

**Section of Taxation**

10th Floor
740 15th Street, N.W.
Washington, DC 20005-1022
202-662-8670
FAX: 202-662-8682
E-mail: tax@abanet.org

November 12, 2010

The Honorable Sander M. Levin
Chairman
United States House of Representatives
Committee on Ways & Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Dave Camp
Ranking Member
United States House of Representatives
Committee on Ways & Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Max S. Baucus
Chairman
United States Senate
Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510-6200

The Honorable Charles E. Grassley
Ranking Member
United States Senate
Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510-6200

Dear Chairmen and Ranking Members:

On behalf of the American Bar Association Section of Taxation, this letter conveys our substantial and serious reservations about the treaty override provision set forth in section 301 of the James Zadroga 9/11 Health and Compensation Act of 2010, H.R. 847 (the "Health Bill"), passed by the House of Representatives on September 29, 2010. This letter has not been approved by the House of Delegates or the Board of Governors of the American Bar Association and should not be construed as representing the position of the American Bar Association.

Summary

The Health Bill proposes to limit treaty benefits on payments to a non-US corporation in certain cases where that corporation is directly or indirectly owned by an entity that would not be entitled to identical treaty benefits. As discussed in further detail below, we consider the proposed treaty override to be problematic because:

1. Virtually every U.S. income tax treaty includes a comprehensive limitation on benefits ("LOB") article that was carefully negotiated by both parties to the treaty and significantly limits the ability of third country persons to benefit from the treaty. If Congress determines that the prevailing LOB provisions do not adequately limit treaty shopping, we recommend that efforts first be made to renegotiate stricter LOB provisions, or terminate any treaties that cannot be renegotiated, before considering a unilateral override.
2. The proposed override appears to be overbroad. If Congress determines that treaty-shopping concerns mandate an override of existing treaties, we recommend that the specific concerns be articulated and that the override be narrowly tailored so that it is no broader than necessary to address such concerns.

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3. We believe treaty overrides diminish the standing of the United States in the international community, weaken the position of the United States with respect to all treaty negotiations, and risk reprisals from our treaty partners that would adversely affect United States taxpayers with investments in such countries. Furthermore, just at a point in time when the U.S. is asking the rest of the world to help it achieve tax transparency in cross border investments by having foreign institutions enter into agreements with the Internal Revenue Service to provide information on investors, a unilateral blanket treaty override may discourage other countries from cooperating in that initiative or entering into, or honoring, exchange of information agreements that are needed to enforce the U.S. tax laws.¹

Description of Proposed Treaty Override.

If enacted, section 301 of the Health Bill will add new section 894(d) to the Code.² Proposed section 894(d) would deny any otherwise-allowable treaty benefits that would reduce the withholding tax imposed on any "deductible related-party payment" if (1) the payor and payee are members of a "foreign controlled group of entities" and (2) such withholding tax would not be reduced under a U.S. income tax treaty if the payment were made directly to the foreign parent corporation of the group. For this purpose, a foreign controlled group of entities is a "controlled group of entities"³ whose common parent is a foreign corporation.⁴ Any deductible payment made, directly or indirectly, by one person to another person is a deductible related-party payment if both persons are members of the same foreign controlled group of entities.⁵ With respect to any deductible related-party payment, the foreign parent corporation is the common parent of the foreign controlled group of entities.⁶

The application of the proposed override is aptly illustrated by the following example.

Individuals resident in Argentina own all of the stock of an Argentine parent corporation ("Argentina Co"). Argentina Co owns 100% of the only class of stock of a Mexican company ("Mex Co"), which

¹ For a more detailed discussion of whether treaty overrides are constitutional, and the potential impact on treaty applications, see A. Infanti, "Curtailling Tax Treaty Overrides: A Call to Action," 62 U.Pitt.L.Rev. 677 (2001).

² References to a "section" are to a section of the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise indicated.

³ For this purpose, proposed section 894(d)(3)(B) would define a controlled group of entities as a controlled group of corporations, as defined in section 1563(a)(1), subject to certain modifications. Among other modifications, the "at least 80 percent" ownership threshold is decreased to "more than 50 percent" and the exclusion of foreign corporations and insurance companies is disregarded. In addition, any partnership or other entity (other than a corporation) is treated as a member of the group if such entity is controlled (within the meaning of section 954(d)(3)) by members of such group.

⁴ Proposed section 894(d)(3)(A).

⁵ Proposed section 894(d)(2).

⁶ Proposed section 894(d)(4).

conducts an active trade or business in Mexico. In connection with that business, Mex Co receives royalty income from its US subsidiary. But for the application of the proposed treaty override, because Mex Co would meet the LOB article in the 1992 U.S.-Mexico Income Tax treaty, the royalties would qualify for a reduced withholding rate under article 12 of the treaty. Under proposed section 894(d), such treaty benefits would be disallowed, despite Mex Co's demonstrably strong nexus with Mexico.⁷

As a matter of U.S. treaty policy, we believe that the denial of treaty benefits in such circumstances is inappropriate.

Most U.S. Income Tax Treaties Already Include LOB Articles Designed to Address Treaty Shopping.

Based on the following portion of the House Report to the Jobs Bill, which contained a substantially identical treaty override provision, we understand that the principal concern giving rise to the proposal is treaty shopping.⁸

The Committee is aware that even though many recent U.S. income tax treaties include limitation on benefits provisions intended to ensure that only persons with sufficient nexus to the treaty partner countries may obtain treaty benefits, foreign multinational taxpayers residing in countries with which the United States does not have comprehensive tax treaties (including tax havens) may engage in treaty shopping. Treaty shopping by foreign multinational companies may involve organizing, in jurisdictions that have income tax treaties with the United States that offer favorable U.S. withholding rates on deductible payments, subsidiaries with no substantial business activities or other connections to those jurisdictions.⁹

While treaty shopping is a legitimate concern, it is not a new issue. Indeed, most U.S. income tax treaties include comprehensive LOB articles specifically designed to address this problem, and those provisions are comprehensively negotiated with treaty partners that typically do not have LOB articles in their other treaties. While LOB articles are similar across many treaties, they contain subtle differences responding to specific concerns of our treaty partners, and for which they specifically negotiated. The prospect of unilaterally denying our treaty partners the benefit of the LOB articles for which they specifically bargained is troubling.

⁷ This example is substantially similar to one discussed in New York State Bar Association, Comments on the Proposed Denial of Treaty Benefits for Certain Related-Party Deductible Payments (Report No. 1213, May 22, 2010), which was responding to a similar provision in the Promoting American Jobs and Closing Tax Loopholes Act, H.R. 4849 (the "Jobs Bill").

⁸ H.R. Report No. 111-447 at 39.

⁹ H.R. Report No. 111-447 at 39-40. Footnote reference omitted.

Since LOB articles first became a regular staple of U.S. income tax treaties in the 1980s, the United States has been extremely successful in renegotiating such provisions as deemed necessary in accordance with evolving U.S. treaty policy. If Congress determines that the prevailing LOB provisions do not adequately limit treaty shopping, we recommend that efforts first be made to renegotiate stricter LOB provisions, as has been done many times in the past. In the event that some treaty partners are not amenable to renegotiation, we recommend that consideration be given to the option of terminating the treaty before proceeding with a legislative override affecting all U.S. income tax treaties.

The Proposed Override Appears to be Overbroad.

As noted above, the proposed override is premised principally on treaty shopping concerns arising where the corporation seeking treaty benefits has "no substantial business activities or other connections" with the other treaty country. It is therefore difficult to understand why the proposed override would apply even where the corporation seeking treaty benefits has very substantial connections with the other treaty country that are sufficient to satisfy the existing LOB article of the relevant treaty.

The example above illustrates this point perfectly. In the example, a Mexican company that has an active trade or business in Mexico, and receives royalties from its U.S. subsidiary in connection with such Mexican business, would not, under the proposed legislation, qualify for treaty benefits because it is owned by an Argentine parent corporation. From the standpoint of U.S. treaty policy, we do not believe the denial of treaty benefits in such circumstances is justified. Even under the current "industry standard" LOB article set forth in the United States Model Income Tax Convention of November 15, 2006 (the "2006 U.S. Model"), treaty benefits are clearly permitted for income earned in connection with an active trade or business.¹⁰

If Congress determines that treaty-shopping concerns mandate an override, we believe the override should be narrowly tailored so that it is no broader than necessary to address such concerns. We recommend that the override include (or authorize the Treasury Department to create) an exception for corporations that would qualify for treaty benefits under modern, state-of-the-art LOB provisions, such as those currently set forth in the 2006 U.S. Model. In this manner, the override would apply only to those very few treaties that do not have a robust LOB provision.

We also understand, based on the following excerpt from the House Report to the Jobs Bill, that the proposed override is motivated by the desire to deny treaty benefits for related-party payments received by affiliates of corporations that engaged in corporate inversion transactions prior to the enactment of section 7874 (hereinafter, "inverted corporations").

The Committee believes that some instances of treaty shopping of the sort described above involve formerly U.S.-based companies that engaged in

¹⁰ Art. 22(3).

corporate inversion transactions prior to the enactment of the corporate anti-inversion rules of section 7874. As a result of these inversion transactions, U.S. parent corporations of multinational groups became subsidiaries of foreign corporations organized in low-or-no-tax jurisdictions. The Committee believes that it is inappropriate to allow treaty benefits for deductible related-party payments in cases in which the foreign parent corporation would not have qualified for benefits under a U.S. tax treaty if the payment had been made directly to the parent, including in cases in which the parent is resident in a tax-haven.¹¹

The House Report suggests that the Committee is concerned with structures where the foreign parent corporation is resident in a low-tax jurisdiction or a tax haven. The proposed treaty override, however, applies even if the foreign parent corporation is resident in a high-tax country. (For instance, we understand that Argentina, the residence of the parent company in our above example, has a 35% corporate income tax rate.) For these reasons, as well as those set forth above, we believe that the proposed treaty override is overbroad. More fundamentally, if Congress determines that affiliates of inverted corporations should be denied access to U.S. income tax treaties in certain circumstances, we recommend a more carefully targeted approach.¹²

Adverse Consequences of Treaty Overrides.

It is generally understood that U.S. treaties (whether or not pertaining to tax) are on an equal footing with other federal laws and that, therefore, Congress has the power to override a prior treaty obligation.¹³ Though Congress has the power to do something, it does not mean it would be advisable to do so. Indeed, we believe that the proposed treaty override could have serious adverse consequences.

When Congress enacts a treaty override, it does not terminate the relevant provision of the treaty or otherwise relieve the United States of its obligations under the terms of the treaty. Rather, the override causes the United States to breach those obligations, and we believe that such breach diminishes the standing of the United States in the international community. That is particularly the case where, as here, the override is a sweeping one that is broader than needed to address any discernible treaty abuse.¹⁴

Furthermore, treaty overrides may discourage other countries from entering into treaties, or honoring existing treaties, with the United States. We note, for example, that exchange-of-information agreements are essential to the increasing effort of enforcement of the U.S. tax laws, among others. It therefore is of critical importance that other

¹¹ H.R. Report No. 111-447 at 40.

¹² A separate question, on which we presently offer no comment, is whether treating such corporations less favorably than similarly situated corporations that did not engage in corporate inversion transactions is appropriate and desirable as a matter of U.S. treaty policy.

¹³ E.g., section 7852(d).

¹⁴ For instance, compare proposed section 894(d) with section 894(c), addressing hybrid entities, which serves to clarify who should properly be viewed as the beneficial owner of an item of income under a treaty, and specifically excludes payments where the treaty itself addresses payments to a hybrid entity.

countries consider it in their best interests to enter into such agreements with the United States and, subsequently, to comply with those agreements. Their incentive to do so is greatly diminished when the United States breaches its own treaty obligations.

For these reasons, we believe that treaty overrides should be considered only in extraordinary circumstances where a very specific (and serious) abuse is identified, a treaty override is needed to correct such abuse, and the override is narrowly tailored to apply solely to the extent necessary to correct such abuse. We respectfully submit that these conditions are not satisfied here and therefore we recommend against enacting the proposed treaty override.

Sincerely,



Charles H. Egerton
Chair, ABA Section of Taxation

cc: Honorable Timothy F. Geithner, Secretary, Department of the Treasury
Honorable Michael F. Mundaca, Assistant Secretary (Tax Policy), Department of the Treasury
Honorable Douglas H. Shulman, Commissioner, Internal Revenue Service
Mr. John L. Buckley, Majority Chief Tax Counsel, House Ways and Means Committee
Mr. Russell Sullivan, Majority Staff Director, Senate Finance Committee
Mr. Jon Traub, Minority Staff Director, House Ways and Means Committee
Mr. Kolan Davis, Minority Staff Director, Senate Finance Committee
Mr. Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation