-country use of U.S. tax treaties. It focused on dividends, interest, and royalties, and denied treaty benefits only if the treaty partner's tax on such income was less than the tax it generally imposed.

Earlier in 1976, the Treasury had given a warning that it was adopting a general policy of curtailing third-country use of U.S. tax treaties when it released the then proposed U.S.-U.K. Income Tax Convention, which contained a limited Article 16-type provision. When the U.S. model was republished in May 1977, it adhered to the 1976 model's policy and provisions against certain types of third-country use.

As the Treasury continued to negotiate treaties following the policies of Article 16, and as the issue concerning treaty shopping received more attention, it became apparent that Article 16 of the 1977 model easily could be avoided. As a result, treaty shopping was continuing, and the Treasury's commitment to end third-country use was questioned. For example, hearings were held by the House of Representatives which focused on this and other treaty issues. [See Income Tax Treaties: Hearings Before the Subcommittee on Oversight of the House Committee on Ways and Means, 96, 2nd Sess. (1980)] During the hearings, Article 16 of the 1977 model was criticized as ineffective.

Commitment to End Use
In June 1981 the Treasury demonstrated its commitment to end most third-country use. The Treasury published a new draft-model U.S. Income Tax Convention. The draft revised and updated the 1977 model in a number of ways, one of the most important of which was to reform substantially Article 16 so that it broadly attacked treaty shopping. The article applies to source-basis tax benefits for all types of income, not just dividends, interest, and royalties.

Under the draft, treaty benefits are denied whether or not the treaty country reduces its tax on the income in question. The focus is on third-country ownership, not on the tax burden imposed by the treaty partner. As a general rule, when a third-country resident owns 25 percent or more of a tax treaty corporation, treaty benefits are denied under the 1981 draft—unless, for example, the corporation has an active business in the treaty country and there is a business purpose for the third-country resident making the investments in the U.S. through the treaty corporation.

On September 15, 1981, the Treasury turned the screws even further when it stated in a letter to the chairman of the Senate Committee on Foreign Relations, Charles H. Percy, that the Treasury was withdrawing from the Senate the proposed income tax treaties with Cyprus and the British Virgin Islands. These treaties had been negotiated by the Carter administration, and both had relatively sophisticated provisions designed to limit the extent to which residents of third countries could use these two treaties to receive U.S. tax benefits.

Based on its review of these treaties, the Reagan Treasury concluded that the opportunities which potentially remained for such third countries were "too great for us to tolerate." The Treasury threatened, moreover, that if
satisfactory negotiations were not concluded by early 1982, the Reagan administration would serve notice of termination for the existing British Virgin islands (BVI) Convention. On June 30, 1982, the Treasury followed through on its threat. On that date the U.S., through the acting secretary of state, terminated the BVI treaty, effective January 1, 1983.

Provisions to Prevent Treaty Shopping
At this time, negotiations are underway between the U.S. and three jurisdictions currently being used by residents of third countries to invest in the U.S. These are the Netherlands, the Netherlands Antilles, and Switzerland. At least one of these three, the Netherlands, is a significant route for U.S. investment in developing countries.

Treasury officials have openly stated on many occasions that these three negotiations involve, among other things, the third-country-use issue, and that it is the Treasury’s objective to add to the new tax treaties with these jurisdictions, as well as to tax treaties with other countries, strong provisions designed to prevent treaty shopping.

Based on the public statements and actions of the Treasury Department through July 1982, perhaps no more than four years will pass before third-country use of U.S. tax treaties will have been substantially eliminated.

The time required to curtail third-country use of U.S. tax treaties depends, in part, upon legislation that would change the Internal Revenue Code to allow tax-free Eurodollar financings and thereby cut down on the role of the Antilles Convention. If the 30 percent U.S. withholding tax were repealed—or amended so that it did not apply to the type of Eurodollar offering currently running through the Netherlands Antilles—then U.S. dependence on the Netherlands Antilles for financing would end and the Treasury would have greater leverage in its negotiations with the Netherlands Antilles.

Conversely, if the statutory 30 percent withholding tax on interest is not amended, more time will be required for the Treasury to conclude the Netherlands Antilles negotiations.

(With new code provisions imposing, for the first time, domestic withholding on dividends and interest, it is unlikely that the Congress will enact legislation to exempt foreign persons from U.S. withholding taxes on interest.)

Alternatively, one probable compromise open to the Treasury is to allow the Netherlands Antilles to continue to be, at least for a period of time, a vehicle for Eurodollar financing by U.S. companies. This would recognize the unique status of the Netherlands Antilles, a status officially tolerated, if not encouraged, in the past by the Treasury.

Meanwhile, U.S. persons investing outside the U.S. and foreign persons investing in the U.S. already find themselves having to adjust to new rules and policies. Termination of the British Virgin Islands treaty at the end of 1982 certainly will cause some restructuring. If the Treasury’s objective of curtailing third-country use is realized, there will be additional dislocation or relocation of U.S. investments by foreign persons who have used the Netherlands, Netherlands Antilles, and Switzerland treaties.

One possibility for the future is that countries which do not now have U.S. income tax treaties will establish a direct income tax treaty relationship with the U.S. Thus, investors from these countries will be able to save U.S. taxes directly and perhaps duplicate or better the tax savings they currently enjoy through treaties with favorable, low source-rates of tax, such as those with the Netherlands and Netherlands Antilles. Where such treaty relationships are not possible, investors will have to consider whether the additional tax burden is so great as to require divestiture.

Conclusion
Foreign persons are frequently attracted to U.S. investments because of the relative economic and political stability of the U.S. Tax benefits are a secondary consideration, and even without special tax treaty benefits U.S. taxes can be reduced through proper planning to a level that appears low by comparison to the tax burden of other countries. Thus, an increase in U.S. taxes due to the scheduled termination or revision of U.S. treaties might be tolerated by some investors.

The U.S. corporations and individuals investing in developing countries through other treaty jurisdictions will certainly encourage the Treasury to expand the U.S. tax treaty network as the Treasury limits third-country use. It is difficult to predict how fast the U.S. treaty network can expand or whether the source-basis foreign tax benefits achieved through an expanded network will be comparable to those currently enjoyed. Certainly, U.S. persons investing overseas will applaud efforts that help the Treasury achieve more favorable treatment from our current treaty partners, such as Canada and West Germany.

In conclusion, it remains to be seen whether the potential cost of the Treasury’s anti-treaty-shopping program—a potential reduction in the flow of capital to the United States and a possible increase in the foreign tax liability of U.S. persons investing in countries without U.S. tax treaties—will be temporary or permanent, small or great. It is clear, however, that the real motivating force of the anti-treaty-shopping program is not, as such, U.S. tax revenue. The issue is whether the U.S. government will regain control over the U.S. tax system to expand the U.S. tax treaty network, improve existing treaty relationships, and target U.S. tax savings on inbound investment to particular countries.

Steven P. Hannes, a principal in the firm’s Washington, D.C. Service Center and chairman of its International Tax Specialty Group, joined Touche Ross in March 1982. Previously, Mr. Hannes was the associate international tax counsel of the U.S. Department of the Treasury, for which he participated in the negotiation of U.S. income tax treaties with such countries as Argentina, Canada, Cyprus, Germany, Jamaica, Nigeria, Norway, Switzerland, and the United Kingdom.