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**Reuven S. Avi-Yonah**

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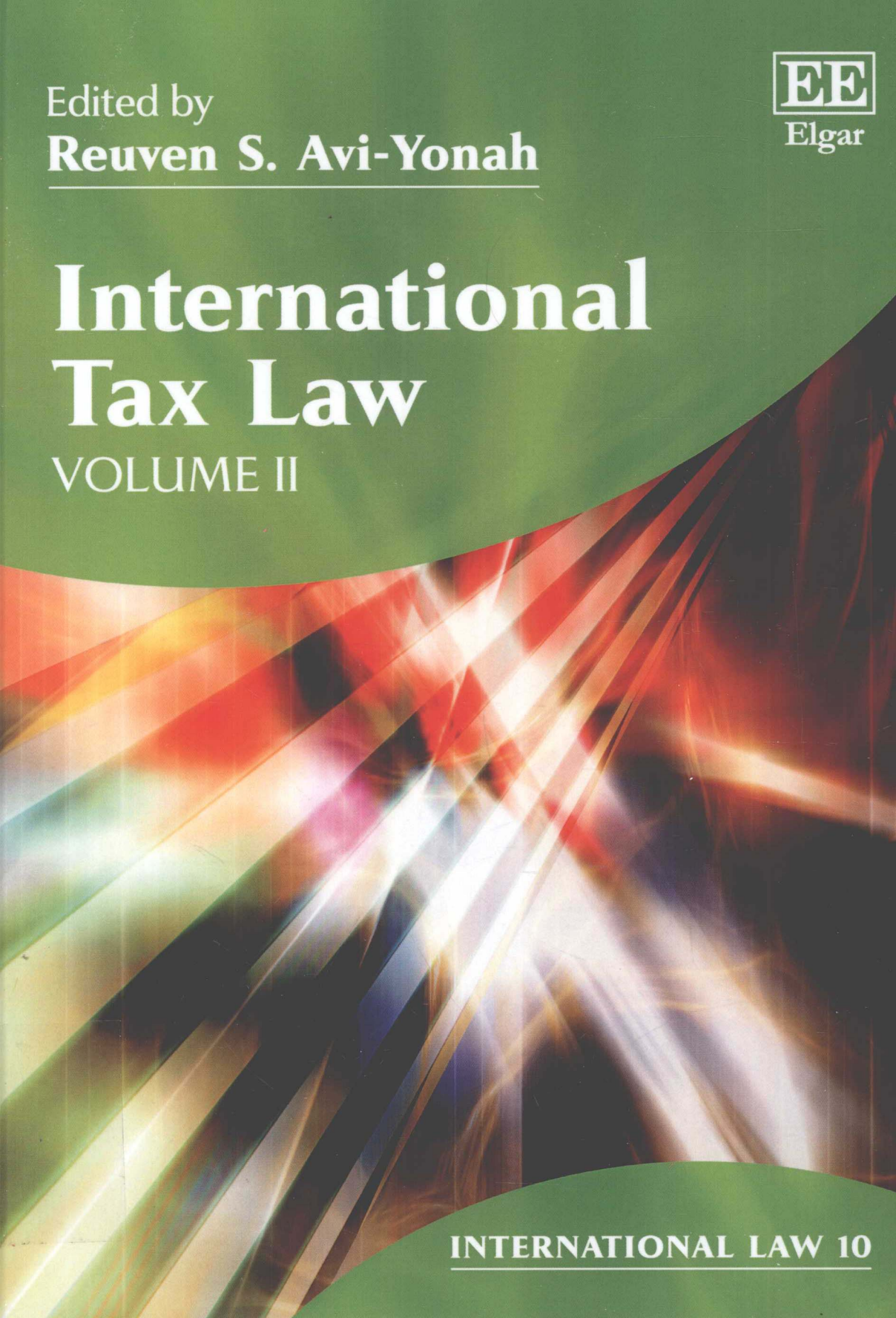
# International Tax Law

## VOLUME II



INTERNATIONAL LAW 10

# International Tax Law
# Volume II

*Edited by*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# Contents

# [1]

## Essay

# International Tax as International Law

REUVEN S. AVI-YONAH*

## I. Introduction

Is international tax law part of international law? To an international lawyer, the question posed probably seems ridiculous. Of course international tax law is part of international law, just like tax treaties are treaties. But to an international tax lawyer, the question probably seems less obvious, because most international tax lawyers do not think of themselves primarily as international lawyers (public or private), but rather as tax lawyers who happen to deal with cross-border transactions. And indeed, once one delves into the details, it becomes clear that in some ways international tax law is different from "regular" international law. For example, international tax lawyers talk about residence and source jurisdiction, not nationality and territoriality, and the different names also carry different content. And while tax treaties are indeed treaties, they are concluded differently than other treaties (for example, they are negotiated by Treasury, not the State Department), are subject to different modes of interpretation (the Vienna Convention on the Law of Treaties (VCLT)[1], the "bible" of the international lawyer, is rarely invoked), and in the United States are subject to a rather peculiar mode of unilateral change, the treaty override.

The purpose of this Essay is to introduce to the international lawyer the somewhat different set of categories employed by international tax lawyers, and explain the reasons for some of the differences. At the same time, I hope to persuade practicing international tax lawyers and international tax academics that their field is indeed part of international law, and that it would help them to think of it this way. For example, I believe that knowledge of the VCLT would help international tax lawyers in interpreting tax treaties and avoiding some common mistakes.

* Irwin I. Cohn Professor of Law, University of Michigan. I would like to thank Eyal Benvenisti, Yariv Brauner, Steve Ratner, Mathias Reimann, and Joel Samuels for their helpful comments.

[1] May 23, 1969, 1155 U.N.T.S. 331.

This Essay has five Sections. After this Introduction, Section II discusses international jurisdiction to tax and how it differs from traditional international law concepts of jurisdiction. The issues addressed in this Section are familiar to international tax lawyers but may be new and interesting for international lawyers. Section III discusses tax treaties and how they differ from regular treaties in both interpretation and modification. Here, international tax lawyers can learn from international lawyers, but also vice versa. Section IV discusses the difficult and much debated question whether there exists an international customary tax law. In this context it is international tax lawyers who have most to gain by listening to international lawyers. Section V concludes by returning to the question posed above, answering in the affirmative, and then summarizing the ways international tax lawyers and international lawyers can learn from each other.

## II. Jurisdiction to Tax

The traditional grounds of jurisdiction to prescribe in international law are nationality ("the activities, interests, status, or relations of [a state's] nationals outside as well as within its territory")[2] and territoriality ("conduct that, wholly or in substantial part, takes place within [a state's] territory").[3] Territoriality is expanded to cover conduct outside a state's territory that has, or is intended to have, a "substantial effect" within its territory.[4] As detailed below, international tax law modifies both concepts to a significant extent, resulting primarily in expanding the scope of nationality jurisdiction.

### *A. Individuals: Redefinition of Nationality Jurisdiction as Residence*

Nationality usually is understood as equivalent to citizenship. Except for the United States, however, almost no other country in the world claims the right to tax its citizens on foreign source income when they live permanently in another country. The United States insists on the right to tax its citizens on worldwide income no matter where they live.[5] The Supreme Court in *Cook v. Tait* upheld this principle because of the benefits the United States provides its citizens even if they live overseas.[6] But the opinion is weak, its underlying rationale is doubtful (are these benefits really so great?), and almost

[2] Restatement (Third) of Foreign Relations Law § 402(2) (1987).
[3] Id. § 402(1)(a).
[4] Id. § 402(1)(c).
[5] IRC §§ 1, 2(d), 7701(a)(30).
[6] 265 U.S. 47 (1924).

no other country follows the rule. Thus, although international law seems to sanction the U.S. practice (and the United States has written it into all its tax treaties), it seems a dubious rule to follow, and it has been criticized by academics.[7]

Instead, every country in the world (including the United States) has adopted a definition of nationality for tax purposes that is much broader than how nationality commonly is understood. That definition is residence, which usually implies mere physical presence in the country for a minimum number of days. In the United States, physical presence for 183 days in a given year generally is sufficient to subject an individual to taxing jurisdiction on her worldwide income for that year.[8] Even fewer days suffice if added to days spent in the United States in the previous two years.[9] Other countries follow a similar rule,[10] although they sometimes supplement it with a "fiscal domicile" test that looks to less bright line factors such as location of principal abode, family ties, and the like. The two tests (physical presence and fiscal domicile) also are incorporated into tax treaties.[11]

This definition is a remarkable expansion of the concept of nationality. I doubt there is another substantive area of international law in which nationality jurisdiction for individuals rests on so flimsy a ground as mere physical presence. In fact, because of this expansive view, it is easy to be subject to residence-based taxation by a country in one year and not in the next, and it is also easy for individuals to have dual tax residency. Elaborate rules are necessary to address situations in which individuals move in and out of resident status from year to year (for example, rules on deemed sales of their property when they leave[12]), and to avoid dual residence double taxation.[13]

Why has nationality-based jurisdiction been so expanded in tax law? The reason is easy to see if one considers the implications of the relative ease of acquiring a tax haven nationality. If tax law followed the general international law rule and imposed worldwide taxation only on citizens, then a lot of U.S. citizens would abandon their citizenship in exchange for that of some Caribbean tax haven jurisdiction,

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[7] See, e.g., Brainard L. Patton, Jr., United States Individual Income Tax Policy as It Applies to Americans Resident Overseas: Or, If I'm Paying Taxes Equal to 72 Percent of My Gross Income, I Must Be Living in Sweden, 1975 Duke L.J. 691; Note, Section 911 Tax Reform, 54 Minn. L. Rev. 823 (1969-1970).

[8] IRC § 7701(a)(30), (b).

[9] IRC § 7701(b)(3).

[10] E.g., William H. Newton, III, International Income Tax and Estate Planning § 5:40 (2d ed. 2004) (discussing similar rule of, among others, Austria, Denmark, France, and Germany).

[11] Id.

[12] E.g., IRC § 877.

[13] E.g., IRC § 7701(b)(2) (setting out rules for the first and last year of residence).

and thereby avoid taxation on their foreign source income while living permanently in the United States. In general, living in a country for over one-half year is considered a sufficient ground for worldwide taxation because of the presumed benefits derived from that country.

The residence rule is so widely followed and incorporated into so many treaties that it can be considered part of customary international law, even though it seems contrary to widely shared understandings of nationality.[14] It is thus appropriate for the United States to follow this rule. It is doubtful, however, whether the United States should continue to insist on taxing its citizens living overseas, especially since because of a combination of exemptions and credits (and enforcement difficulties) it collects little tax from them.[15]

### *B. Corporations: Expansion of Nationality Jurisdiction to CFCs*

The nationality of a corporation is a thorny issue, which comes up in other areas of the law as well. In general, corporations are considered nationals based either on the country in which they are incorporated (the U.S. approach), or the country from which they are managed and controlled (the U.K. approach), or both.[16] Each approach has its advantages and disadvantages; the U.S. approach is the easiest to administer but also the most manipulable, as shown recently by so-called inversion transactions in which corporations shifted their nominal country of incorporation to Bermuda while retaining all of their headquarters and management in the United States.[17] The U.K. approach is manipulated less easily but requires more administrative resources to police.

The interesting aspect of nationality jurisdiction for corporations in tax law is the gradual adoption of a rule that permits countries to tax "controlled foreign corporations" (CFCs), that is, corporations controlled by nationals, as if they were nationals themselves. This rule originated with the United States.[18] Because the definition of corporate nationality in the United States is formal (country of incorporation),[19] it is easy for U.S. nationals (residents) who have foreign source income to avoid taxation on such income by shifting it to a corporation incorporated in another country, preferably a tax haven,

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[14] See Section IV.

[15] See, e.g., IRC §§ 901, 911-912.

[16] See, e.g., Rev. Rul. 72-378, 1972 C.B. 662 (noting that countries can base corporate residence on place of incorporation or on place of management and control); Finance Act, 1989, § 249 (Eng.).

[17] See, e.g., Hal Hicks, III, Overview of Inversion Transactions: Selected Historical, Contemporary, and Transactional Perspectives, 30 Tax Notes Int'l 899, 905 (June 2, 2003).

[18] See text accompanying notes 21-23.

[19] IRC § 7701(a)(4).

where it can accumulate tax free. For example, Jacob Schick, the inventor of the Schick disposable razor, transferred his patent to it to a Bermuda corporation that accumulated the royalties. Schick later proceeded to retire to Bermuda, gave up his U.S. citizenship, and lived on the accumulated tax-free profits.[20]

To address this problem, in 1937 the United States adopted a rule that taxed shareholders of "foreign personal holding corporations" (FPHCs).[21] A FPHC was defined as a foreign corporation controlled (over 50% by vote) by five or fewer U.S. resident individuals, and whose income was over 60% passive (since passive income was considered easier to shift than active income).[22] Interestingly, at the time, the United States considered it a breach of international law to tax a FPHC (a foreign national) directly on foreign source income;[23] instead, it adopted a rule that taxed the U.S. shareholders on a deemed dividend of the accumulated passive income of the FPHC.[24] This rule can be compared to the personal holding company (PHC) regime adopted at the same time, which applied to domestic corporations and taxed them directly on their accumulated income at the shareholder rate (PHCs were used by shareholders to shelter U.S. source income from the higher individual rate by earning the income through a corporation subject to tax at a lower rate).[25]

Judge Frank of the Second Circuit upheld the deemed dividend rule without paying any attention to its international law implications.[26] And yet, it clearly represented a major expansion of U.S. residence taxing jurisdiction, since taxing a deemed dividend is economically equivalent to taxing a foreign corporation directly on foreign source income. It certainly could be argued that in 1943 this rule was a breach of international law, just like Judge Hand's antitrust decision in *United States v. Aluminum Co. of America*,[27] which invented the effects doctrine, was likewise arguably a breach of international law.[28]

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[20] Tax Evasion and Avoidance: Hearings Before the Joint Comm. on Tax Evasion and Avoidance, 75th Cong. 63 (1937).

[21] See Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income, 52 SMU L. Rev. 445, 475 (1999); H.R. Rep. No. 75-1546, at 13-14 (1937), excerpted in J.S. Seidman, Seidman's Legislative History of Federal Income Tax Laws, 1938-1961, at 189 (1938).

[22] See Peroni, et al., note 21, at 476.

[23] See Reuven S. Avi-Yonah, The Deemed Dividend Problem, 4 J. Tax'n Global Transactions 33, 34 (2004) [hereinafter Deemed Dividend Problem].

[24] Revenue Act of 1937, Pub. L. No. 75-377, §§ 331-341, 50 Stat. 813, 1731.

[25] Revenue Act of 1937, Pub. L. No. 75-377, §§ 351-360, 50 Stat. 813, 1732.

[26] Eder v. Commissioner, 138 F.2d 27, 28-29 (2d Cir. 1943).

[27] 148 F.2d 416 (2d Cir. 1945).

[28] See Roger P. Alford, The Extraterritorial Application of Anti-Trust Laws: The United States and European Community Approaches, 33 Va. Int'l L. 1, 42 (1999).

The impact of the deemed dividend rule was greatly expanded when the Kennedy administration decided in 1961 to propose applying the same rule to all income of corporations that are over 50% controlled by large (10% by vote each) U.S. shareholders, that is, to subsidiaries of U.S multinationals (CFCs).[29] Ultimately, this resulted in the enactment in 1962 of subpart F, which applied the deemed dividend rule to certain types of income (mostly passive income) of all CFCs.[30]

Again, there was no international law challenge to the deemed dividend rule. Instead, other countries began to copy the CFC regime: Germany in 1972,[31] Canada in 1976,[32] Japan in 1978,[33] France in 1980,[34] and the UK[35] in 1984. Currently, there are 23 countries with CFC rules (mostly developed ones),[36] and the number is likely to increase. Thus, it would seem that the CFC concept arguably has become part of customary international law, just like the expansion of territorial jurisdiction over international waters rapidly changed international law from the 1970's onward.

Even more striking is the fact that many of the countries adopting the CFC rule abandoned the deemed dividend idea, which can lead to significant difficulties in practice, in favor of direct taxation of the CFC's shareholders on its earnings on a pass-through basis.[37] Thus, the jurisdictional rule has been changing and no longer seems to require a deemed dividend, and may even permit direct taxation of a CFC on its foreign source income because it is controlled by residents. Indeed, the Service itself has adopted this view, because it now believes that both the PHC regime, as well as the older accumulated earnings tax regime, apply directly to foreign corporations even though their effect is to tax the corporation on foreign source income.[38] This is particularly striking for PHCs, because it was so clear in 1937 that the United States had no jurisdiction to tax foreign corporations on foreign source income that Congress did not bother to specify that a PHC could not be a foreign corporation (while at the same time adopting the parallel FPHC regime explicitly for foreign corpora-

[29] See Peroni et al., note 21, at 476.

[30] Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960 (adding IRC §§ 951-964).

[31] OECD, Controlled Foreign Company Legislation 22 (1996).

[32] Id. at 23.

[33] Id. at 23.

[34] Id. at 24.

[35] Id.

[36] See Brian J. Arnold, General Report, Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, 86b Cahiers de Droit Fiscal Int'l (2001).

[37] Avi-Yonah, Deemed Dividend Problem, note 23, at 35-38.

[38] Rev. Rul. 60-34, 1960-1 C.B. 203; see IRC § 542(c)(7); Reg. § 1.532-1(a).

tions).[39] Now this oversight enables the Service to argue that under the new understanding of jurisdictional limits, the PHC rules as well as the FPHC rules apply to foreign corporations.

Claiming that nationality jurisdiction applies to foreign corporations just because they are controlled by nationals is a striking departure from ordinary international law. Compare, for example, the oft-recurring disputes about the extraterritorial application of international sanctions. In both *Fruehauf*[40] and *Sensor*[41], the foreign courts explicitly rejected U.S. claims to require foreign subsidiaries of U.S. multinationals to obey U.S. sanctions aimed at China and the USSR, respectively. In *Sensor*, the Dutch court went through all the possible grounds for jurisdiction and explicitly found that none applied.[42] It was clear that nationality jurisdiction did not apply even though the subsidiary was controlled from the United States.

What, then, enables the United States and other countries to expand nationality jurisdiction to subsidiaries in the tax area? The explanation is the "first bite at the apple rule," adopted by the League of Nations in 1923.[43] Under that rule, the source (territorial) jurisdiction has the primary right to tax income arising within it, and the residence (nationality) jurisdiction is obligated to prevent double taxation by granting an exemption or a credit. Thus, permitting the expansion of residence jurisdiction to CFCs does not harm the right of source jurisdictions to tax them first; residence (nationality) jurisdiction only applies as a residual matter when the source jurisdiction abstains from taxing. This still leads sometimes to complaints by source jurisdictions that the residence jurisdiction is taking away their right to effectively grant tax holidays to foreign investors,[44] but the restricted application of CFC rules to passive income mitigates even that.

In general, I believe this story is a good illustration of the growth of customary international law in the tax area. In the 1930's-1960's pe-

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[39] See Avi-Yonah, Deemed Dividend Problem, note 23. As a result, the FPHC regime and the PHC regimes were duplicative, as well as redundant in light of the later PFIC regime, and both were repealed (FPHC completely, PHC for foreign corporations) in the American Jobs Creation Act of 2004, Pub. L. No. 108-35, § 413.

[40] Fruehauf Corp. v. Massardy Cours D'Appel Paris, May 22, 1965, Gaz Pal 1965 (France), translated in 5 I.L.M. 476 (1966).

[41] Compagne Europeénne des Petroles, SA v. Sensor Nederland, BV, Distr Ct, The Hague, Sept. 17, 1982, 36 Rechtspraak van de Week-Kort Geding 167, translated in 22 I.L.M. 66 (1983).

[42] Id. at 70-74.

[43] Report on Double Taxation, Submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp, League of Nations Doc. No. E.F.S. 73.F.19 (1923), reprinted in 4 Staff of Joint Comm. on Tax'n, Legislative History of United States Tax Conventions 4003 (1962).

[44] See, e.g., Antonio Figueroa, Tax Treaties and International Investment Flows, Taxation and International Capital Flows 93-97 (1990).

riod, there was a clear rule of customary international law that prohibited taxing foreign corporations on foreign source income. That rule was observed universally and was considered binding, as illustrated by the United States using the deemed dividend mechanism to avoid an outright breach. Once, however, a lot of countries changed the rule by taxing shareholders directly on CFC income, the United States no longer considered it binding, as indicated by applying the PHC regime to foreign corporations.[45] The next step for the United States would be to abolish the obsolete deemed dividend rule and replace it by a direct tax on the CFCs.

### *C. The Problem of Territorial Jurisdiction (Source)*

The right of countries to tax income arising in their territory is well established in international law. In fact, some countries (for example, France) begin with the assumption that the only income they have the right to tax is domestic source income, although France and other territorial jurisdictions have long since begun to tax some income of nationals from foreign sources.[46] And even countries that begin with worldwide taxation of nationals, like the United States and the UK, in practice do not tax foreign source income as heavily.

The special problem of territoriality in the tax area is that the source of income is very difficult to define. In fact, most public finance economists would deny that it is a meaningful concept in the majority of cases.[47] Think of a law firm in country *A* that provides advice on the legal implications of a merger of two multinationals whose parents are in countries *A* and *B* and whose operations are in 20 countries around the globe. What is the economic source of the law firm's income?

Ideally, one could imagine a world in which all countries tax only on a nationality (residence) basis, and the only problem would be assigning residence to individuals (not too hard) and to corporations (quite difficult). But in practice, as long as countries desire to tax nonresidents on domestic source income, as they have every right to do under international law, the problem of defining source would persist.

To some extent the problem has been solved by arbitrary rules embodied in tax treaties that define the source of various categories of

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[45] See Revenue Act of 1934, Pub. L. No. 73-216, § 351, 48 Stat. 680, 751–52 (adding PHC regime).

[46] Hugh J. Ault & Brian J. Arnold, Comparative Income Taxation: A Structural Analysis 379, 389 (2d ed. 2004).

[47] Hugh J. Ault & David F. Bradford, Taxing International Income: An Analysis of the U.S. System and Its Economic Premises, 14 Tax'n in the Global Economy 11, 31-32 (Assaf Razin & Joel Slemrod eds., 1990).