Brooklyn Journal of International Law

Volume 41
Issue 3 *SYMPOSIUM: Reconsidering the Tax Treaty*

Article 8

2016

Unilateral Responses to Tax Treaty Abuse: A Functional Approach

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UNILATERAL RESPONSES TO TAX TREATY ABUSE: A FUNCTIONAL APPROACH

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INTRODUCTION

Bilateral tax treaties are the backbone of the international tax regime.[1] At least in broad strokes, the substance of this international tax regime has been remarkably consistent.[2] Recent years, however, have seen a dramatic increase in treaty abuse by taxpayers[3] to such an extent that the Organisation for Economic Co-operation and Development (OECD) expressed concern that "the bilateral structure of the international tax regime has lost its integrity."[4]

Jurisdictions have the right to terminate tax treaties, subject to minimal procedural constraints.[5] Nonetheless, even in the face of overwhelming evidence of treaty abuse, tax treaties are

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1. *See* REUVEN AVI-YONAH, INTERNATIONAL TAX AS INTERNATIONAL LAW: AN ANALYSIS OF THE INTERNATIONAL TAX REGIME 3 (2007) ("The claim the international tax regime exists . . . rests mainly on the bilateral tax treaty network . . . .").

2. According to Avi-Yonah, this regime is comprised of two principles. The first principle is the single tax principle, which states that income from cross border transactions is taxed once (not more, but also not less than once). *Id.* at 8. The second principle is the benefits principle, which states that the source jurisdiction gets primary right of taxation on active income and the residence jurisdiction gets the primary right of taxation on passive income. *Id.* at 11.

3. The Organisation for Economic Co-operation and Development (OECD) identified treaty abuse as one of the target areas of the project to prevent base erosion and profit shifting. *See* ORG. FOR ECON. CO-OPERATION & DEV. [OECD], PREVENTING THE GRANTING OF TREATY BENEFITS IN INAPPROPRIATE CIRCUMSTANCES, ACTION 6 - 2015 FINAL REPORT (2015).

4. Yariv Brauner, *What the BEPS?*, 16 FLA. TAX REV. 55, 92 (2014).

5. For model termination articles, see MODEL CONVENTION WITH RESPECT TO TAXES ON INCOME AND ON CAPITAL art. 31 (ORG. FOR ECON. CO-OPERATION & DEV. 2014) [hereinafter OECD MODEL CONVENTION].

rarely terminated. The reason for rarely terminating treaties seems to be that potential responses to abusive treaty-based tax schemes are perceived to be hierarchical.[6] Jurisdictions are expected to respond to abusive schemes in an escalating manner, adopting harsher measures if previously adopted methods failed to solve the problem. In this context, a termination of a tax treaty is viewed as a last resort measure, only to be adopted if all other policy responses fail.

This article argues that the hierarchical view of unilateral responses to treaty abuse is misguided. Unilateral responses to treaty-based abuse are not hierarchically ordered. Rather, the approach to treaty abuse should be functional and adopt specific types of unilateral responses based on the type of treaty abuse at issue. In order to advance this argument, this article develops a taxonomy of tax-treaty abuses based on two factors: a geographical breadth of abuse, and a substantive breadth of abuse. The geographical breadth of abuse considers the number of treaties being abused. Namely, whether there are only a few treaties being abused, or whether there are many treaties that are consistently being abused. The second factor—namely, the substantive breadth of abuse—considers whether there are only one or two provisions consistently being abused, or whether the treaty as a whole is used as an instrument of abuse.

Different combinations of geographical and substantive breadths of abuse ultimately call for different unilateral responses. Within this context, treaty termination should not be viewed as a "last resort" measure. Sometimes it is simply a first-best (if not the only) solution. Specifically, if the abuse is geographically narrow (meaning, only one treaty is abused), but substantively broad (meaning, the treaty as a whole is primarily used for abusive purposes), a treaty should be terminated. In such circumstances, termination is the most cost-effective way to solve the abuse problem. On the other hand, termination might be an irrelevant response in other instances, for example, when multiple treaties are narrowly abused.

This article proceeds as follows: Part I explains the resistance to treaty termination. Part II explores the different types of available unilateral responses to treaty abuse (including terminations), by surveying past unilateral responses by the United States to treaty abuse. Part III categorizes the U.S. responses

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6. *See* discussion *infra* Part I.

based on geographical breadth and substantive types of abuse, and explains the circumstances that warrant each type of response.

I. THE HIERARCHICAL VIEW OF UNILATERAL RESPONSE TO TREATY ABUSE

Asserting that the abuse of bilateral treaties threatens the integrity of the international tax regime[7] may seem paradoxical at first: since tax treaties are bilateral instruments, treaty abuse can theoretically be easily and efficiently dealt with, without threatening the bilateral structure of the international tax regime.[8] If a bilateral tax treaty is heavily abused, the offended jurisdiction can simply exercise its right to terminate the treaty.[9] The termination of such treaty would solve the abuse problem in that specific context, while sending a strong message to taxpayers, as well as other treaty partners, that abuse will not be tolerated. Moreover, a termination of one treaty (or even dozens) out of thousands of bilateral treaties currently in place worldwide, should not threaten the systemic integrity of the international tax regime.[10]

Tax treaties are rarely terminated, however, even when clearly abused by taxpayers. For example, the United States has unilaterally terminated bilateral tax treaties only on very few occasions.[11] Recently, notwithstanding the mounting evidence of treaty abuse, the U.S. Department of Treasury (the "Treasury") strongly resisted the idea of treaty terminations, referring to it as a "nuclear weapon."[12]

The resistance to treaty termination is not unique to the United States. The OECD recently adopted a set of recommendations following the massive Base Erosion and Profit Sharing

7. Brauner, *supra* note 4.

8. *Id.* Generally, treaty abuse is viewed as an issue best addressed by changes to domestic law, for example, by adding domestic anti-abuse rules that address treaty-based abuse. *Id.* Changes in the domestic laws of one or a few countries, or terminations of a few treaties by one country, are unlikely to have an immediate systemic effect on the network of bilateral tax treaties. *Id.* ("[T]reaty abuse generally has been considered a domestic law issue.").

9. Treaties typically contain termination articles. *See* OECD MODEL CONVENTION, *supra* note 5.

10. *See* Brauner, *supra* note 4.

11. *See* discussion *infra* Part II.D.

12. Lee A. Sheppard, *News Analysis: Who's Willing to Sign New U.S. Treaty Provisions?*, 79 TAX NOTES INT'L 192, 194 (2015).

Project ("BEPS Project") aimed at curtailing tax avoidance.[13] Action 6 of the OECD's BEPS Project is specifically aimed at combating treaty abuse.[14] This effort is quite remarkable in the sense that addressing treaty abuse has been historically viewed as a domestic issue, and the project marked the first coordinated international attempt focused on treaty abuse. But even though Action 6 recognizes that "each country has the sovereign right" to terminate a treaty,[15] it forcefully states that treaty termination is a "last resort" option in responding to treaty abuse.[16]

Thus, it seems that developed jurisdictions take the view that the termination of a tax treaty should be taken as a final measure when other responses to treaty abuse have failed. This paints unilateral responses to treaty abuse as a set of hierarchal options, gradually escalating in severity, with termination being the last available option. This article puts unilateral responses to treaty terminations in coherent policy terms, and suggests that there is no such hierarchy. Instead, different responses are suitable for different types of abuse.

II. THE UNITED STATES' EXPERIENCE IN RESPONDING TO TREATY ABUSE

This Part offers a menu of unilateral responses available for treaty abuse through case studies involving the United States. The unilateral responses to treaty abuse discussed herein include: overrides, renegotiations, turnoff provisions, and terminations. This Part explains the different circumstances under which the United States adopted each of the four policy instruments. The survey indicates that these policy instruments were not part of a hierarchical set of responses.

A. Treaty Overrides

A treaty override is domestic legislation that has the effect of undoing treaty provisions.[17] In the United States, treaties and

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13. For more information and access to BEPS Project documents, see *Base Erosion and Profit Shifting*, ORG. FOR ECON. CO-OPERATION & DEV., http://www.oecd.org/ctp/beps.htm (last visited May 22, 2016).

14. *See generally* OECD, *supra* note 3.

15. *Id.* at 15.

16. *Id.* at 103.

17. In at least one instance, the Treasury overrode treaties by administrative action in the context of conduit financing arrangements. *See* Treas. Reg. § 1.881-3 (2012). However, the regulations were promulgated under the broad

legislation have the same authoritative power.[18] It is well established that, where two equally authoritative rules contradict each other, the rule enacted later-in-time takes precedent.[19] This interpretative doctrine gives Congress the ability to override treaties by a later-in-time law. The United States has been quite active in legislating treaty overrides,[20] a practice that has drawn some criticism.[21] The Branch Profits Tax ("BPT") example can help to illustrate the United States' use of overrides.

All treaties to which the United States is a signatory specify that a treaty resident's business income shall only be taxed in the United States if the income is attributable to the resident's "permanent establishment" in the United States.[22] A domestic corporation, wholly owned by such foreign resident, is generally not considered to be a permanent establishment.[23] Income attributable to a permanent establishment is thus taxed once to the foreign resident.

If, in the alternative, a foreign resident operates in the United States through a wholly owned domestic corporation, the domestic corporation is subject to the usual corporate tax in the United States. Upon repatriation of dividends from the corporation to the foreign resident, the dividend is subject to a gross withholding tax (the rate of which varies among treaties).[24] The income is thus taxed twice.

This U.S. treaty system closely follows the U.S. domestic system of taxation: proprietors are taxed once on income they generate directly, while corporate income is subject to two levels of

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authority of I.R.C. § 7701(l), which itself may be understood to instruct the Treasury to override treaties.

18. U.S. CONST. art. VI, cl. 2.

19. For a discussion of the later-in-time rule in the context of tax treaties, see Anthony Infanti, *United States*, *in* TAX TREATIES AND DOMESTIC LAW ¶ 13.1.2 (Guglielmo Maisto ed., 2006).

20. *Id*.

21. For a summary of the negative view of treaty overrides, see Reuven S. Avi-Yonah, *Treaty Overrides: A Qualified Defense of U.S. Practice*, *in* TAX TREATIES AND DOMESTIC LAW ¶ 4.2 (Guglielmo Maisto ed., 2006).

22. U.S. MODEL INCOME TAX CONVENTION art. 7(1) (U.S. DEP'T OF THE TREASURY 2006).

23. In such a case, the domestic corporation itself is a tax resident in the United States under the treaty. *Id*. art. 4(1). As such, the domestic corporation is subject to corporate taxes in the United States.

24. *Id*. art. 10.

tax, once at the corporate level and another at the shareholder level upon distribution or disposition.

Before 1986, foreign residents with active business in the United States generally operated through wholly owned corporate subsidiaries in order to enjoy limited liability.[25] This meant that foreign investors from treaty jurisdictions were usually subject to two levels of tax. This status quo was disrupted with the rise of the Limited Liability Company (LLC) during the early 1980s.

While a LLC accords its members all the benefits of limited liability, a wholly owned LLC is generally disregarded for tax purposes.[26] During the 1980s, foreign residents from treaty jurisdictions started to use LLCs instead of domestic corporations in conducting their U.S.-based activities. Because the LLCs were disregarded for tax purposes, the foreign residents were only taxed in the United States on profits generated by permanent establishments. Repatriation of funds was not taxed again because a LLC was not a corporation, and repatriation from a LLC was not a "dividend" subject to withholding under any of the tax treaties then in force. Operating through a LLC, thus, enabled foreign residents to operate in the United States with the benefits of limited liability, but without the need to incorporate a domestic subsidiary, which enabled the avoidance of the dividend withholding tax.[27] The United States, however, never intended treaties to be used as an instrument to avoid the second level of tax on corporate distributions. In 1986, the United States responded by adding to its tax code section 884, known as the BPT.

The BPT creates a withholding mechanism on branch earnings repatriated from the United States to a foreign parent.[28] The

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25. For a discussion about the historical background of the enactment of the Branch Profits Tax, see, for example, Omri Marian & Yariv Brauner, *United States*, *in* DEPARTURES FROM THE OECD MODEL AND COMMENTARIES: RESERVATIONS, OBSERVATIONS AND POSITIONS IN EU LAW AND TAX TREATIES 537, 549–50 (Guglielmo Maisto ed., 2014); Reuven S. Avi-Yonah, *supra* note 1, at 92–96.

26. Under the default rule prescribed in the regulations, a single-owner LLC is disregarded for tax purposes. *See* Treas. Reg. § 301.7701-3(b)(1)(ii) (2012).

27. For further discussion, see *supra* note 25.

28. Generally, under the mechanism prescribed by I.R.C. § 884, a reduction in a foreign corporation's net U.S. assets is treated as a "dividend equivalent amount." Such amount is subject to a 30 percent gross taxation, unless a tax treaty modifies that rate.

BPT was intended to fix the discrepancy between foreign corporations operating in the United States through LLCs, and those operating through domestic corporate subsidiaries. The BPT effectively functions as a proxy to a second level of tax on corporate distributions from the foreign parent to its shareholders. The problem, however, was that U.S. treaties did not prescribe any tax on business income except from the taxes imposed on permanent establishments. In fact, some U.S. treaties at the time explicitly prohibited a second level of tax on foreign corporate distributions to foreign shareholders.[29] The BPT has effectively overridden the treaties then in effect. Subsequently, the United States renegotiated all of its tax treaties to insert a BPT provision.

B. Renegotiations

The United States has renegotiated its tax treaties on various occasions. Broadly speaking, such renegotiations take one of two forms. The first, referred to as "extensive renegotiations," occurs when there is a renegotiation of many tax treaties to address a problem shared by all renegotiated treaties. The other form of renegotiation refers to the renegotiation of a particular provision or a particular treaty. Each of the two types of renegotiations is separately discussed below.

1. Extensive Renegotiations

Over the years, the United States experienced many instances in which taxpayers from non-treaty jurisdictions "bought" their way into treaties through a process known as "treaty shopping." In the past, if a resident from a non-treaty jurisdiction wished to invest in the United States but wanted to enjoy treaty benefits, the foreign resident could incorporate a shell corporation in a treaty jurisdiction, and make the U.S. investment through such corporation. As a tax resident in a treaty jurisdiction, the wholly owned corporation (and by extension, the non-treaty owner) would reap treaty benefits. The result was that "[in] the most extreme case of treaty shopping, it mean[t] we ha[d] a treaty

29. *See* Marian & Brauner, *supra* note 25, at 550 ("[T]he BPT effectively imposed a second level of tax on the branch in lieu of second level of tax on distribution, where treaty provisions were specifically drafted to prevent a second level of tax on such distributions.").

with the world."[30] This was not a desirable result, since "third country nationals' use of the U.S. treaty network reduce[d] the incentive to governments outside the U.S. treaty network to negotiate treaties with the United States that offer[ed] concessions to U.S. nationals."[31]

The main innovation of U.S. tax treaty policy in this context was the introduction of Limitation on Benefits ("LOB") article in all U.S. treaties. This has been achieved through extensive renegotiations of all existing treaties.[32] The LOB provision is regarded as the "ultimate anti-abuse rule."[33] LOB provisions prescribe qualification rules that are intended to prevent corporate taxpayers who lack sufficient connections to the treaty jurisdictions from receiving treaty benefits.

The creation of the LOB policy is commonly attributed to *Aiken Industries v. Commissioner*.[34] In *Aiken Industries*, a Bahamian parent corporation made a loan to its U.S. subsidiary. Under U.S. law at the time, interest paid to a foreign resident was subject to gross withholding at a rate of 30 percent.[35] Such withholding is many times relieved by tax treaties. The United States and the Bahamas, however, did not have a tax treaty in place. In order to avoid withholding, the Bahamian parent assigned its rights to receive interest under the loan to one of its other subsidiaries, a Honduran corporation. The United States did have a tax treaty with Honduras at the time under which interest payments were exempt from withholding.

The U.S. subsidiary paid a deductible interest to the Honduran subsidiary, thus eliminating some of the U.S. tax base. The Honduran subsidiary immediately turned and made a back-to-back payment to the Bahamian parent. The U.S. subsidiary claimed it was not required to withhold on the deductible payments made to Honduras under the Honduran treaty then in effect. The Tax

30. Jeff Gerth, *U.S. is Opening Talks on Tax Haven Treaty*, N. Y. TIMES (Jan. 15, 1982), http://www.nytimes.com/1982/01/15/business/us-is-opening-talks-on-tax-haven-treaty.html?pagewanted=1 (quoting Alan W. Granwell, the Treasury Department's international tax counsel at the time).

31. R. Eliot Rosen, *U.S. Files Notice of BVI Treaty Termination*, 16 TAX NOTES 77, 78 (1982).

32. *See* Marian & Brauner, *supra* note 25, at 559–60.

33. *Id*. at 559.

34. Aiken Indus., Inc. v. Comm'r, 56 T.C. 925 (1971).

35. I.R.C. § 871 (1986).

Court rejected this argument, concluding that the Honduran corporation "was merely a conduit for the passage of interest payments from [the U.S. subsidiary] to [the Bahamian parent], and it cannot be said to have received the interest as its own."[36]

The case, however, was a Pyrrhic victory for the IRS. The decision provided taxpayers with a roadmap to avoid the classification as a "conduit." In *Aiken*, the back-to-back amounts were identical. After *Aiken*, taxpayers engaged in similar intermediary financing arrangements that withstood court scrutiny, among others, by allocating a small margin of profit to be kept by the conduit intermediaries that were incorporated in treaty jurisdictions.[37] One well-known example is *SDI Netherlands v. Commissioner*.[38] In *SDI*, a Bermudian corporation that owned certain IP rights protected in the United States licensed such rights to an affiliate in the Netherlands, which relicensed them to a U.S. affiliate. The U.S. affiliate paid royalties to the Netherlands, which made a back-to-back payment of royalties to Bermuda. Had the U.S. affiliate paid the royalties directly to Bermuda, they would have been subject to a 30 percent withholding tax. The payment to the Netherlands, however, was exempt under the treaty in force at the time between the United States and the Netherlands. The IRS failed to convince the Tax Court that the arrangement was a sham because, among other reasons, the Dutch entity did keep a small taxable spread in the Netherlands.[39] The immediate response of the Treasury was to renegotiate the tax treaty with the Netherlands to include a strict LOB provision.

However, the treaty-shopping problem was much wider than just the Netherlands or the Honduras treaties. Over the years, the IRS made several administrative attempts to address treaty

36. *Aiken Industries,* 56 T.C. at 934.

37. Since then, the IRS has promulgated regulations to combat such perceived abuse as well. *See supra* note 17.

38. *See, e.g.*, SDI Netherlands v. Comm'r, 107. T.C. 161 (1996).

39. *Id.* at 175–76 ("The schedules of royalty payments provided for a spread, . . . which compensated petitioner for its efforts . . . . Under the circumstances herein, we think these arrangements should be accorded separate status with the result that, although the royalties paid by petitioner to SDI Bermuda were derived from the royalties received by petitioner from SDI USA, they were separate payments.").

shopping,[40] but faced an uphill battle due to the fact that treaties explicitly granted benefits, but did not impose specific residency qualification requirements. The United States therefore had no choice but "to battle treaty-shopping head-on by negotiating it away in its tax treaties."[41] Each treaty signed after *Aiken* included a LOB provision, and existing treaties have since been renegotiated to include such provisions.

2. Targeted Renegotiations

Renegotiations of treaties can also be targeted to a particular provision in the context of a specific treaty. For example, in 2007 the United States and Canada signed a protocol to the U.S.-Canada treaty amending the treatment of hybrid entities. Hybrid entities are entities that are treated as corporations by one jurisdiction, but as a tax-transparent entities in the other jurisdiction.[42]

Until then, taxpayers were able to use hybrid entities to generate deductions in one jurisdiction with no corresponding inclusions in the other.[43] For example, a U.S. parent corporation would make a loan to a wholly owned Canadian Unlimited Liability Company ("ULC"). The ULC would be treated as a corporation for Canadian purposes, but as a disregarded entity for U.S. purposes. Thus, interest payments made from the ULC were deductible in Canada, reducing tax liability in Canada. Under the treaty, the ULC was not required to withhold on the interest payment made to the United States. In the United States, however, the payments did not create income to the parent, because being made from a disregarded entity, the payments never functionally happened from a U.S. point of view. From a U.S. tax perspective, the payments looked like a transfer of money between two bank accounts owned by the same entity. This type of

40. The IRS issued several rulings aimed at denying treaty benefits in abusive circumstances. *See*, *e.g.*, Rev. Rul. 84-152, 1984-2 C.B. 381; Rev. Rul. 84-153, 1984-2 C.B. 383.

41. Marian & Brauner, *supra* note 25, at 560.

42. Protocol Amending the Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, Can.-U.S., Sept. 21, 2007, S. TREATY DOC. NO. 110-15 (2008).

43. *See* STAFF OF J. COMM. ON TAXATION, 110TH CONG., JCX-57-08, EXPLANATION OF PROPOSED PROTOCOL TO THE INCOME TAX TREATY BETWEEN THE UNITED STATES AND CANADA 40–41 (2008).

planning was available due to unique differences between Canadian and U.S. entity classification rules, and it made sense to address them through renegotiation.[44]

C. Turn-off Provisions

In many instances, it is possible to deal with particular issues in advance. For example, if specific provisions of a tax treaty are more prone to abuse than others, it is possible to rig the treaty with "fail-safe" mechanisms that automatically "turn off" treaty benefits if specific conditions are met. The United States had done so on a few occasions.

For example, the treaty between the United States and Luxembourg provides special anti-abuse provisions for "triangular permanent establishments." Generally, if a U.S. resident operates in Luxembourg through permanent establishment, Luxembourg gets the primary right to tax such profits.[45] The United States, however, agrees to give up taxation of its residents under the assumption that Luxembourg will tax them.

Yet, it is possible for a taxpayer to make deductible payments out of the Luxembourg permanent establishment to another Luxembourg treaty partner (not the United States), thus eliminating the tax in Luxembourg without necessarily creating a corresponding inclusion. In order to prevent that, the treaty with Luxembourg contains a provision that "turns off" treaty benefits for a permanent establishment if the permanent establishment is not subject to a minimum threshold of taxation where it operates.[46]

The United States recently introduced a similar concept into its proposed revisions to the U.S. Model Treaty.[47] Under the

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44. The United States previously overrode treaties due to concerns regarding the use of hybrid entities. *See* I.R.C. § 894(c). This rule, however, was not broad enough to address some of the same concerns in the context of the U.S.-Canada Treaty.

45. Convention Between the Government of the United States of America and the Government of the Grand Duchy of Luxembourg for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, Lux.-U.S., art. 9, Apr. 3, 1996, S. TREATY DOC. NO. 104-33 (1996).

46. *Id*. art. 22.

47. U.S. MODEL INCOME TAX CONVENTION (U.S. DEP'T OF THE TREASURY 2016) [hereinafter U.S. MODEL]. For discussion of such fail-safe mechanisms, see Allison Christians & Alexander Ezenagu, *Kill-Switches in the New U.S. Model Tax Treaty*, 41 BROOK. J. INT'L L. 1043 (2016).

Model Treaty, certain treaty benefits are "turned off" if, *after* the treaty has entered into force, the other contracting state introduces a "Special Tax Regime" ("SPR").[48] A SPR is "any statute, regulation or administrative practice that provides a preferential effective rate of taxation to such income or profit, including through reductions in the tax rate or the tax base" which results in certain tax benefits such as preferential tax rates or a permanent deduction.[49] This provision expresses the belief that treaty benefits in one country (in this case, the United States) should only be granted under the premise that the benefited stream of income will be taxed in the other jurisdiction.

D. Terminations

Occasionally, the United States has terminated tax treaties unilaterally for political reasons, such as terminating a tax treaty with South Africa during the Apartheid period.[50] Such terminations are not responding to treaty abuse, and as such are not discussed. Terminations due to treaty abuses are few and far between. Several such instances are explored below.

1. The Termination of the British Virgin Islands Extension in the U.K. Treaty

In 1979, the Treasury announced that it intended to renegotiate the territorial extension of the U.K. treaty to the British Virgin Islands (BVI)[51] and in early 1981 a new treaty was announced. In September of 1981, however, the Treasury asked the Senate to suspend its consideration of the ratification of the newly negotiated treaty.[52] According to the Treasury, the pending treaty was designed to prevent, or at least limit, the extent to which residents of third countries could access U.S. treaty benefits. In reviewing the newly negotiated treaty, the Treasury concluded that the opportunities for such an abuse remained "too great to tolerate."[53]

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48. U.S. MODEL, *supra* note 47, art. 3(1)(1).
49. *Id.*
50. *See* Comprehensive Anti-Apartheid Act, 22 U.S.C. §§ 5001–5117 (1986) (repealed 1993).
51. Letter from John E. Chapoton, Assistant Sec'y for Tax Policy, Treasury Dep't, to Charles H. Percy, Chairman, Senate Comm. on Foreign Relations (Sept. 15, 1981), *reprinted in* 13 TAX NOTES 645 (1981).
52. *Id.*
53. *Id.*

The Treasury's fears of the BVI treaty being used for treaty-shopping schemes were well-grounded. For example, during the 1970s, non-treaty investors in U.S. real estate structured their investments using BVI shell corporations.[54] The BVI entity would finance the U.S. real estate investment with debt, interest on which would be deductible in the United States. This eliminated some of the U.S. tax base. No income would be subject to tax in the BVI, since the BVI was a tax haven. The BVI shell corporation would pay the interest receipts from the United States back-to-back to the non-treaty jurisdiction. Had such payments been made directly to the non-treaty jurisdiction, they would have been subject to a 30 percent gross withholding tax. Moreover, being a tax haven jurisdiction with strict bank secrecy laws, it was possible for U.S. taxpayers to "round trip" their domestic investment through the BVI corporation (meaning, a U.S. person would invest in the United States through a wholly owned BVI corporation) without the IRS ever knowing about it. In effect, it enabled U.S. taxpayers to enjoy treaty benefits in a purely domestic context.

Consequently, the Treasury reopened negotiations with the BVI with the key issue being an anti-abuse provision that was intended to prevent non-treaty residents from avoiding U.S. withholding taxes by claiming BVI-treaty residency. The renegotiation eventually reached an impasse after the BVI resisted the insertion of an anti-treaty-shopping provision.[55] In response, the Treasury decided to terminate the treaty.[56]

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54. For a discussion of tax planning schemes involving real estate investment financed through the BVI, see Richard L. Reinhold, *What Is Tax Treaty Abuse? (Is Treaty Shopping an Outdated Concept?)*, 53 TAX LAW. 663, 665–67 (2000).

55. On February 24, 1982, the Chief Minister of the BVI issued a statement indicating that the negotiations were at an impasse. According to the Minister, the United States insisted on including an anti-abuse provision in the treaty to prevent treaty shopping by third country nationals, but the BVI resisted that step. *See* Rosen, *supra* note 31, at 77.

56. In a U.S. Department of State letter dated June 23, 1982 to the Senate Foreign Relations Committee informing it of Treasury's decision to terminate the extension of the U.S.-U.K. tax treaty to the BVI, Daniel W. McGovern, the Deputy Legal Adviser, noted the decision to terminate was ultimately grounded in the Treasury's report following review that the current treaty indicates potential for tax abuse. On June 30, 1982, the U.S. Department of State filed an official notice with the British Embassy in Washington, indicating that the United States would terminate the extension of the U.S.-U.K. income tax treaty to the BVI effective January 1, 1983. Speaking on June 24, 1982 at the

2. The Mid-1980s Terminations of Caribbean and African Territorial Extensions

On January 1, 1983, the Treasury announced that it will terminate, as of January 1, 1984, the extensions of old tax treaties to over a dozen British and Belgian jurisdictions, primarily located in the Caribbean.[57] According to the press release, the terminations occurred because the existence of the territorial extensions did not reflect the economic relationship between the United States and these respective jurisdictions, and were susceptible to abuse.[58]

Responding to congressional inquiry, the Treasury reasoned that, given the earlier termination of the treaty with the BVI (as well as renegotiations that resulted in the inclusion of anti-abuse provisions in other treaties), there was a concern that the territorial extensions at issue would replace the recently terminated BVI treaty as instruments of tax abuse.[59] Unlike the BVI case, however, the Treasury did not attempt to renegotiate the territorial extensions at issue, but immediately terminated them. The reasoning was that "[f]or the most part these treaties were not being used; there [was] very little investment flow between the United States and these jurisdictions."[60]

The minimal flow of true investment between the United States and these jurisdictions, combined with the fact that such

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Fourth Annual Institute on Multinational Taxation, the Treasury's International Tax Counsel, Alan W. Granwell, said that a tax treaty is a "bilateral relationship between the contracting jurisdictions," and if persons who are not residents of the jurisdictions can obtain benefits under the treaty, "it creates tensions between the law on the books and treaty use." *Id.* at 78.

57. I.R.S. News Release R-2222 (July 1, 1983). The territories with which territorial extensions were terminated were Anguilla, Rwanda, Barbados, St. Christopher, Belize, Nevis, Burundi, St. Lucia, Dominica, St. Vincent, Falkland Islands, the Grenadines, the Gambia, Seychelles, Grenada, Sierra Leone, Malawi, Zambia, Montserrat, and Zaire. *Id.*

58. *Id.*

59. Treasury Secretary Donald T. Regan explained why the Treasury terminated the BVI treaty by responding to inquiries from a member of the Senate's Finance Committee. *See Secretary Regan On Termination of Caribbean Tax Treaties*, 22 TAX NOTES 640, 641 (1984) ("The Treasury Department's action was intended to address current abuse and, significantly, the potential for future abuse following the termination of the British Virgin Islands treaty and the renegotiation of the Netherlands Antilles treaty.").

60. *Id.*

jurisdictions were de facto tax havens, led the Treasury to believe that such jurisdictions might become dependent upon income deriving from abusive activities. The concern, in other words, was that the treaties would be used primarily for abuse, rather than for legitimate investments.[61]

Under such circumstances, renegotiations were viewed negatively. The Treasury reasoned that past experience in renegotiating treaties "has shown that if the existing treaties remain in force during renegotiations, the treaty partner will underestimate the seriousness of the U.S. concern and will also lengthen the renegotiation process as long as possible. This has the adverse consequences of allowing treaty abuses to continue."[62] Renegotiation is called for, according to the Treasury, only in cases where "establishing a treaty relationship . . . promotes real economic activities of residents of the two jurisdictions."[63]

The Treasury also explained that the treaty terminations may serve a purpose beyond eliminating the particular abuse at issue. Termination "sends the clearest possible signal to present or potential treaty partners . . . that the United States is serious about its intent to curtail treaty shopping."[64]

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61. In hearings, which took place throughout September 1987 before the House of Representatives' Subcommittee of the Committee on Government Operations, Assistant Secretary for Tax Policy of the Department of Treasury, Donald Chapoton, submitted prepared statements and responses to subcommittee requests. When questioned about the reasons for terminating the 1945 Income Tax Convention between the United States and the United Kingdom, and the 1948 Income Tax Convention between the United States and Belgium, Chapoton stated:

> Moreover, there was apparently little use of the treaties by residents of these jurisdictions. In addition, the treaties did not contain safeguards against use by third country residents to obtain U.S. tax benefits. Although these treaties had not yet been widely used by third country residents, there was an indication that such use was growing.

See International Tax Evasion/Tax Treaty Issues: Hearing Before the Subcomm. on Gov't Operations, 100th Cong. 60 (1987) (statement of Donald Chapoton, Acting Assistant Sec'y on Tax Policy, Treasury Dep't) [hereinafter Chapoton Statement].

62. *Supra* note 59.

63. *Id.*

64. *Id.*

3. The Netherlands Antilles Treaty Termination

On June 29, 1987, the Treasury announced that the United States delivered notices to the Netherlands of the termination of the extension of the 1948 income tax treaty as it applied to the Netherlands Antilles. In accordance with the terms of the treaty, the termination was to be effective as of January 1, 1988.[65] In a letter, J. Roger Mentz, Assistant Secretary of Tax Policy, wrote that the termination of the treaty "represents a positive step in this Administration's efforts to eliminate opportunities for abuse of the United States income tax treaties through treaty shopping, the practice by which residents of third countries establish or use entities in a treaty country to derive income from United States investments under the treaty's favorable tax terms."[66]

At the time, the Antilles functioned as an offshore center for foreign investment in the United States. The Antilles also played a crucial role in U.S. companies' Eurobond financing.[67] Although the Antilles levied only nominal taxes on the tax haven business, "the volume of U.S. financing through the Antilles was so great that it produced 25–30% of [the] islands' total tax revenues."[68] Meanwhile, the amount of U.S. revenue lost through this haven was estimated to be between $700 million to $1 billion.[69]

For eight years prior to the termination of the treaty, the Treasury tried to renegotiate a more restrictive treaty with the Antilles, premised on the anti-treaty-shopping criteria in the U.S. Model Income Tax Treaty, as well as an exchange of information mechanisms.[70] The negotiations failed due to "the unwillingness of Treasury to tolerate an increase in treaty shopping for which the Antilles lobbied."[71]

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65. U.S. Tax Treaties Rep. (CCH) 457.01, Aruban Income Tax Treaty: Treaty Background (2016).

66. U.S. Tax Treaties Rep. (CCH) 458.80, Annotations: Termination (2016).

67. Gerth, *supra* note 30.

68. David R. Francis, *US Tries to Stem Flow of US Tax Revenue Through Antilles 'Haven,'* CHRISTIAN SCI. MONITOR (Jan. 10 1984), http://www.csmonitor.com/1984/0110/011047.html.

69. *Id.*

70. Frith Crandall, *The Termination of the United States-Netherlands Antilles Tax Treaty: What Were the Costs of Ending Treaty Shopping*, 9 NW. J. INT'L L. & BUS. 355, 378 (1988).

71. Mark F. Johnson, *Antilles Treaty Termination Favored, but Period of Uncertainty in Bond Market Lies Ahead*, 36 TAX NOTES 127, 129 (1987).

Two months after the termination of the treaty, O. Donaldson Chapoton, the Acting Assistant Treasury Secretary for Tax Policy, discussed the termination of the Netherlands Antilles treaty at a Congressional hearing. He cited the primary reason for seeking to renegotiate the Netherlands Antilles treaty related to its potential for abuse by treaty shopping third-country investors.[72] Mr. Chapoton noted that the principal objection to treaty shopping was that it undermined the leverage the United States would otherwise bring to negotiations for new or revised treaties with the countries of residence of the treaty shoppers. It therefore posed a serious obstacle to the United States' efforts to bargain with trading partners for concessions, like low withholding tax rates on income derived by U.S. persons from those jurisdictions, which are so important to the international competitive standing of U.S. multinationals. He also noted that the Antilles treaty had been used by third-country residents for treaty shopping more extensively than any other U.S. income tax treaty. He presented data from IRS forms reporting income payments to nonresidents for 1983 and 1984 to highlight the massive extent to which third-country residents channeled their investments into the United States through entities established in the Antilles.[73]

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72. *See* Chapoton Statement, *supra* note 61, at 27 ("The primary reason for seeking to renegotiate the Netherlands Antilles treaty related to its potential for abuse by treaty-shopping third-country investors.").

73. *Id.* Chapoton provided the following data regarding payments channeled through the Antilles:

> Payments of all types of U.S. source income subject to withholding to residents of the Netherlands Antilles (a jurisdiction of approximately one-quarter million people) were $2.1 billion, or 19 percent of the total U.S. payments to all countries, in 1983. In 1984, payments to Antilles residents were $2.8 billion, or 16.4 percent of such payments to the world. With respect to interest, the comparable figures are even more striking. In 1983, U.S. source interest payments of almost $2 billion, or 33.4 percent of the total interest payments to the world of $5.9 billion, were made to residents of the Antilles. In 1984, this figure had increased to $2.6 billion, or 26.2 percent of the total payments of $10 billion. This percentage decline for the Antilles probably reflects the effect of the introduction, during 1984, of the U.S. exemption for portfolio interest, which has lessened the need for use of the Antilles as a route for issuing Eurobonds by U.S. companies.
>
> To further highlight these interest figures, in 1983 interest payments to the Antilles exceeded the sum of interest payments to Canada, Germany, the United Kingdom, and France by $120 million. In

4. The Malta Treaty Termination

On November 16, 1995, the United States announced it had delivered a notice of termination relating to the tax treaty with Malta.[74] The reason was the "lack of a provision dealing with limitation of benefits in the treaty."[75] The Treasury also stated that the termination "provide[d] an example of Treasury's commitment to prevent misuse of income tax treaties by third country residents even if it means termination of long-standing relationships."[76]

At the time, Malta changed its domestic tax law to allow "foreign-owned companies in Malta . . . to derive income from the U.S. at a reduced tax rate specified in the double taxation treaty and, therefore, effectively pay no tax in Malta."[77] This created a strong incentive for treaty shopping. Aside from treaty shopping, the United States was also concerned "that Malta was unable to obtain and exchange tax information held by financial institutions."[78] Under these circumstances, "the continuation of the treaty with Malta was [regarded as] not consistent with U.S. tax treaty policy."[79]

III. A Functional Categorization of Unilateral Responses to Treaty Abuse

This Part offers a functional matrix of unilateral responses to treaty abuse based on the U.S. experience, which is not based on a hierarchy. In the alternative, it suggests that response to

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> 1984, Antilles interest payments were 82 percent of the sum of the interest payments to these four countries.

Id. at 28.

74. The Malta treaty has since been renegotiated, and the new treaty entered into force on November 23, 2010. *See* Convention Between the Government of the United States of America and the Government of Malta for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Malta-U.S., Aug. 8, 2008, S. TREATY DOC. NO. 111-1 (2009) (entered into force Nov. 23, 2010) [hereinafter Tax Convention with Malta].

75. Sindhu G. Hirani, *U.S. Terminates Tax Treaty with Malta over Limitation of Benefits Provision*, DAILY TAX REP. (BNA) (Nov. 17, 1995).

76. *Id.*

77. *Malta and the U.S. Start Talks to Terminate Double Tax Accord*, 95 TAX NOTES INT'L 244 (1995).

78. Tax Convention with Malta, *supra* note 74, at vi.

79. Hirani, *supra* note 75.

treaty abuse should be categorized based on the identity of the abuser, namely whether the abuser is a taxpayer or a treaty signatory.

A. A Matrix of Responses

The U.S. experience of unilateral responses to treaty abuse is telling. The survey in Part II does not paint a clear picture of a hierarchy of responses. For example, one might expect negotiations to be a "first step" that would precede any "harsher" response, such as an override or termination. But, renegotiations do not precede overrides. If anything, renegotiations come after an override. This was the case with the BPT. Only after the adoption of the BPT did the United States engage all of its treaty partners to renegotiate BPT provisions into the treaties. Even terminations are not always preceded by negotiations, as was the case of the 1980s terminations of the Caribbean territorial extensions. In that case, termination was the first and only response.

Can this mixture of responses be explained? This article suggests that U.S. responses to treaty abuse make a lot of sense once a functional approach is adopted. Rather than a simple hierarchical view, the U.S. experience demonstrates that different measures are adopted in response to different types of abuses, and in different contexts. Specifically, the type of observed unilateral responses seem to depend on two factors: the geographical breadth of the abuse, and the substantive type of the abuse.

Geographical breadth refers to whether the abuse is prevalent across multiple treaties or whether it is confined to a particular treaty (or very few treaties). The breadth of the substantive abuse refers to whether the abuse makes use of specific treaty provisions (for example withholding provisions), or whether taxpayers abuse the treaty in general (that is, by treaty shopping, where the treaty can be used in multiple schemes to avoid taxation). Based on the two factors, it is possible to build a matrix of observed U.S. responses to treaty abuse.[80]

80. Obviously, a treaty can be abused in more than one way. The quadrants above are a simplistic depiction of reality, and assume that the different types of abuse are independent of one another, which is not necessarily the case. In reality, since different types of abuse may occur simultaneously within the same treaty or set of treaties, it is possible that one policy response is available to address the abuses.

Figure 1: Categorization of Unilateral Responses to Treaty Abuse

Categorization of Unilateral Responses to Treaty Abuse

		Geographical Breadth	
		Systemic (all/most treaties)	Particular (one/few treaties)
Substantive Breadth	Systemic (treaty shopping)	Renegotiate all (example: LOB provisions)	Termination (example: Netherlands Antilles termination)
	Particular (specific provisions)	Overrides (example: BPT)	Renegotiations/turn-offs (example: Canada treaty's hybrids entity rules SPR in the new proposed U.S. model)

The matrix shows that available policy responses to treaty abuse are taken under different circumstances. For example, reference to treaty terminations as a "last resort" option is somewhat of a misnomer. Sometimes termination is simply the only relevant response. In other instances; it is irrelevant. This is an important observation, since viewing treaty termination as a "last resort" option may instill an inherent bias against its use as a policy instrument, even when termination is the correct approach to take. In the following sections, this article briefly discusses the quadrants of the matrix presented above. It explains why each policy instrument may be preferable over other available choices in specific contexts.

1. Treaty Shopping Across Multiple Treaties: Renegotiate All

In a sense, this type of a problem is a worst case scenario: all treaties are prone to abuse in ways we cannot really anticipate. Renegotiation of all existing treaties to include LOB provisions was the U.S. course of action once it became apparent that treaty shopping was a systemic problem.

The main argument against such an approach is its cost. Renegotiation is time consuming and difficult to achieve. Additionally, in the meantime, abuse may continue. There is no viable alternative to systemic abuse (or the potential of systemic abuse), however, across multiple treaties. For example, one theoretical alternative would be to terminate all treaties (either by way of termination notices or through overrides that comprehensively deny treaty benefits), and to hope to renegotiate new ones.

The cost for such an action would be enormous, both economically and politically. From an economic point of view, such an across-the-board move would surely be overkill. Most cross-border transactions are probably legitimate rather than abusive. Multiple terminations, or a broad override, would deny treaty benefits to many taxpayers that are legitimately engaged in cross-border transactions involving treaty jurisdictions. The economic result would likely be disastrous. Moreover, a one-swoop cancellation of multiple treaties would completely tarnish the reliability of the United States as a tax treaty partner (and maybe even as a treaty partner in general).

Another alternative is to terminate a few particularly "bad" treaties. This is unlikely to solve the problem because abusers could simply replace terminated treaties with other treaties still in effect that do not contain LOB provisions.

2. Particular Types of Abuse Across Multiple Treaties: Overrides

Could the United States have addressed the BPT issue differently? What other actions could the United States have taken in response to the rise of the LLC, which in turn denied the United States' collection of dividend withholding taxes?

The option of treaty termination seems extreme in such a context. First, since this was a problem for all treaties in place at that time, it would require the termination of all treaties resulting with the problems noted above. In addition, treaty terminations in such a case would be overbroad within the context of each treaty. If the treaty generally functions properly, and there is only one dysfunctional article prone to abuse (in that case, the dividend withholding article), it seems extreme to terminate a treaty and deny all other intended benefits that have nothing to do with dividend withholding.

The United States could potentially renegotiate all treaties to include BPT provisions (which the United States eventually did after the enactment of the BPT). However, unlike in the context of systemic abuse schemes discussed above, an override can be targeted to address the specific abuse at issue, and be made immediately applicable to all treaties. This seems to provide a relatively low cost way to quickly solve the problem and stop the abuse.

There is still a political cost, of course, in overriding treaties. The United States has indeed been criticized for its override practices.[81] But, given that the override addresses abuse, meaning, instances where the treaties are used in unintended manners, the political costs seem to have been bearable.[82] In many instances, overrides also address problems shared by the other jurisdictions.[83] In such circumstances, little resistance is expected.

3. Particular Abuse in One Treaty: Renegotiation or "Turn Off" Provisions

A particular type of abuse in a specific treaty probably represents the easiest case for tax authorities. When one provision of one treaty is consistently abused by bona fide residents of the treaty jurisdiction, the obvious course of action is a targeted renegotiation of that specific provision.

Termination of the treaty seems extreme, as it denies all other benefits of the treaty that are not associated with the particular abuse. An override is also inapt, since it seems impossible to draft legislation so narrow so as to target one type of abuse in one treaty, without affecting other treaties.

If a particular treaty is known to be susceptible to abuse in particular circumstances, it might be helpful to include safeguard mechanisms that automatically "turn off" treaty benefits in response to a particular type of abuse. This can be tailored to the particular context of each treaty, as was the case with the Luxembourg treaty.[84]

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81. *See generally*, *e.g.*, Anthony C. Infanti, *Curtailing Tax Treaty Overrides: A Call to Action*, 62 U. PITT. L. REV. 677 (2001).

82. Avi-Yonah, among other scholars, supports treaty overrides based on the argument that treaty partners usually face the same abuse problems and, therefore, may be amenable to the override. *See* Avi-Yonah, *supra* note 21, at 65.

83. *Id.*

84. *See supra* Part II.C.

4. Systemic Abuse of a Single Treaty: Renegotiation or Termination

The U.S. experience in treaty terminations tells a very particular story: treaties are terminated when, in the context of a particular treaty, two factors converge. The first factor involves when the treaty is systematically abused (or has the potential for systematic abuse). In some cases, such as in the BVI and the Netherlands Antilles Treaties, the abuse seems to have been supported (if not encouraged) by the treaty partner. The second factor is that the abuse (or the potential for it) is large in comparison to any legitimate uses of the treaty. In such context, the treaty functions primarily as an avoidance instrument, and not as an instrument that alleviates double taxation and supports investment.

It may be reasonable to renegotiate a treaty before terminating it. But, it does not seem necessary. In fact, negotiation may only prolong the period of abuse. If it is apparent that a treaty can only serve as an instrument of abuse, why have it at all? Termination solves the problem immediately. At the same time, few innocent taxpayers are harmed by the termination, since little (if any) legitimate cross-border dealing is ongoing between the treaty jurisdictions. For example, in the context of the Caribbean extension terminations, the Treasury reasoned that

> because of the minimal flows of investment between the United States and these jurisdictions and because abuse of these treaties by third country residents had not yet become widespread, the economic impact would not be great. If, however, terminations were delayed, and treaty shopping abuses became widespread, there could be a far more severe impact.[85]

Not only that, the termination sends a strong message to both taxpayers and treaty partners that abuse will not be tolerated.[86]

There is, of course, a potential political cost to termination. When the United States terminated the BVI treaty, some members of Congress were critical. It was suggested that the Treasury's decision "to request a renegotiation of the terms of the treaty it agreed to only a few months earlier br[ought] into question the country's adherence to bilateral agreements which

85. *See* Regan, *supra* note 59.
86. *Supra* note 64.

might have repercussions far beyond the circumstances of this tax treaty."[87]

Such fear is unfounded. The United States is hardly the only country in the world that has to deal with tax avoidance and evasion through tax havens. Other jurisdictions face the same problem. It is more likely that such jurisdictions would view treaty terminations with tax havens favorably, as it prevents U.S.-based investors from using tax havens to avoid taxes in other industrialized jurisdictions. The United States' economic relations with non-haven jurisdictions are much more substantial than its relations with tax havens. The political gains of favorable perception by non-haven jurisdictions—appreciating the fact the United States takes the lead in engaging a shared problem—likely outweighs any political repercussions.[88]

B. Government Abuses Versus Taxpayer Abuses

Another way to functionally categorize unilateral responses to treaty abuse is based on the identity of the main offender. Clearly, in all instances of abuse, taxpayers benefit from lower tax bills. But in some instances, the abuse is encouraged, or even facilitated, by the treaty partner (as thought to be the case of the Netherlands Antilles treaty).

If taxpayers take advantage of a treaty in a manner that is inconsistent with the intention of the treaty partners, the response should be taxpayer focused. The idea here would be to close loopholes, for example, through an override. However, when a problem is persistent across multiple treaties and also broad in scope, an override might not solve the problem. In such a case, there is a need to renegotiate the treaties with all treaty partners, such as in the case of the LOB provision. Since the interests of the negotiating parties are largely aligned, there is a good chance that the effort will be successful.

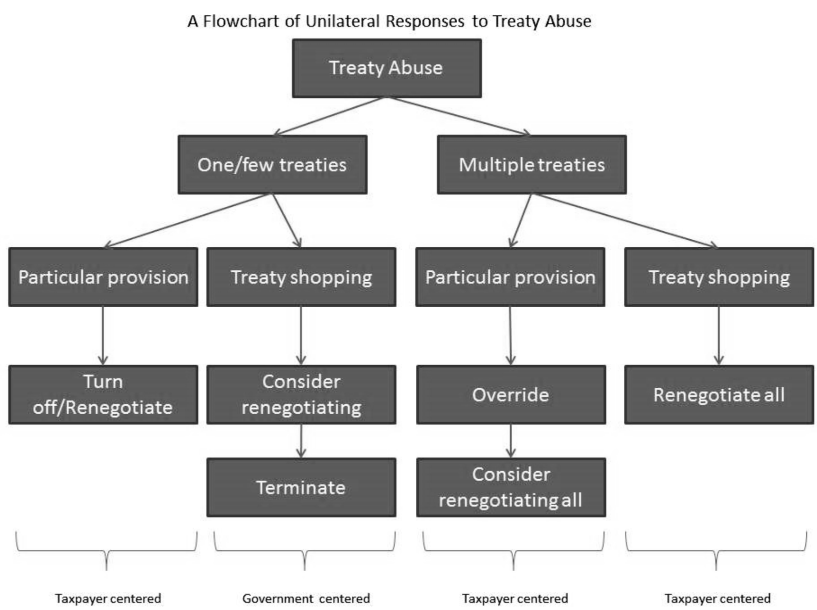
If a treaty partner facilitates or encourages the abuse, the response should target the treaty partner, and not taxpayers who simply take advantage of opportunities provided by the treaty

87. Letter from Guy Vander-Jagt, Ways and Means Comm. Member, to Donald T. Regan, Treasury Sec'y (Oct. 6, 1981), *reprinted in* 13 TAX NOTES 1200 (1981).

88. Some industrialized jurisdictions have even followed suit. For example, Norway terminated its own treaty with BVI in 1988—though a new treaty was concluded in 2009, and entered into force in 2011—as did Denmark, and Japan in 2001.

partner. Termination can thus be categorized as a government-centered response. These ideas are illustrated in the flowchart below.

Figure 2: A Flowchart of Unilateral Responses to Treaty Abuse



The main idea prescribed by the flowchart is that termination is a correct solution in instances where the abuser is the treaty jurisdiction rather than taxpayers. Termination is not a last resort response to treaty abuse. It is simply the correct response to abuse of a treaty by a signatory state.

CONCLUSION

Recent years have seen a dramatic increase in the attention given to abusive tax schemes using double-taxation treaties. The ensuing discourse tends to view potential responses to treaty abuses as a hierarchical set of options, gradually escalating, where treaty termination is a last resort option.

This article explains that responses to treaty abuse are a function of the type of abuse, and that they are not hierarchically ordered. Additionally, this article also offers a taxonomy of potential unilateral responses to treaty abuse. The argument brought forward is that the nature of the response depends on the geographical breadth of the abuse, and the breadth of substantive abuse.