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HOW REFORM-FRIENDLY ARE U.S. TAX TREATIES?

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INTRODUCTION

The United States taxes the worldwide income of its citizens, tax residents, and domestic corporations (collectively, "U.S. taxpayers")[1] and allows a credit for foreign taxes paid on foreign-source income.[2] To that end, a tentative (pre-credit) U.S. tax liability is calculated based on the taxpayer's worldwide income that is determined on a before-foreign-tax basis, and a limited credit for foreign taxes is then allowed against the tentative U.S. tax liability.[3] As a result, only a residual U.S. tax is paid, but no refund is granted for excess foreign tax payments. Along with foreign taxes directly paid, creditable foreign taxes of a domestic corporate taxpayer include foreign taxes paid by an at-least-10-percent-owned foreign corporation on the income underlying dividend distributions by the foreign corporation to the U.S. corporation.[4] The effect is that a corporate U.S. taxpayer is allowed an indirect foreign tax credit in addition to the direct foreign tax credit allowed to all U.S. taxpayers.

The United States is committed to allowing direct and indirect foreign tax credits not only statutorily but also through the many bilateral income tax treaties it entered into with trading partners, virtually all of which include an article that is identical

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1. I.R.C. §§ 1, 2(d), 11(a), 11(d), 61–63, 7701(a)(30). Generally, tax residents include "green card" holders and aliens meeting a "substantial presence" test, and domestic corporations are corporations created or organized in the United States or under its federal or state laws. I.R.C. § 7701(b), 7701(a)(3)–(4).

2. I.R.C. §§ 901–909. The foreign tax credit is elective, and taxpayers may choose to take a foreign tax deduction instead, which treats foreign taxes paid as a regular and deductible cost of doing business abroad. I.R.C. §§ 901(a), 164(a)(3), 275(a)(4).

3. I.R.C. §§ 901, 904. If, for example, a U.S. taxpayer subject to a 35 percent U.S. tax rate earns $100 of foreign-source income that is subject to a 20 percent foreign tax, the taxpayer's tentative U.S. tax liability is $35 (35% X $100). A foreign tax credit for the $20 (20% X $100) of foreign taxes paid is then applied against the $35 tentative U.S. tax liability for a final U.S. tax liability of $15 ($35 - $20).

4. I.R.C. §§ 902, 960, 78.

or very similar to Article 23 of the U.S. Model Treaty.[5] Under Article 23, each treaty partner commits to its method of relief from double taxation, which in the case of the United States is the foreign-tax-credit (or credit) method.[6] Limitations aside, a foreign tax credit reduces, dollar for dollar, the home country tax liability by foreign taxes paid. The dollar-for-dollar credit has been the understood meaning of the foreign tax credit since its invention by T.S. Adams in 1918,[7] through the 1923 League of

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5. *See* U.S. MODEL INCOME TAX CONVENTION art. 23 (U.S. DEP'T OF THE TREASURY 2016) [hereinafter U.S. MODEL TREATY], and identical or similar articles in previous U.S. model treaties (for example, the 2006, 1996, and 1981 U.S. Model Treaties) and in actual U.S. treaties. Generally, countries enter into income tax treaties for the stated purpose of avoiding double taxation and preventing fiscal evasion with respect to taxes on income. Tax treaties are usually organized as follows. After the definitional and general articles on the scope of the treaty (as generally applying to "residents" of one or both signatories, as defined in the treaty) and the taxes covered, the substantive articles of the treaty allocate the taxing rights between the signatories, mainly with respect to income derived by a resident of one state (the residence country) from sources within the other state (the source country). With the residence country generally maintaining its right to tax its residents, the substantive articles lay out the extent to which the source country may or may not tax types of income of residents of the other state. Generally, source countries have a right to tax business income of residents of the other state only to the extent attributable to a "permanent establishment" of the taxpayer in the source country. The source country's rights to tax non-business investment income of a resident of the other state vary, depending on the treaty and on the type of income. Usually, such non-business investment income is either exempt or taxed at a reduced rate by the source country. A relief-from-double-taxation article usually completes the picture by imposing the obligation to prevent double taxation on the residence country. The most common ways to relieve double taxation are exemption from residence-country taxation, foreign tax credit, or a combination of both, but certain treaties provide for foreign tax deductibility instead. U.S. treaties include a limitation-on-benefits article mainly aimed at preventing "treaty shopping." Most treaties include a nondiscrimination article, along with articles providing for dispute resolution procedures, administrative assistance, and exchange of information.

6. *Id.*

7. *See* Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 DUKE L.J. 1021, 1045 (1997).

Nations Report on Double Taxation[8] and, at least in the treaty context, until this day.[9]

Recent proposals for reforming the U.S. international tax system, however, deviate from the classic worldwide or credit features of the system and raise the question of whether and to what extent such proposals are treaty compatible.[10] For example, the 2011 and 2014 proposals by then-Chairman David Camp of the House Ways and Means Committee generally would exempt from U.S. taxation 95 percent of repatriated immobile foreign-source business income and disallow any foreign tax credit or deduction with respect to all such income, with the 5 percent taxable portion being a proxy for the disallowance of allocable deductions.[11] The 2013 proposal by then-Chairman Max Baucus

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8. *Report on Double Taxation Submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman, and Sir Josiah Stamp*, League of Nations Doc. E.F.S. 73.F.19 (1923) [hereinafter *Report on Double Taxation*].

9. *See, e.g.*, REUVEN S. AVI-YONAH, ADVANCED INTRODUCTION TO INTERNATIONAL TAX LAW 4, 44 (2015) (describing the foreign tax credit as a dollar-for-dollar reduction in the U.S. tax liability for foreign taxes); DANIEL SHAVIRO, FIXING U.S. INTERNATIONAL TAXATION 11–12, 49 (2014) (describing the standard foreign tax credit as having a 100 percent "marginal reimbursement rate" (MRR) for foreign taxes and as "a 100 percent, dollar-for-dollar, refund from the U.S. government of its foreign taxes paid.").

10. Scholarship and commentary that raise the issue of treaty compatibility of international tax reform proposals include SHAVIRO, *supra* note 9; Stephen E. Shay, *Theory, Complications, and Policy: Daniel Shaviro's* Fixing U.S. International Taxation, 9 JRSLM. REV. LEGAL STUD. 104, 112–14 (2014); Daniel Shaviro, *Response to Comments on* Fixing U.S. International Taxation, 9 JRSLM. REV. LEGAL STUD. 132, 140–41 (2014) [hereinafter Shaviro, *Response*]; Martin A. Sullivan, *Shaviro's Fixing U.S. International Taxation*, 74 TAX NOTES INT'L 492 (2014); Reuven S. Avi-Yonah, *Buying into Shaviro's Anti-FTC Position?*, 73 TAX NOTES INT'L 449 (2014); Daniel Shaviro, *The Crossroads Versus the Seesaw: Getting a "Fix" on Recent International Tax Policy Developments*, 69 TAX L. REV. 1, 22, 35–40 (2015) [hereinafter Shaviro, *Crossroads*]; Alvin C. Warren, Jr., *The Relationship Between a Credit and a Deduction for the Foreign Taxes of Multinational Corporation* (Harvard Law Sch. Pub. Law & Legal Theory Research Paper Series, Paper No. 14-23, 2014), http://ssrn.com/abstract=2442306; *see also* Pekar v. Comm'r, 113 T.C. 158, 162–63 (1999); Kappus v. Comm'r, 337 F.3d 1053, 1055–56 (D.C. Cir. 2003); Haver v. Comm'r, 444 F.3d 656, 657 (D.C. Cir. 2006).

11. H. COMM. ON WAYS & MEANS, 112TH CONG., TAX REFORM ACT OF 2011 DISCUSSION DRAFT (Comm. Print 2011), http://waysandmeans.house.gov/UploadedFiles/Discussion_Draft.pdf; H. COMM. ON WAYS & MEANS, 113TH CONG., TAX REFORM ACT OF 2014 DISCUSSION DRAFT 782–855 (Comm. Print 2014), http://waysandmeans.house.gov/UploadedFiles/Statutory_Text_Tax_Reform_Act_of_2014_Discussion_Draft_022614.pdf.

of the Senate Finance Committee includes two options: the so-called Option Y and Option Z.[12] To ensure a global minimum tax at a combined rate of at least 80 percent of the U.S. rate on covered foreign-source business income, Option Y would exempt such income from U.S. taxation if the income is subject to an effective foreign tax rate of 80 percent or more of the U.S. rate, but otherwise would tax such income at 80 percent of the U.S. rate and allow a full foreign tax credit. Option Z would instead tax 60 percent of covered foreign-source business income at the full U.S. rate, exempt the remaining 40 percent, and allow a credit for only 60 percent of the applicable foreign taxes. As part of the proposed budgets for 2016 and 2017, the Obama administration's proposal would impose a per-country residual minimum tax on covered foreign source business earnings at a rate of 19 percent reduced (but not below zero) by 85 percent of the foreign effective tax rate.[13] To make improvements to the current system across many dimensions that include the lockout effect, income shifting, the choice of location, and complexity, Rosanne Altshuler and Harry Grubert propose the imposition of a 15 percent per-country minimum tax on foreign-source active income with expensing for real investment in the country and a credit for the effective foreign tax rate up to the 15 percent threshold.[14] They also consider varying the proposal by disallowing the expensing and/or calculating the minimum tax on an overall, instead of on a country-by-country, basis.[15] Finally, as one method

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12. STAFF OF THE J. COMM. ON TAXATION, 113TH CONG., JCX-15-13, TECHNICAL EXPLANATION OF THE SENATE COMMITTEE ON FINANCE CHAIRMAN'S STAFF DISCUSSION DRAFT OF PROVISIONS TO REFORM INTERNATIONAL BUSINESS TAXATION (Comm. Print 2013) [hereinafter JCX-15-13], http://images.politico.com/global/2013/11/19/jct_technical_explanation_of_chairmans_staff_international_discussion_d___.pdf.

13. U.S. DEP'T OF THE TREASURY, GENERAL EXPLANATION OF THE ADMINISTRATION'S FISCAL YEAR 2016 REVENUE PROPOSALS (2015) [hereinafter GENERAL EXPLANATION 2016], http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2016.pdf; U.S. DEP'T OF THE TREASURY, GENERAL EXPLANATION OF THE ADMINISTRATION'S FISCAL YEAR 2017 REVENUE PROPOSALS (2016) [hereinafter GENERAL EXPLANATION 2017], https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2017.pdf.

14. Harry Grubert & Rosanne Altshuler, *Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax*, 66 NAT'L TAX J. 671, 676–78 (2013).

15. *Id.*

for implementing his proposal to set the marginal reimbursement rate for foreign taxes paid on foreign-source income at less than 100 percent without overburdening such income with domestic taxes, Daniel Shaviro proposes to tax foreign-source business income at a reduced U.S. rate and to allow a deduction, not credit, for foreign taxes paid.[16] Shaviro notes that alternative methods for implementing his proposal include Option Z and the Obama administration's proposal.[17]

This article addresses the treaty compatibility aspect of reform proposals. Treaty override aside, treaty compatibility is a bar to the implementation, not enactment, of a domestic tax law.[18] That is, being treaty incompatible does not mean that a domestic tax law cannot be enacted but only that that law would produce a worse result to a taxpayer than what is allowed under the applicable treaty. And by claiming treaty benefits, the taxpayer can achieve the favorable treaty result. Section 871(a)(1) of the Internal Revenue Code (the "Code")[19] is a good example of a treaty-incompatible provision of U.S. tax law that no one would raise treaty concerns about. This provision imposes a 30 percent final withholding tax on certain amounts—including interest, dividends, and royalties—received from sources within the United States by a nonresident alien individual. U.S. treaties on the other hand provide for lower (including zero) tax rate limits for certain such items, and a taxpayer claiming treaty benefits would be taxed at the applicable reduced treaty rates, not the 30 percent statutory rate.[20] What is the problem then, and what is the difference, if any, between §871(a)(1), which is incompatible with treaty rate limits on the one hand, and a reform that would be incompatible with the treaty credit method (Article 23) on the

16. SHAVIRO, *supra* note 9.

17. Shaviro, *Response, supra* note 10, at 140–41; Shaviro, *Crossroads*, *supra* note 10, at 35–40; *see also* Sullivan, *supra* note 10.

18. I.R.C. §§ 894(a), 7852(d); *see also* Johnson v. Browne, 205 U.S. 309, 321 (1907) ("Repeals by implication are never favored, and a later treaty will not be regarded as repealing an earlier statute by implication unless the two are absolutely incompatible and the statute cannot be *enforced* without antagonizing the treaty." (emphasis added)). Note that Article 23 overrides Article 1(4) of the U.S. Model Treaty. *See* U.S. MODEL TREATY, *supra* note 5, art 1(5). Article 1(4) is the saving clause, which preserves the right of each treaty partner to tax its own residents as if the treaty were not in effect.

19. All section and regulation references are to the Code and the regulations thereunder.

20. *See, e.g.*, U.S. MODEL TREATY, *supra* note 5, arts. 10–13.

other hand? That one is incompatible with a treaty rate limit while the other is incompatible with a treaty method is inconsequential because a rate limit is but a simple method.[21] And like a non-U.S. taxpayer who claims treaty benefits from the United States as a source country with a tax rate that is higher than that allowed by a treaty, a U.S. taxpayer can claim treaty benefits from the United States as a residence country if the treaty credit method produces a better result than that of the U.S. statutory method.[22] This is what income tax treaties are meant to do—guarantee a result, not a method. The problem, however, lies elsewhere and relates to the purpose of the proposal whose treaty compatibility is at issue. If, unlike §871(a)(1),[23] the purpose of a proposal is to reform the U.S. international tax system, treaty incompatibility would raise a serious question regarding the point in and efficacy of a reform that in most cases would be overridden by existing treaty obligations.[24] This issue can be

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21. That Articles 10–13 benefit residents of the treaty partner while Article 23 benefits a U.S. resident is also an irrelevant difference.

22. *See, e.g.*, Pekar v. Comm'r, 113 T.C. 158 (1999); Kappus v. Comm'r, 337 F.3d 1053 (D.C. Cir. 2003); *see also* Haver v. Comm'r, 444 F.3d 656 (D.C. Cir. 2006).

23. The 30 percent withholding tax rate of §871(a)(1) could be viewed as an incentive for non-treaty partners to seek to enter into a treaty with the United States.

24. For example, when the Belgian courts examined whether Belgium's replacement of its foreign-tax-credit relief for foreign-source dividend income with a foreign tax deduction, they found that the repeal of the foreign tax credit was compatible with Belgium's treaties with the Netherlands, Germany, and France because these treaties allowed Belgium full autonomy in changing its internal tax laws in this respect. The courts, however, found that the repeal did violate Belgium's treaty with the United States and granted Belgian shareholders of U.S. companies a treaty credit relief despite the Belgian domestic law repeal of the foreign tax credit. *See* Marc Quaghebeur, *ECJ Examines, for the Third Time, Belgian Tax Treatment of French Dividends*, 69 TAX NOTES INT'L 1045, 1048 (2013). Unlike Belgium's treaties with the Netherlands, Germany, and France, the Belgium-U.S. treaty then in effect provided that Belgium's obligation to allow a credit was subject to changes of Belgian laws without changing the principle of allowing a credit, which is similar to the U.S. obligation under Article 23(2) of the U.S. Model Treaty. *See* Convention Between the United States of America and the Kingdom of Belgium for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Belg.-U.S., art. 23(3)(b), July 9, 1970, 23 U.S.T. 2687 (terminated).

dealt with, however, either by renegotiating or overriding all existing treaties.[25] But, the renegotiation option is an onerous task,[26] and while treaty override is permissible under U.S. law,[27] it is a violation of international law.[28] Establishing that a reform proposal is treaty compatible obviates the need for renegotiating or overriding existing U.S. treaties.

The article is structured as follows. Part I introduces the relevant language of Article 23 of the U.S. Model Treaty and construes its credit principle. Part II.A explains why a U.S. move to an exemption system would be treaty compatible even under the most literal and formalistic reading of the treaty language as requiring a credit system. The key is that the treaty language (Article 23) subjects the U.S. obligation to allow a credit to limitations of U.S. law as it may be amended without changing the "general principle" of allowing a credit. Therefore, this article argues that exempting foreign-source business income can be coordinated with standard foreign-tax-credit limitations without violating any treaty or rendering any part of it a surplusage. The article then explains why the Camp proposal is such an exemption system and therefore treaty compatible. Part II.B argues that for the same reasons that an exemption system is treaty

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25. For example, a 2013 pending protocol to the Japan-United States 2003 income tax treaty would amend Article 23 of the 2003 treaty to conform it to Japan's recent move from a full worldwide system to a business-income and participation-exemption system. The protocol would replace existing Article 23(1)(b) of the 2003 treaty, which provides that Japan allow indirect foreign tax credit for dividends received by a Japanese corporation from an at least 10 percent-owned U.S. corporation, with new Article 23(1)(b), which provides for a participation exemption with respect to such dividends.

26. *See, e.g.*, Avi-Yonah, *supra* note 10.

27. *See* U.S. CONST. art. VI, § 2; I.R.C. §§ 894(a), 7852(d); Reuven Avi-Yonah, *Tax Treaty Overrides: A Qualified Defense of US Practice*, *in* TAX TREATIES AND DOMESTIC LAW 65, 65 (Guglielmo Maisto ed., 2006); JOHN P. STEINES, JR., INTERNATIONAL ASPECTS OF U.S. INCOME TAXATION 271–73 (6th ed. 2015); *see also* Shay, *supra* note 10, at 10–11; *infra* notes 178–181 and accompanying discussion.

28. Vienna Convention on the Law of Treaties arts. 26–27, May 23, 1969, 1155 U.N.T.S. 331 [hereinafter Vienna Convention]; Avi-Yonah, *supra* note 27; STEINES, *supra* note 27. The United States signed the Vienna Convention on April 24, 1970 but has not yet ratified it. Nonetheless, the United States considers the substantive provisions of the Vienna Convention as codifying customary international law on the law of treaties. Avi-Yonah, *supra* note 27; Michael S. Kirsch, *The Limits of Administrative Guidance in the Interpretation of Tax Treaties*, 87 TEX. L. REV. 1063, 1078 (2009); Rebecca M. Kysar, *Interpreting Tax Treaties*, 101 IOWA L. REV. 1387, 1402 (2016).

compatible, any fixed or floating intra-item combination of exemption and credit, such as Option Z, is also treaty compatible and that this approach has been implemented in U.S. tax law for more than twenty-five years. Building on Alvin Warren's credit and deduction interchangeability analysis,[29] Part II.C algebraically demonstrates through a uniform method that each of the Option Y, Obama administration, and Altshuler and Grubert proposals is a perfect floating combination of exemption and full credit. Applying the same method, this article also demonstrates that while reduced rate deductibility cannot be expressed as a perfect combination of exemption and credit, Shaviro's proposal can be implemented through various treaty-compatible combinations of exemption and credit. Part III explains why it is unlikely that taxpayers or treaty partners would object to the enactment of any of the proposals, even if they were not treaty compatible.

Warren's analysis focuses on the conditions under which a credit and a deduction for foreign taxes are interchangeable, and allows for partial creditability (less than dollar-for-dollar credit). Following a similar methodology, the analysis here focuses on the interchangeability between combinations of exemption and full credit on the one hand and other structures on the other hand, but without allowing for partial credit. The importance of exemption and *full* credit combinations for treaty purposes is in that such combinations preserve the general principle of dollar-for-dollar credit for foreign taxes against the U.S. tax on foreign-source income, which, as explained below, is the key for treaty compatibility. The general argument is that any system that is or can be expressed as an outright fixed or floating combination of exemption and credit is treaty compatible regardless of how it is actually labeled or expressed. That is so because, as explained below, even under a literal and formalistic application of treaties, such systems would comply with Article 23's requirement not to change the general principle of allowing a credit.

I. THE "RELIEF FROM DOUBLE TAXATION" ARTICLE OF U.S. TREATIES

After introducing the relief-from-double-taxation language of Article 23 of the U.S. Model Treaty and framing the treaty-compatibility question addressed in this article, this Part turns to

29. Warren, Jr., *supra* note 10.

understanding the meaning of the terms "credit" and "general principle" of Article 23(2). As will become clearer, interpreting these terms is central to resolving the main treaty-compatibility question of this article.

A. Article 23 of the U.S. Model Treaty

Virtually all U.S. income tax treaties include an article that is identical or very similar to Article 23 of the U.S. Model Treaty,[30] which provides, in pertinent part:

> Relief From Double Taxation
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> 1. In the case of [Country X], double taxation will be relieved as follows:
>
> 2. In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof), the United States shall allow to a resident or citizen of the United States as a credit against the United States tax on income applicable to residents and citizens:
>
> a) the income tax paid or accrued to [Country X] by or on behalf of such resident or citizen; and
>
> b) in the case of a United States company owning at least 10 percent of the voting stock of a company that is a resident of [Country X] and from which the United States company receives dividends, the income tax paid or accrued to [Country X] by or on behalf of the payer with respect to the profits out of which the dividends are paid . . . .
>
> 3. For the purposes of applying paragraph 2 of this Article, an item of gross income, as determined under the laws of the United States, derived by a resident of the United States that, under this Convention, may be taxed in [Country X] shall be deemed to be income from sources in [Country X] . . . .

In Article 23(2), the United States undertakes to allow direct and indirect foreign tax credits subject to existing limitations of U.S. law as may be amended without changing the general principle of the Article. This qualification opens the door for possible deviations from the standard credit system, and the question is how far one can go.

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30. *See* U.S. MODEL TREATY, *supra* note 5, art. 23.

Consistent with the language of Article 23(2), courts have found Code limitations on the foreign tax credit to be treaty compatible when the limitations existed at the time a treaty with language similar to that of Article 23(2) was entered into,[31] but have left unresolved the treaty-compatibility question of limitations introduced by later Code amendments.[32] It was unnecessary for the courts to resolve this question in the cases they discussed because they concluded that, even if a conflict had existed between the treaty and the subsequent Code provision, the Code provision would have overridden the treaty under the later-in-time rule.[33] But, treaty override seems to be permissible under U.S. law "only where the subsequent Code provision itself or accompanying legislative history clearly states an intent to override,"[34] and even then, treaty override remains a violation of international law.[35] As noted, however, establishing that a reform proposal is treaty compatible obviates the need to override or renegotiate existing U.S. treaties. Again, the key for treaty compatibility of subsequent Code provisions is the language of Article 23(2), which subjects the U.S. obligation to allow a credit to limitations of U.S. law as may be amended without changing the "general principle hereof."[36]

The first question to address in this respect is whether the term "hereof" refers to the treaty in general, to Article 23 in general, or to Article 23(2) in particular. The general principle of the

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31. Pekar v. Comm'r, 113 T.C. 158 (1999) (finding that a foreign tax credit limitation in the Code is treaty compatible because it existed when the treaty, with language similar to that of Article 23, was entered into); *see also* Haver v. Comm'r, 444 F.3d 656, 658 (D.C. Cir. 2006) (holding that for a treaty to override a foreign tax credit limitation of U.S. law that existed when the treaty was entered into, "the treaty would have to indicate that the contracting parties intended to override inconsistent portions of U.S. law.").

32. *Haver*, 444 F.3d at 659 ("Therefore, it is unnecessary for us to decide what more might have been contemplated by the provision in Article 23[(2)] that conditions the tax credit on limitations of U.S. law 'as it may be amended from time to time without changing the general principles' of the Treaty. Nor need we ponder whether the United States may effectively abrogate the Treaty by enacting legislation that cannot be reconciled with the Treaty."); Kappus v. Comm'r, 337 F.3d 1053, 1056 (D.C. Cir. 2003) ("The question of whether the Treaty and statute can be harmonized as the government suggests is an extremely close one. It is not, however, a question that we need resolve.").

33. *Haver*, 444 F.3d; *Kappus*, 337 F.3d.

34. STEINES, *supra* note 27, at 272.

35. *Id.*; Avi-Yonah, *supra* note 27.

36. *Pekar*, 113 T.C.; *Kappus*, 337 F.3d; *Haver*, 444 F.3d.

treaty is its stated principle or purpose that is "the elimination of double taxation with respect to taxes on income without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance."[37] As Article 23 and its title seem to indicate, the general principle of Article 23 is the relief from double taxation.[38] Relief from double taxation is a broader principle than that of the treaty, which includes the qualifier "without creating opportunities for non-taxation etc." Attaching significance to the difference between the terms "relief" and "elimination" would further narrow down the treaty principle. Arguably, because the general principle of a treaty article cannot coherently be broader than the general principle of the treaty itself, there is good basis for the argument that the general principle of Article 23 should be limited to that of the treaty.[39] It is not necessary, however, to resolve this issue because, in any event, the "general principle hereof" refers to neither of these two principles, but to the narrower general principle of Article 23(2), which obviously is the allowance of a credit. First, the U.S. Treasury Department's (the Treasury) Model Technical Explanation (the "Model Technical Explanation")—which the Treasury follows in its actual technical explanations of actual U.S. tax treaties—makes it unequivocally clear that the term "general principle hereof" refers to the general principle of the allowance of a credit;[40] and

37. *See* U.S. MODEL TREATY, *supra* note 5 (introductory paragraph).

38. *See id.* art. 23.

39. Vienna Convention, *supra* note 28, art. 31(1), which provides that "[a] treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty *in their context and in the light of its object and purpose*" (emphasis added). *See* Reuven S. Avi-Yonah, *International Tax as International Law*, 57 TAX L. REV. 483, 491–93 (2004).

40. U.S. MODEL TECHNICAL EXPLANATION ACCOMPANYING THE U.S. MODEL INCOME TAX CONVENTION OF NOVEMBER 15, 2006 art. 23(2) (U.S. DEP'T OF THE TREASURY 2006) [hereinafter MODEL TECHNICAL EXPLANATION], https://www.treasury.gov/press-center/press-releases/Documents/hp16802.pdf ("The credits allowed under paragraph 2 are allowed in accordance with the provisions and subject to the limitations of U.S. law, as that law may be amended over time, so long as the general principle of the Article, that is, *the allowance of a credit*, is retained." (emphasis added)). As of the writing of this article, the Treasury Department has not yet released the Technical Explanation of the 2016 U.S. Model Treaty, but no material updates, if any, to the 2006 Model Technical Explanation are expected with respect to Article 23, whose language is identical in both models. *See* PREAMBLE TO 2016 U.S. MODEL INCOME TAX CONVENTION (U.S. DEP'T OF THE TREASURY 2016) [hereinafter 2016

"[i]t is well settled that the Executive Branch's interpretation of a treaty 'is entitled to great weight.'"[41] This is all the more so true here, where the Treasury's interpretation of the term at issue is the most restrictive interpretation for the United States.[42] Second, interpreting the term "general principle hereof" as referring to the general principle of Article 23(2) is the most sensible interpretation. That is so because, regardless of how restrictive this interpretation is for the United States, the term "general principle hereof" is used in Article 23(2) in the context of the allowance of a credit, and it makes the most sense for the term "hereof" to refer to the particular paragraph in which it is used, especially where the general principle of Article 23(2)—that is, the allowance of a credit—is a subset of the broader general principle of Article 23 or of the treaty. Third, the only actual U.S. treaty that defines the term "general principle hereof" for purposes of the equivalent of Article 23(2) is the U.S.-Germany treaty,[43] which provides that the term refers to the "avoidance of double taxation by allowing a credit."[44]

PREAMBLE], https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Preamble-US%20Model-2016.pdf.

41. Abbot v. Abbot, 130 S. Ct. 1983, 1993 (2010); *see also* Kolovrat v. Oregon, 81 S. Ct. 922, 926 (1961) ("While courts interpret treaties for themselves, the meaning given them by the departments of government particularly charged with their negotiation and enforcement is given great weight."); Garcia v. Comm'r, 140 T.C. 141, 160 ("Petitioner agrees with respondent that the Treasury Technical Explanation is useful in interpreting the Swiss Tax Treaty, and we concur."); *cf.* Kirsch, *supra* note 28.

42. A reference in Article 23(2) to broader general principles—e.g., relief from double taxation—would allow the United States more flexibility in amending its internal tax laws without violating Article 23(2).

43. Convention Between the Federal Republic of Germany and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes, Ger.-U.S., Aug. 29, 1989, 1708 U.N.T.S. 3 (as amended) [hereinafter U.S.-Germany Treaty].

44. *Id.* Protocol art. 19. Interestingly, the Court of Appeals in Haver v. Comm'r, 444 F.3d 656, 659 (D.C. Cir. 2006) referred to the "general principle hereof" of Article 23(1) of the U.S.-Germany treaty (which is the equivalent of Article 23(2) of the Model Treaty) as referring to the "'general principles [sic]' of the Treaty." This statement is of no significance for our purposes. First, the statement was made incidentally in a dictum and without any substantiation or reasoning. Second, if the court understood the term "general principle hereof" of Article 23(1) of the U.S.-Germany treaty to refer to the general principle of the treaty rather than that of Article 23(1) of that treaty, then the court must have overlooked the clear definition to the contrary in the protocol to the

Therefore, we will proceed with the notion that the term "general principle hereof" refers to the general principle of Article 23(2) that is the principle of allowing a credit. Note that because this interpretation is the most restrictive interpretation for the United States,[45] other interpretations of the term would make the case of this article easier.

B. The Meaning of "Credit" and the "General Principle" of Article 23(2)

Recall that in Article 23(2), the United States undertakes to allow a "credit" subject to limitations of U.S. law, as may be amended without changing the general principle of allowing a credit. The term "credit" is not defined in the U.S. Model Treaty or in actual U.S. treaties, and Article 3(2) of the U.S. Model Treaty, which is included in all U.S. tax treaties, provides that, unless the context requires otherwise, any term not defined in a treaty shall have the meaning it has at that time under the internal laws (primarily tax laws) of the treaty partner with respect to whose taxes the treaty is being applied—here, the United States.[46] The unless-the-context-requires-otherwise qualifier is meant to address the concern that "[t]he use of 'ambulatory' definitions . . . may lead to results that are at variance with the intentions of the negotiators and of the Contracting

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treaty. What is more is that the court even misread the term to include "principles" in plural, which might have misled the court in presuming that, while Article 23(1) has one general principle, the treaty had several ones.

45. *See supra* note 42 and accompanying text.

46. *See*, *e.g.*, Estate of Burghardt v. Comm'r, 80 T.C. 705, 711–13 (1983). The language of Article 3(2) of the U.S. Model Treaty is as follows:

> As regards the application of the Convention at any time by a Contracting State any term not defined therein shall, unless the context otherwise requires, or the competent authorities agree to a common meaning pursuant to the provisions of Article 25 (Mutual Agreement Procedure), have the meaning which it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.

U.S. MODEL TREATY, *supra* note 5, art. 3(2).

States when the treaty was negotiated and ratified."[47] This concern, however, is not present here because, as explained below, the concepts and principles underlying the current meaning of the foreign tax credit and its limitations under U.S. law predate the first treaty in which the United States started using a variation of the modern language of Article 23 that is now used in virtually all U.S. treaties.[48] Because, therefore, the context of Article 23(2) does not require otherwise, and because, as a more specific rule of interpretation,[49] Article 3(2) prevails over the Vienna Convention general rules of interpreting treaties,[50] the term "credit" should have the meaning it has under U.S. tax law. Note that there is also no policy rationale against this interpretation of the term "credit." The policy argument against interpreting treaty terms according to the domestic laws of the country applying the treaty is meant to address the concern that treaty partners with different internal laws would apply the same treaty provision differently.[51] But, by its terms, Article 23(2) may be applied only by the United States, not by the other treaty partner, and therefore, this concern is not present here.

Limitations aside, a credit reduces, dollar for dollar, the U.S. tax liability by foreign taxes paid. The dollar-for-dollar reduction in the U.S. tax for foreign taxes paid has been the U.S. (and global) understanding of the foreign tax credit since its invention by T.S. Adams in 1918,[52] through the 1923 League of Nations

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47. MODEL TECHNICAL EXPLANATION, *supra* note 40, art. 3(2).

48. Convention Between the United States of America and the Kingdom of Norway for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Property, Nor.-U.S., Dec. 3, 1971, 23 U.S.T. 2832 [hereinafter U.S.-Norway Treaty].

49. Klaus Vogel, *Double Tax Treaties and Their Interpretation*, 4 INT'L TAX & BUS. LAW 1,70 (1986); F. Engelen & A. Gunn, *Article 3(2) of the OECD Model Tax Convention and the Scope of Domestic Law*, 66 BULL. FOR INT'L TAX'N (2012).

50. Vienna Convention, *supra* note 28, arts. 31–33. Even if the Vienna Convention were to apply here, Article 31(1) would provide that "[a] treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty *in their context and in the light of its object and purpose*" (emphasis added), which would bring us back to the context of the allowance of a credit for the purpose of preventing double taxation. *Cf.* Avi-Yonah, *supra* note 39.

51. *See* Vogel, *supra* note 49, at 63.

52. Graetz & O'Hear, *supra* note 7, at 1045.

Report on Double Taxation,[53] and until this day.[54] It is also consistent with the Organisation for Economic Co-operation and Development (OECD) Model Treaty (the "OECD Model Treaty") view of credit.[55] This is also the clear reading and plain meaning

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53. *See Report on Double Taxation, supra* note 8.

54. *See* I.R.C § 901 (providing for a dollar-for-dollar credit); *see also* AVI-YONAH, *supra* note 9; SHAVIRO, *supra* note 9; MICHAEL J. GRAETZ & DEBORAH H. SCHENK, FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES 25, 211 (7th ed. 2013) (describing a tax credit in general as a dollar-for-dollar credit) ("A credit represents a direct reduction in tax in the amount of the allowable credit . . . . [A] dollar of tax credit saves a dollar of taxes.").

55. MODEL CONVENTION WITH RESPECT TO TAXES ON INCOME AND ON CAPITAL (ORG. FOR ECON. CO-OPERATION & DEV. 2014) [hereinafter OECD MODEL TREATY]. The OECD Model Treaty language on methods for eliminating double taxation includes two alternative articles: Article 23A, which describes the exemption method, *see infra* note 99 (setting forth the full language of Article 23A) and Article 23B, which describes the credit method. Article 23B provides as follows:

> 1. Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall allow:
>
> a) as a deduction from the tax on the income of that resident, *an amount equal to the income tax paid in that other State*;
>
> b) as a deduction from the tax on the capital of that resident, *an amount equal to the capital tax paid in that other State*.
>
> Such deduction in either case shall not, however, exceed that part of the income tax or capital tax, as computed before the deduction is given, which is attributable, as the case may be, to the income or the capital which may be taxed in that other State.
>
> 2. Where in accordance with any provision of the Convention income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital.

Id. art 23B (emphasis added). Paragraph (1) describes the credit as a deduction from the home-country pre-credit tax liability of "*an amount equal* to the income tax paid" to the source country, which is the classic dollar-for-dollar credit method. The same description of the credit method is also evident in OECD Article 23A (first sentence of Article 23A(2)), which, as explained in notes 99 and 106 and accompanying text, combines the exemption and credit methods.

of Article 23(2) or any provision requiring the allowance of a credit. Interpreting the credit requirement as also allowing a partial credit (i.e., a credit on less than a dollar-for-dollar basis) would render Article 23(2), or any provision requiring the allowance of a credit, meaningless. That is so because, as demonstrated by Warren, any system (including a foreign-tax-deduction system) could be reconstructed and expressed as a partial credit system.[56]

Therefore, but for the limitations, the general credit principle of Article 23(2) would be stated as the allowance for a reduction in the U.S. tax liability, dollar for dollar, by foreign taxes paid. And, as it happened, when the United States first introduced the foreign tax credit to the world in the Revenue Act of 1918,[57] the credit was unlimited and reduced the U.S. tax liability, dollar for dollar, by foreign taxes paid.[58] Since then, however, several Code limitations were added. Some of those limitations were added long before the United States started using the language of Article 23(2) in its treaties. Such preexisting limitations, which by definition are treaty compatible,[59] are instrumental in shaping the general credit principle of Article 23(2).

The first and most important foreign tax credit limitation is the so-called "overall limitation." The Revenue Act of 1921 added this limitation, which today is codified in §904 of the Code. The overall limitation restricts the amount of allowable credit for a taxable year to the taxpayer's tentative (pre-credit) U.S. tax liability for the year, multiplied by the ratio of the taxpayer's taxable foreign-source income to the taxpayer's entire (worldwide) taxable income for that year.[60] Excess credits are carried over to

56. *See* Warren, Jr., *supra* note 10.

57. Graetz & O'Hear, *supra* note 7, at 1022.

58. *Id.* at 1045.

59. *See supra* note 31 and accompanying text.

60. Consider, for example, a U.S. taxpayer with $200 of U.S.-source income and $100 of foreign-source income subject to a 50 percent foreign tax. If the U.S. tax rate is 35 percent, the taxpayer's tentative (pre-credit) U.S. tax liability is $105 (35% X $300). Under an unlimited foreign tax credit, the $50 of foreign taxes would be applied against the tentative U.S. tax liability and a residual U.S. tax of only $55 would be paid ($105 - $50 = $55). The overall limitation, however, limits the foreign tax credit here to only $35, which is the product of the $105 tentative U.S. tax liability and the ratio (100/300) of the taxpayer's taxable foreign-source income ($100) to the taxpayer's entire (worldwide) taxable income ($300). Therefore, the taxpayer would then have a $70

preceding or succeeding taxable years.[61] The overall limitation is meant to protect the U.S. tax base on U.S.-source income from erosion by the foreign tax credit.[62] It is easier to see how the overall limitation achieves this objective by algebraically rearranging the limitation formula to cancel out worldwide taxable income from both the tentative U.S. tax liability multiplier (which is the product of the U.S. tax rate and worldwide taxable income) and the denominator of the limitation ratio. This rearrangement reduces the limitation formula to the product of the U.S. tax rate and foreign-source taxable income. This product is effectively the U.S. tax on taxable foreign-source income. Limiting the credit to the U.S. tax on taxable foreign-source income keeps the U.S. tax on U.S.-source income unaffected by the credit or by foreign tax systems.[63] To be sure, taxable foreign-source income refers to foreign-source income that is taxable from a U.S. perspective. That is, U.S.-exempt foreign-source income is excluded from the limitation formula, reflecting the fact that such foreign-source income is not subject to U.S. tax against which a credit could be taken.[64]

Remaining materially unchanged until this day, the overall limitation was introduced in 1921, long before the United States entered into its first ever income tax treaty in 1932[65] or its first treaty to include a "relief from double taxation" article in 1939;[66] and it was not until 1971[67] that the United States started using

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residual U.S. tax liability ($105 - $35), and $15 excess credit to be carried back or forward.

61. I.R.C. § 904(c).

62. Graetz & O'Hear, *supra* note 7; John P. Steines, Jr., *The Foreign Tax Credit at Ninety-Five Bionic Centenarian*, 66 TAX L. REV. 545, 548 (2013).

63. *See* H.R. REP. NO. 108-755, at 379 (2004) (Conf. Rep.) ("The foreign tax credit generally is limited to the U.S. tax liability on a taxpayer's foreign-source income, in order to ensure that the credit serves the purpose of mitigating double taxation of foreign-source income without offsetting the U.S. tax on U.S.-source income.").

64. Article 23(3) is not relevant here because foreign source exempt income is excluded from the limitation formula not as artificially resourced as U.S.-source income but because it is exempt income.

65. Convention and Protocol Between the United States of America and France Concerning Double Taxation, Fr.-U.S., Apr. 27, 1932, 49 Stat. 3145 (terminated).

66. Convention and Protocol Between the United States of America and Sweden Respecting Double Taxation, Swed.-U.S., Mar. 23, 1939, 54 Stat. 1759 (terminated).

67. *See* U.S.-Norway Treaty, *supra* note 48.

a variation of the modern language of Article 23 that is now used in virtually all U.S. treaties. Because Article 23(2) incorporates preexisting Code limitations into the U.S. treaty obligation to allow a credit, one cannot really think about the meaning of the general credit principle of Article 23(2) without considering a preexisting limitation of such major importance and general effect as the overall limitation. That the overall limitation became an integral part of the foreign tax credit is also evidenced by the OECD Model Treaty language on methods for eliminating double taxation, which provides that the credit is limited to the home-country pre-credit tax on taxable foreign-source income.[68]

It should be clear by now that Article 23(2)'s general principle of allowing a credit includes the overall limitation, and can therefore be narrowed to refer to a dollar-for-dollar reduction in the amount of U.S. tax on U.S.-taxable foreign-source income by the amount of foreign taxes paid. To see why the overall limitation merely narrows the general principle of dollar-for-dollar credit but does not alter its meaning to partial credit, one could think of a continuum of reasonable dollar-for-dollar foreign-tax-credit methods, ranging from the strictest nonrefundable, no-carryover credit applied on a transactional (item-by-item) basis to the most lenient fully refundable unlimited credit.[69] The most lenient version of the foreign tax credit is familiar: the foreign tax credit in its original 1918 form. Each dollar of the creditable foreign taxes would be credited against the taxpayer's overall tentative U.S. tax liability, and excess credits would be refundable by the U.S. government. This is the simplest and clearest method for implementing a full dollar-for-dollar credit. Restricting this method a bit and making the credit nonrefundable would not alter the dollar-for-dollar meaning of the credit. Creditable foreign taxes would still be fully credited against the taxpayer's overall tentative U.S. tax liability. The only difference is that creditable foreign taxes that exceed the tentative U.S. tax

68. OECD MODEL TREATY, *supra* note 55, arts. 23A(2) (second sentence), 23B(1) (flush language), 23B(2).

69. A nonrefundable credit is usable only to the extent of the tax liability against which the credit is taken. Some credits, such as the foreign tax credit, allow excess credits to be carried over to, and used in, preceding or succeeding taxable years. A refundable credit, on the other hand, would entitle the taxpayer to a refund from the government to the extent the creditable expenditure (here, foreign taxes paid) exceeds the tax liability against which the credit is taken.

liability would not be refunded, and may or may not be carried over to preceding or succeeding taxable years. In fact, most credits of U.S. tax law are nonrefundable but still maintain their standard dollar-for-dollar credit meaning,[70] which remains true regardless of the existence or nonexistence of a carryover feature.[71] An unlimited foreign tax credit does not require any correlation between the income on which foreign taxes are paid and the income triggering the U.S. tax liability against which the credit is taken.[72] Therefore, an unlimited foreign tax credit would permit cross crediting or foreign-tax averaging.[73] Limiting the foreign tax credit to apply on a transactional basis, however, would move the credit to its strictest form.[74] Such a transactional limitation—which would require full tax-base correlation between the creditable foreign tax and the U.S. tax liability

70. GRAETZ & SCHENK, *supra* note 54, at 25 ("A credit represents a direct reduction in tax in the amount of the allowable credit . . . . Most credits are nonrefundable, which means they only offset tax liability.").

71. *Id.* at 212 ("*Some* credits can be carried over to a succeeding year." (emphasis added)).

72. Consider a U.S. taxpayer that earns an item of $100 of foreign-source income (item 1) subject to 50% foreign tax and another item of $100 of foreign-source income (item 2) subject to 10% foreign tax. With a 35% U.S. tax rate, the taxpayer's tentative U.S. tax liability would be $70 (35% X $200). An unlimited foreign tax credit would allow the taxpayer to use all the $60 of foreign taxes paid ($50 + $10) as an offset against all the $70 of tentative U.S. tax liability, even though $15 of the $50 foreign taxes paid on item 1 exceeded the $35 tentative U.S. tax liability on that item.

73. The taxpayer in the preceding footnote could still use the $15 excess credit on item 1 as an offset against the tentative U.S. tax liability on item 2 because item 2 was subject to a low effective foreign tax rate. The taxpayer, therefore, is said to have engaged in cross crediting or in foreign tax credit averaging.

74. For an item-by-item limitation, or any other limitation on the tax against which a credit is taken, to be effective, the credit must be nonrefundable. Imposing a limitation on the tax against which a refundable credit is taken would be practically meaningless because it would just convert the excess credit into a refund, effectively producing the same result. Note that in certain situations the item-by-item limitation might work in favor of the taxpayer. The main, and probably only, example is a situation in which the taxpayer has separate foreign-source loss and income items. Foreign-source losses under an item-by-item limitation would not offset foreign-source income from a different transaction. Therefore, foreign taxes on the profit transaction would be fully creditable up to the U.S. tax rate. Under an overall limitation, however, foreign-source loss items offset foreign-source income items, thereby reducing the overall amount of foreign-source income, which in turn reduces the limitation and, therefore, the foreign tax credit amount. *Cf. infra* note 86.

against which a credit would be taken[75]—would disallow any sort of cross crediting or averaging.[76] This transactional credit approach is clearly a legitimate dollar-for-dollar credit approach, and arguably even the most theoretically correct one.[77] That is so because the purpose of the foreign tax credit is to relieve double taxation, and the purpose of the limitation is to protect the U.S. tax base on U.S.-source income, but neither the credit nor the limitation is meant to encourage one foreign transaction over another;[78] and if, from a nontax perspective each transaction is evaluated separately, then there should be no averaging or cross crediting of any kind.[79] In fact, several European countries have

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75. That is, foreign taxes paid on an item of foreign-source income would be creditable, dollar for dollar, only against the tentative U.S. tax liability on such an item.

76. Under a transactional limitation, the taxpayer described in footnote 72 may credit the $50 of foreign taxes on item 1 only against the $35 U.S. tax on item 1, and the $10 of foreign taxes on item 2 only against the $35 U.S. tax on item 2. Cross crediting or averaging are not allowed. Therefore, the U.S. tax liability on item 1 would be eliminated, leaving $15 of nonrefundable excess credit, and the U.S. tax liability on item 2 would be reduced to $25. The excess credit on item 1 may or may not be carried over depending on whether the transaction giving rise to item 1 spans and produces income beyond the taxable year.

77. *See* STEINES, *supra* note 27, at 390 ("In theory, the limitation arguably should apply separately to each item of foreign source income, on a transaction-by-transaction basis. But that approach, which would prevent averaging ('cross-crediting') high taxes on one transaction with low taxes on another and thereby maximize U.S. residual tax, would be hopelessly impractical to administer."); STAFF OF THE J. COMM. ON TAXATION, 111TH CONG., JCS-4-09, DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2010 BUDGET PROPOSAL, PART THREE: PROVISIONS RELATED TO THE TAXATION OF CROSS-BORDER INCOME AND INVESTMENT 76 (Comm. Print 2009) ("The U.S. foreign tax credit limitation provisions historically have included rules that restrict cross-crediting in order to preserve the U.S. tax base. In its most restrictive (or theoretically purest) form, the limitation would function on an item-by-item basis, so that foreign tax imposed on any item of income could offset only the U.S. tax on that item. Historically, however, the actual limitation rules have operated instead with respect to more administrable groupings of similar items of income.").

78. STEINES, *supra* note 27, at 402.

79. *Id.* For example, cross crediting could encourage a taxpayer in an excess credit position to undertake a less profitable foreign transaction instead of a more profitable one if the former is subject to lower enough foreign taxes such that the increased benefit from cross crediting would outweigh the foregone pretax profitability.

used the transactional approach in the past, and some still do.[80] The reason the transactional item-by-item limitation was never implemented in the United States was that it was viewed as impractical to administer.[81] But, that does not make it less legitimate or theoretically incorrect. Note that the transactional approach may even make better sense from a treaty perspective because, subject to anti-avoidance consistency rules, U.S. treaties can be applied on an item-by-item basis.[82] The overall limitation, on the other hand, bundles all items of foreign-source income together and allows averaging,[83] but unlike the unlimited credit, it does not allow an overall excess credit to reduce the U.S. tax on U.S.-source income.[84] Therefore, the overall limitation does not affect the dollar-for-dollar credit feature because it lies somewhere between the unlimited credit and the transactional credit on the continuum of legitimate dollar-for-dollar credit methods.

What about the other Code limitations? The Revenue Act of 1932 added a per-country limitation. This limitation requires the application of the general limitation separately with respect to each country,[85] with the sum of allowable credits from all countries not to exceed the overall limitation. The per-country limitation follows the same general principle underlying the overall limitation—protecting the U.S. tax base on U.S.-source

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80. ORG. FOR ECON. CO-OPERATION & DEV. [OECD], TAXATION OF CROSS-BORDER PORTFOLIO INVESTMENT, MUTUAL FUNDS AND POSSIBLE TAX DISTORTIONS 36 (1999); *United Kingdom-Corporate Taxation-Country Surveys-International Aspects*, IBFD TAX RESEARCH PLATFORM, https://online.ibfd.org/kbase/#topic=doc&url=/collections/gtha/html/gtha_uk_s_006.html&WT.z_nav=Navigation&colid=4915 (last visited Sept. 8, 2016); *Ireland-Corporate Taxation-Country Surveys-International Aspects*, IBFD TAX RESEARCH PLATFORM, https://online.ibfd.org/kbase/#topic=doc&url=/collections/gtha/html/gtha_ie_s_006.html&WT.z_nav=Navigation&colid=4915 (last visited Sept. 9, 2016).

81. *See supra* note 77.

82. *See, e.g.,* Rev. Rul. 84-17, 1984-1 C.B. 308; MODEL TECHNICAL EXPLANATION, *supra* note 40, arts. 1(2), 7(2); STEINES, *supra* note 27, at 286–87.

83. The specifics could become more intricate, but the general idea is clear. *See, e.g.*, I.R.C. § 904(d)(6); U.S. MODEL TREATY, *supra* note 5, art. 23(3).

84. *See supra* discussion accompanying notes 60–64.

85. The limitation would be applied separately with respect to each country by including in the numerator of the limitation's ratio only taxable income from sources in that country.

income from erosion by the foreign tax credit—but also prevents averaging across countries. Therefore, the per-country limitation was generally stricter than the overall limitation except when the taxpayer had income in one foreign country and incurred a loss in another, in which case the opposite was true.[86] The Internal Revenue Code of 1954 repealed the overall limitation, leaving the per-country limitation the only one in effect. Public Law 86-780 of 1960 permitted taxpayers to use the reenacted overall limitation instead of the default per-country limitation.[87] The Tax Reform Act of 1976 repealed the per-country limitation and since then the overall limitation has been mandatory. The per-country limitation undoubtedly keeps the credit within the spectrum of full dollar-for-dollar credits because it merely restricts foreign tax averaging to transactions within each country.[88] But, because the per-country limitation is based on the same general principle underlying the overall limitation—namely, protecting the U.S. tax base on U.S.-source income from erosion by the foreign tax credit—neither the rise nor the fall of the per-country limitation around the time the modern language of Article 23(2) was first introduced in 1971[89] alters the general credit principle.[90] Nonetheless, the historic per-country limitation provides additional support for the notion that the

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86. *See* STAFF OF THE J. COMM. ON INTERNAL REVENUE TAXATION, 83RD CONG., SUMMARY OF THE NEW PROVISIONS OF THE INTERNAL REVENUE CODE OF 1954 AS AGREED TO BY THE CONFEREES 98 (Comm. Print 1955).

87. Before then, the Technical Amendments Act of 1958 allowed taxpayers to carry their unused foreign taxes (excess credit) up to two years back or five years forward.

88. For example, Article 23 of the 1981 U.S. Model Treaty provided for a per-country limitation with respect to non-income taxes that the treaty treated as creditable income taxes. *See* U.S. MODEL INCOME TAX CONVENTION (U.S. DEP'T OF THE TREASURY 1981); *see also* Pamela B. Gann, *The Concept of an Independent Treaty Foreign Tax Credit*, 38 TAX L. REV. 1, 30–41 (1982). The inclusion of this provision was discontinued in later model and actual treaties.

89. *See supra* note 67 and accompanying text.

90. The 1976 Act also introduced the overall foreign loss recapture rule, which reduced the limitation and, therefore, the credit in years following an overall foreign loss year. I.R.C. § 904(f). The purpose of this recapture rule is to eliminate a double tax benefit, once in the overall foreign loss year when such foreign loss reduces U.S. source taxable income and again in a later profit year if the foreign country has no net operating loss carry-forward provision. The overall foreign loss recapture rules are also another refinement of the same principle of protecting the U.S. tax base on U.S.-source income from erosion by an unlimited foreign tax credit.

general credit principle may be applied on a stricter basis than the overall basis for the purpose of restricting cross crediting.[91]

To limit cross-crediting practices, the Tax Reform Act of 1986 featured the basket limitations by introducing eight separate limitation categories, or baskets, in addition to a residual general limitation category. The basket limitations require the separate application of the foreign-tax-credit limitation (including the carryover rules) to each basket by replacing the numerator of the limitation ratio with the foreign-source taxable income from that basket. The American Jobs Creation Act of 2004 (effective in 2003) reduced the number of baskets from nine to five, and since 2007 only two baskets remain: passive and general limitation.[92] Viewed as subsequent domestic law amendments with respect to many U.S. treaties or as preexisting limitations with respect to later treaties, the basket limitations, significant as they may be, are still just a refinement of the general overall limitation principle of protecting the U.S. tax base on U.S.-source income from erosion by the foreign tax credit. By limiting averaging separately within each basket, the basket limitations make the foreign tax credit a stricter version of the dollar-for-dollar credit against the U.S. tax on U.S.-taxable foreign-source income but still more lenient than the transactional version. Therefore, the basket limitations do not alter the general credit principle of Article 23(2).

To sum up, the general principle of allowing a credit in the meaning of Article 23(2) refers to the principle of a dollar-for-dollar reduction in the amount of U.S. tax on U.S.-taxable foreign-source income by the amount of foreign taxes paid, applied on an overall basis, item-by-item basis, or any basis in between.

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91. *See supra* discussion accompanying notes 74–82.

92. Consider a U.S. taxpayer that earns $100 of foreign source active business income subject to 50 percent foreign tax and $100 of foreign source passive investment income subject to 10 percent foreign tax. With a 35 percent U.S. tax rate and no basket limitations, the taxpayer's tentative U.S. tax liability would be $70 (35% X $200) and would get a foreign tax credit for all the $60 of foreign taxes paid ($50 + $10). This high-low foreign tax averaging is not a problem in itself. The problem is in that, in being mobile, the booking of passive income can be manipulated to allow cross-crediting opportunities. Applying the overall limitation to each basket separately would impose a $35 limitation on the active basket and a $35 limitation on the passive basket, allowing only $35 out of the $50 of foreign taxes on active income to be credited in the current year. The 2004 Act also reduced the excess credit carryback period to one year but increased the carryforward period to ten years.

Clearly, to give effect to the limitation, the reduction in the amount of U.S. tax on U.S.-taxable foreign-source income is only to the extent of such U.S. tax and may not reduce it below zero.[93] This view is also consistent with the OECD Model Treaty,[94] which describes the credit method as a dollar-for-dollar credit[95] and limits the credit to the home-country pre-credit tax on taxable foreign-source income.[96]

II. Treaty Compatibility of Reform Proposals

The article turns next to examining the treaty compatibility of various reform proposals. After establishing that a U.S. move to an exemption system would be treaty compatible, this Part explains why the Camp proposal is such a treaty-compatible exemption proposal and why, as an outright fixed combination of exemption and full credit, Option Z is also treaty compatible. This Part then demonstrates why any proposal that is or can be expressed as a fixed or floating combination of exemption and full credit would be treaty compatible, and shows that the Option Y, the Grubert and Altshuler, and the Obama administration proposals are treaty compatible. This Part then turns to discussing Shaviro's proposal and explains how it can be implemented in a treaty-compatible manner.

A. Exemption

The determination of how a U.S. move to an exemption system would fare with Article 23 entails two questions. First, whether an exemption system is compatible with Article 23(2). Second, if answered yes, whether a U.S. *move* to such a system would raise treaty concerns.

1. Exemption Systems

Under an exemption system, the home country relieves double taxation by exempting covered foreign-source income of its taxpayers from the home-country tax. To also allow a credit for foreign taxes on such income would be a double relief. Therefore,

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93. *See supra* note 74.

94. *See supra* last two sentences of note 39.

95. *See* OECD Model Treaty, *supra* note 55, arts. 23A(2) (first sentence), 23B(1) (flush language) (both describing the credit as a deduction of the amount of foreign tax from the home-country pre-credit tax).

96. *Id.*

there should be no allowance of a credit for foreign taxes on foreign-source income that is exempt from home-country taxation by reason of its exemption system.[97] Although Article 23 is titled "Relief from Double Taxation" and the Model Technical Explanation of Article 23 states that Article 23 "describes the manner in which each Contracting State undertakes to relieve double taxation," the U.S. obligation under Article 23(2) to allow a credit does not include language similar to the "double-taxation-will-be-relieved-through" language of Article 23(1) regarding the treaty partner's obligation.[98] Therefore, the theoretically correct conclusion that a U.S. move to an exemption system would obviate the U.S. obligation to allow a credit with respect to income that is no longer subject to double taxation does not immediately follow technically and requires some more substantiation.

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97. Foreign-source income could be exempt from the home-country tax not by reason of an exemption system, for example, due to base differences between the home and source countries. The extent to which, if at all, a worldwide system would allow a credit for foreign taxes on such income could be a matter of cross crediting or averaging.

98. The "double-taxation-will-be-relieved-through" language of Article 23(1) is not necessarily understood to mean that the treaty partner is obligated to apply the treaty relief method only when actual U.S. taxation is imposed on U.S.-source income of a resident of the treaty partner. For example, the equivalent provision (Article 25(2)) in the income tax treaty between the United States and Luxembourg provides that "[i]n Luxembourg double taxation shall be eliminated as follows: a) where a resident of Luxembourg derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the United States, Luxembourg shall . . . exempt such income or capital from tax . . . ." 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. 25(2), Apr. 3, 1996, 2148 U.N.T.S. 81. This provision has been understood by some to mean that Luxembourg should exempt U.S.-source income that the treaty would allow the United States to tax, regardless of whether the United States actually taxes such income. *See*, *e.g.*, *Bilateral Tax Treaty Negotiations Between the United States and Luxembourg*, TREASURY.GOV (June 22, 2016), https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Luxembourg-Statement-06222016.pdf. This interpretation focuses on the language "in accordance with the provisions of this Convention, may be taxed in the United States," and seems to view the language "[i]n Luxembourg double taxation shall be eliminated" as requiring the elimination of the *potential* for double taxation and therefore tolerating non-taxation.

An exemption system combines exemption and credit because what it typically means is that only foreign-source business income (mainly in the form of dividends received by a U.S. parent from controlled foreign corporations) is exempt from U.S. taxation, but other foreign-source income (mainly investment income) remains taxable by the home country on a worldwide basis with an allowance for a foreign tax credit.[99] Therefore, qualifying an exemption system under Article 23(2) would not render any part of the article a surplusage. To be sure, also the language of Article 23(2)(b) would remain necessary because the exemption would apply only to dividends out of business income, such that

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99. For example, Article 23A of the OECD Model Treaty describes the exemption method for relief from double taxation as a combination of exemption (paragraph 1) and credit (paragraph 2) as follows:

> 1. Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall, subject to the provisions of paragraphs 2 and 3, exempt such income or capital from tax.
>
> 2. Where a resident of a Contracting State derives items of income which, in accordance with the provisions of Articles 10 and 11, may be taxed in the other Contracting State, the first-mentioned State shall allow as a deduction from the tax on the income of that resident an amount equal to the tax paid in that other State. Such deduction shall not, however, exceed that part of the tax, as computed before the deduction is given, which is attributable to such items of income derived from that other State.
>
> 3. Where in accordance with any provision of the Convention income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital.
>
> 4. The provisions of paragraph 1 shall not apply to income derived or capital owned by a resident of a Contracting State where the other Contracting State applies the provisions of this Convention to exempt such income or capital from tax or applies the provisions of paragraph 2 of Article 10 or 11 to such income.

OECD MODEL TREATY, *supra* note 55, art. 23A.

dividends out of investment (or passive) income would remain both taxable in the United States and eligible for the indirect foreign tax credit.

Under an exemption system, foreign-source business income would be exempt from U.S. taxation and therefore excluded from the limitation formula. All that is needed to effectively disallow any credit for foreign taxes on such exempt income is to introduce a new limitation basket for U.S.-exempt foreign-source income. As a result of the application of the overall limitation to each basket separately,[100] the U.S.-taxable-foreign-source-income multiplier of the exemption basket limitation would be zero, resulting in a zero limitation in the basket at all times.[101] Therefore, this exemption basket would both prevent the crediting of foreign taxes on U.S.-exempt foreign-source income and ensure that all such foreign taxes are carried over as excess credit within the separate exemption basket until their expiration.[102] The exemption basket limitation basically restricts cross crediting by requiring a tax-base correlation between the creditable foreign taxes and the U.S. taxes against which the credit is taken. Not being stricter than a transactional (item-by-item) limitation on the spectrum of allowable methods of dollar-for-dollar credit, the exemption basket limitation is a legitimate limitation that does not change the general principle of allowing a credit.[103] That is, Article 23(2)'s general credit principle—namely, the allowance of a dollar-for-dollar reduction (but not below zero) in the amount of U.S.-tax on U.S.-taxable foreign-source income by the amount of foreign taxes—remains in place, and therefore an exemption system with the exemption basket mechanism is compatible with Article 23(2). This view is also

100. I.R.C. § 904(d)(1).

101. Recall that the overall limitation formula is the taxpayer's tentative (pre-credit) U.S. tax liability for the year multiplied by the ratio of the taxpayer's taxable foreign-source income to the taxpayer's entire (worldwide) taxable income for that year. *See supra* note 60 and accompanying text. When the limitation is applied separately to the exemption basket, the formula result will always be zero because there is zero taxable foreign-source income in the exemption basket.

102. Recall the zero limitation in the basket at all times.

103. *See supra* notes 72–96 and accompanying text. Applying the foreign tax credit general limitation on a transactional (item-by-item) basis would result in the disallowance of credit for foreign taxes on U.S.-exempt foreign-source income because of the required full tax-base correlation between the creditable foreign taxes and the U.S. tax against which the credit is taken.

consistent with the OECD Model language of OECD Article 23A (describing the exemption method)[104] and OECD Article 23B (describing the credit method),[105] both of which envision and allow combinations of exemption and credit,[106] which is what an exemption system is all about.[107]

Thus, if we must worry about formalism in applying treaty provisions, any exemption system could be easily structured and drafted in a manner that the disallowance of credit for foreign taxes on U.S.-exempt foreign-source income is reached through an exemption basket mechanism (which is but a treaty-compatible limitation on cross crediting). Such strict formalism, however, is not warranted in applying Article 23(2). Recall that Article 23(2) allows post-treaty statutory amendments of foreign tax credit limitations so long as such amendments do not change the general principle of allowing a credit. A basic rule of construction in the treaty-compatibility context is that when a treaty and a statute relate to the same subject, they must be construed "so as to give effect to both, if that can be done without violating the language of either."[108] Far from violating the language of Article 23(2), a substance-over-form harmonizing interpretation of Article 23(2) is consistent with, and even mandated by, the undefined term "credit" and Article 23(2)'s reference to its own "general principle." This view holds even under the most literal or formalistic approach in interpreting treaties. First, as discussed above, Article 3(2) of the U.S. Model Treaty, which is included in all U.S. tax treaties, provides that, unless the context requires otherwise, the term "credit," as an undefined treaty term, shall have the meaning it has under U.S. tax law.[109] Because the substance-over-form approach is fundamental to all

104. *See supra* note 99.

105. *See* OECD MODEL TREATY, *supra* note 55.

106. *See id.* arts. 23A(2), 23B(1) (flush language), 23B(2). Note that the U.S. Model Technical Explanation follows the same approach by stating that Article 23(1) of the U.S. Model Treaty "provides that the other Contracting State will provide relief from double taxation through [the credit method/the exemption method/a mixture of the credit and exemption methods]."

107. *See supra* note 99 and accompanying text.

108. Kappus v. Comm'r, 337 F.3d 1053, 1056 (D.C. Cir. 2003) (citing Whitney v. Robertson, 124 U.S. 190, 194 (1888)).

109. *See supra* notes 46–51 and accompanying text.

aspects of U.S. tax law,[110] it applies also to the meaning given to the term "credit." Note here that the context of Article 23(2) does not require otherwise because the substance-over-form approach has always been a "black-letter principle" of U.S. tax law.[111] Second, Article 23(2) refers to its own "general principle." The term "general principle," either generally or as an undefined treaty term taking a U.S.-internal-law meaning, indicates a substance-over-form approach as well.[112] Third, the rationale behind the argument that treaties should be interpreted restrictively is that a country should be presumed to have waived its sovereignty only when the text of the treaty provision leaves no doubt as to such intention.[113] This rationale, however, does not apply here because the nonrestrictive substance-over-form interpretation of Article 23(2) in this context is meant to preserve U.S. sovereignty.

Because the bottom-line effect of the exemption basket limitation is to disallow credit for foreign taxes on U.S.-exempt foreign-source income,[114] and because the treaty-compatibility determination turns on the substance, not form, of the credit limitation, substituting the exemption basket mechanism with an effectively equivalent outright statutory disallowance of credit for

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110. *See*, *e.g.*, PPL Corp. v. Comm'r, 133 S.Ct. 1897, 1905 (2013) (citing Comm'r v. Sw. Expl. Co., 350 U. S. 308, 315 (1956) ("[T]ax law deals in economic realities, not legal abstractions.")).

111. *Id.* Recall that the unless-the-context-requires-otherwise qualifier of Article 3(2) of the U.S. Model Treaty is meant to address the concern that "[t]he use of 'ambulatory' definitions . . . may lead to results that are at variance with the intentions of the negotiators and of the Contracting States when the treaty was negotiated and ratified." MODEL TECHNICAL EXPLANATION, *supra* note 40, art. 3(2); *see supra* note 47 and accompanying text.

112. Article 19 of the Protocol to the U.S.-Germany Treaty, *supra* note 44, includes an unusual provision that defines the term "general principle hereof" of Article 23(1) of that treaty, which is the equivalent of Article 23(2) of the U.S. Model Treaty. The provision provides that "the 'general principle hereof' means the avoidance of double taxation by allowing a credit . . . . While the details and limitations of the credit pursuant to this paragraph may change as provisions of United States law change, any such changes must preserve a credit for German taxes . . . . This definition does not change the analysis above. Apart from the provision's unusual nature (as it does not seem to appear in other treaties), the definition still implies a reference to a principle. But, more importantly, the definition uses the undefined term "credit," which in any event brings back the substance-over-form approach. *See supra* notes 109–111.

113. *See* Vogel, *supra* note 49, at 32.

114. *See supra* notes 100–102 and accompanying text.

foreign taxes on U.S.-exempt foreign-source income—say, for simplification purposes—should not raise treaty compatibility concerns. In such a context, such an outright disallowance of credit is but a different form of what in substance is the same domestic law limitation—namely, the exemption basket limitation—that does not change the "general principle" of allowing a credit. Note that without first establishing that the effectively equivalent exemption basket limitation is treaty compatible, the mere fact that the effect of a limitation is to disallow a credit for foreign taxes on U.S.-exempt foreign-source income would arguably not be sufficient grounds for the conclusion that such a limitation qualifies under Article 23(2). The reason is that the general principle of Article 23(2) is not the allowance of a dollar-for-dollar credit for foreign taxes on U.S.-taxable foreign-source income but the allowance of a dollar-for-dollar credit for foreign taxes against the U.S. tax on U.S.-taxable foreign-source income.[115]

2. A Move to an Exemption System

The conclusion that an exemption system is treaty compatible does not necessarily mean that a *move* to an exemption system would be treaty compatible as well. The negotiations and signing of a tax treaty take into account the tax systems and rate structures in effect in both countries, such that future system or rate changes in either country could distort the balance on which the treaty allocation of taxing rights was based. This "reliance" concept is central to the proposed changes to the Introduction of the OECD Model Treaty regarding the identification of tax policy considerations that are relevant to the decision to enter into, amend, or terminate a treaty,[116] and to Treasury's corresponding, (then-) proposed additions of the "special tax regimes" ("STR") provisions and a "subsequent changes in law" article

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115. *See supra* Part I.B.

116. ORG. FOR ECON. CO-OPERATION & DEV. [OECD], PREVENTING THE GRANTING OF TREATY BENEFITS IN INAPPROPRIATE CIRCUMSTANCES, ACTION 6: 2014 DELIVERABLE 103 (2014); ORG. FOR ECON. CO-OPERATION & DEV. [OECD], PREVENTING THE GRANTING OF TREATY BENEFITS IN INAPPROPRIATE CIRCUMSTANCES, ACTION 6 - 2015 FINAL REPORT 94–95 (2015) [hereinafter ACTION 6 FINAL REPORT].

(new Article 28) to the U.S. Model Treaty.[117] These proposals were followed both by the OECD's proposed changes to the OECD Model Treaty, which included new provisions on STR and a new general rule intended to make a tax treaty responsive to certain future changes in a country's domestic tax laws,[118] and most recently by Treasury's introduction of the new STR provisions and Article 28 into the (2016) U.S. Model Treaty.[119] In a sense, Articles 1(7) and 1(8) of the (2016) U.S. Model Treaty could also be added to the list.[120]

At best, however, it is still highly doubtful that this reliance concept had anything to do with Article 23. First, Article 23 is articulated merely as a "relief from double taxation" article and there is no indication to any other effect in the article's language or Model Technical Explanation, despite the fact that since January 2003, the OECD commentary on OECD Article 23 has included language on optional revisions to OECD Article 23B(2) reflecting the reliance issue.[121] Second, short of termination, which is too drastic an action to be seriously considered and which in any event can be unilaterally exercised without cause,

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117. SELECT DRAFT PROVISIONS OF THE U.S. MODEL INCOME TAX CONVENTION, SPECIAL TAX REGIMES (U.S. DEP'T OF THE TREASURY 2015), https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Treaty-Special-Tax-Regimes-5-20-2015.pdf; SELECT DRAFT PROVISIONS OF THE U.S. MODEL INCOME TAX CONVENTION, SUBSEQUENT CHANGES IN LAW (U.S. DEP'T OF THE TREASURY 2015) [hereinafter DRAFT PROVISIONS: ARTICLE 28], https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Treaty-Subsequent-Changes-in-Law-5-20-2015.pdf.

118. ORG. FOR ECON. CO-OPERATION & DEV. [OECD], REVISED DISCUSSION DRAFT, BEPS ACTION 6: PREVENT TREATY ABUSE 16–19 (2015) [hereinafter REVISED DISCUSSION DRAFT], http://www.oecd.org/tax/treaties/revised-discussion-draft-beps-action-6-prevent-treaty-abuse.pdf; ACTION 6 FINAL REPORT, *supra* note 116, at 96–98.

119. *See* U.S. MODEL TREATY, *supra* note 5, arts. 3(l), 11(2)(c), 12(2)(a), 21(2)(a), 28; 2016 PREAMBLE, *supra* note 40.

120. Generally, Article 1(7) requires matching the source-country treaty relief with the residence-country inclusion, while Article 1(8) is the updated "triangular permanent establishment" provision. Those provisions would deny, or allow the source country to deny, treaty benefits with respect to income that enjoys low or no taxation by the residence country or on a combined basis, and can also apply to post-treaty changes in a treaty partner's domestic laws resulting in such effects. *See* U.S. MODEL TREATY, *supra* note 5, art. 1(7), (8).

121. ORG. FOR ECON. CO-OPERATION & DEV. [OECD], COMMENTARIES ON THE ARTICLES OF THE MODEL TAX CONVENTION para 31.1 (2010); Org. for Econ. Cooperation & Dev. [OECD], *2002 Reports Related to the OECD Model Tax Convention*, ISSUES IN INT'L TAXATION, no. 8, May 16, 2003, at 25–26.

there is nothing a treaty partner can unilaterally do under the treaty about the other country's violation of Article 23.[122] Indeed, an affected taxpayer can claim treaty benefits under Article 23 from the violating home country, possibly leading to a mutual agreement procedure involving the two countries;[123] but, if anything,[124] that could be a remedy for the affected taxpayer not the other country whose purported reliance interest clearly would not be aligned with the taxpayer's interests, especially in the context of a U.S. move to an exemption system.[125] New Article 28 of the 2016 U.S. Model Treaty, on the other hand, would allow the source country to retain its full taxing rights and deny treaty benefits with respect to dividend, interest, royalty, or other income in certain cases of post-treaty reductions in, or exemptions from, the residence-country company tax if consultations "with a view to amending the [treaty to] restore an appropriate allocation of taxing rights" do not progress.[126] The proposed STR provisions follow the same general idea if the residence country effectively employs post-treaty special tax regimes that reduce its tax with respect to certain deductible related-party payments.[127] Third, and perhaps most importantly, even those new provisions do not apply to a move to an exemption system that exempts only foreign-source dividends or business profits from permanent establishments, which is the exemption system examined here.[128]

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122. A mutual agreement procedure without a mandatory arbitration mechanism would not be effective in this context because it would require a bilateral agreement, and if the specific treaty provides for mandatory arbitration in its mutual agreement procedure article, such arbitration can be triggered only if a case is initiated by the taxpayer or is presented to either competent authority on a taxpayer-specific basis. *See* U.S. MODEL TREATY, *supra* note 5, art. 25(6).

123. *Id.* art. 25.

124. *See supra* note 122.

125. If the United States moves to an exemption system, the treaty partner's reliance interest would be to reinstate a worldwide system with or without a foreign tax credit, which is contrary to the taxpayer's interest.

126. DRAFT PROVISIONS: ARTICLE 28, *supra* note 117; *see also* 2016 PREAMBLE, *supra* note 40.

127. *See* U.S. MODEL TREATY, *supra* note 5, arts. 3(1)(l), 11(2)(c), 12(2)(a), 21(2)(a); *see also* 2016 PREAMBLE, *supra* note 40. The OECD's proposed additions follow the same idea. *See* REVISED DISCUSSION DRAFT, *supra* note 118, at 16–19; ACTION 6 FINAL REPORT, *supra* note 116, at 96–98.

128. *See* U.S. MODEL TREATY, *supra* note 5, arts. 3(1)(l), 28; *see also* 2016 PREAMBLE, *supra* note 40; *cf.* DRAFT PROVISIONS: ARTICLE 28, *supra* note 117, at 3, 4 ("The reference [to an exemption for substantially all foreign source in-

A move to such an exemption system would not raise any reliance interest concerns because, in any event, all treaties preserve the source-countries' right to fully tax business profits of permanent establishments.[129]

If it was not for the reliance issue, one can wonder, however, why else would the United States commit itself to the specifics of the current language of Article 23 instead of having Article 23 simply say: "Double taxation will be relieved through the credit method, the exemption method or a combination of the two."[130] Arguably, such language would be clear enough to convey the desired idea and at the same time would allow for future reform flexibility along the spectrum of acceptable methods. One possible explanation for why the United States prefers the more specific language of Article 23 is the concern that the general language would open the door for taxpayers to challenge the U.S. statutory relief from double taxation as inadequate in principle. Another possible explanation is that the United States prefers not to give U.S. taxpayers any ideas about or hopes for possible changes to the U.S. tax system in order to minimize undesirable behavioral responses to such expectations.[131] In any event, as discussed below, the specific language of Article 23 allows for at least the same flexibility that the suggested general language would offer.

3. The Camp Proposal

If a U.S. move to an exemption system is treaty compatible, would the enactment of the Camp proposal also be treaty compatible? As mentioned above,[132] the Camp proposal would ex-

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come] does not include taxation systems under which only foreign source dividends or business profits from foreign permanent establishments are exempt from tax by a Contracting State.").

129. *But see* Shay, *supra* note 10, at 113 (viewing treaty negotiations on a unitary, not item-by-item, basis) ("The source country reduces its withholding taxes on dividends, interests, and royalties and does not tax business income unless the treaty partner resident has a permanent establishment, in exchange for the residence country agreeing to either credit the source country taxes or exempt income the source country is permitted to tax under the treaty.").

130. *Cf.* MODEL TECHNICAL EXPLANATION, *supra* note 40, art. 23(1).

131. One example is how expectations for future reductions in the repatriation tax rate contribute to the foreign earnings lockout problem. *See, e.g.*, Fadi Shaheen, *Understanding Lockout*, 69 TAX L. REV. 231, 253–61 (2016).

132. *See supra* text accompanying note 7.

empt from U.S. taxation 95 percent of repatriated immobile foreign-source business income and disallow any foreign tax credit or deduction with respect to all such income. The treaty concern about this proposal is that it leaves 5 percent of the repatriated immobile foreign-source income taxable without the allowance of a credit.

This full taxation of 5 percent of the covered income, however, is a substitute for the disallowance of deductions for expenses incurred in generating exempt income.[133] Viewed this way, this proxy taxation should not be problematic, especially since the disallowance of such deductions would serve the same general purpose of the overall limitation—namely, protecting the U.S. tax base on domestic source income.[134] Furthermore, a direct disallowance of such actual allocable deductions would be unquestionably justified because then there would be no proxy taxation, 100 percent of the covered income would be fully exempt and the allocable expenses would be clearly attributable to fully exempt income. Therefore, what the proposal's proxy taxation is really about is not a tax on the 5 percent proxy base amount as taxable income, but a haircut equal to the proxy base amount on allowable deductions. That is, in essence, the covered income is fully exempt, but taxable income (e.g., U.S.-source taxable income) is increased by the proxy base amount as a result of the reduction by the same amount in the amount of allowable deductions. Thus, again, if one must worry about formalism in applying treaty provisions, the Camp proposal could be easily redrafted to reflect its substance by setting the participation exemption at 100 percent (instead of 95 percent) and adding a haircut on allowable deductions equal to 5 percent of the covered income. Reaching the exact same result, the proposal then would be a straightforward exemption system and therefore treaty compatible.

But, again, such strict formalism is not warranted. We have already established that a move to an exemption system would be treaty compatible because it would not change the "general

133. STAFF OF THE J. COMM. ON TAXATION, 83RD CONG., JCX-15-14, TECHNICAL EXPLANATION OF THE TAX REFORM ACT OF 2014, A DISCUSSION DRAFT OF THE CHAIRMAN OF THE HOUSE COMMITTEE ON WAYS AND MEANS TO REFORM THE INTERNAL REVENUE CODE: TITLE IV - PARTICIPATION EXEMPTION SYSTEM FOR THE TAXATION OF FOREIGN INCOME 24 (Comm. Print 2014).

134. SHAVIRO, *supra* note 9, at 188. *But cf.* Shay, *supra* note 10, at 113.

principle" of Article 23(2).[135] We have also demonstrated that perhaps not in form but definitely in substance, the original 95-percent Camp proposal is an exemption system.[136] Therefore, because the treaty compatibility question here is a question of substance, not form,[137] the Camp proposal is treaty compatible also in its original form.

B. Intracategory Combinations of Exemption and Credit

Under a standard exemption system, foreign-source business income is fully exempt and foreign-source investment income is fully taxed with an allowance for a foreign tax credit. This system combines exemption and credit across source categories of income. But, what about an intracategory combination like Option Z, which keeps foreign-source investment income fully taxable with the allowance of a credit, but combines exemption and credit for foreign-source business income? Recall that under Option Z, 60 percent of the covered foreign-source business income is taxable at the full U.S. rate and the remaining 40 percent of the covered foreign-source business income is exempt, and the allowed credit is only for 60 percent of the applicable foreign taxes.

A move to such a system would be treaty compatible for the exact same reasons discussed above with respect to an exemption system. By definition, the exempt portion of business income would be excluded from the foreign-tax-credit limitation formula; and ideally, the limitation would be applied separately to an investment-income basket, a taxable-business-income basket, and an exempt-income basket.[138] As discussed above, substituting the exemption basket limitation with an outright disallowance of credit for foreign taxes on U.S.-exempt foreign-source income remains treaty compatible.[139] Option Z follows this outright-disallowance structure. It does so by adding to the two existing passive and general limitation baskets[140] a new limitation basket for the 60 percent taxable portion of the covered business income coupled with an outright disallowance of credit for foreign taxes on the 40 percent exempt portion of the covered

135. *See supra* Part II.A.1, 2.
136. *See supra* discussion accompanying notes 133–134.
137. *See supra* discussion accompanying notes 108–115.
138. *See supra* discussion accompanying notes 100–107.
139. *See supra* discussion accompanying notes 108–115.
140. *See supra* text accompanying note 92.

business income.[141] Again, if formalism so requires, Option Z could be easily redrafted to create a fourth basket for the 40 percent exempt portion of the covered business income instead of the outright disallowance of credit for foreign taxes on such income.

Option Z, therefore, is basically identical to an exemption system in all aspects but one. Both systems combine exemption and credit, and both systems disallow credit for foreign taxes on the exempt covered income, either by an exemption basket limitation mechanism or by an outright disallowance. The only difference between the two systems is that, while an exemption system combines exemption and credit across source categories of income, Option Z does so within a category of income. This difference, however, is inconsequential. In fact, since 1988, the Code has included an actual example of an intracategory combination of exemption and credit, and no treaty compatibility concerns have been raised about it. That is the special foreign tax credit limitation rule for capital gains.[142] Long-term capital gains of individual taxpayers are accorded a preferential tax rate.[143] By generally excluding the rate differential portion of capital gains from foreign-source *taxable* income in the (shorthand) foreign tax credit limitation formula,[144] the special rule effectively treats the preferential rate as a combination of exemption and credit.[145] If, for example, the capital gain preferential tax rate is 20 percent and the full tax rate is 40 percent, the rate differential portion would be 20% / 40% = 50%. If the taxpayer has $100 of foreign-source capital gain and no other foreign-source income, the taxpayer's foreign tax credit limitation, in the shorthand form, would be 40% X [$100 – (50% X $100)] = $20. Because taxing all capital gain at 50 percent of the full rate is exactly the same as taxing 50 percent of all capital gain at the full rate and exempting the remaining 50 percent from taxation,

141. *See* JCX-15-13, *supra* note 12, at 51.

142. I.R.C. § 904(b)(2)(B).

143. *See* I.R.C. § 1(h).

144. In fact, the rule excludes the rate differential portion of foreign-source capital gain from the numerator and the rate differential portion of all capital gain from the denominator of the full foreign tax credit limitation formula. *See* I.R.C. § 904(b)(2)(B).

145. The special rule also applies to qualified dividend income that enjoys the same preferential rate. *See id.*

the effect of the special rule is to exclude the exempt portion of capital gain from the limitation formula.[146]

Hence, Option Z is treaty compatible. Option Z is a fixed combination of exemption and credit because the exempt (or credit) portion is a fixed percentage, here 40 percent (or 60 percent credit). There is obviously no magic to using 40 percent, and any other fixed percentage between 0 and 100 percent inclusive would do. But, what about a floating percentage?[147] Because any fixed percentage would work and any floating percentage is fixed in hindsight, there is no reason why a floating percentage would not work as well. Once applied, the floating percentage becomes fixed, thereby determining the exempt and taxable portions, and we are back on familiar territory.[148] Again, the determinative feature here is the effective allowance in all cases of a dollar-for-dollar reduction (but not below zero) in the amount of U.S. tax

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146. Indeed, a taxpayer may be in an excess limitation position enough to allow the taxpayer to credit all foreign taxes in the basket regardless of the reduction in the limitation amount, rendering the exclusion of the exempt portion of capital gain from the limitation formula of no current-year significance. But, the taxpayer may also have no excess limitation whatsoever, in which case the exclusion of the exempt portion of capital gain from the limitation formula would be fully effective. Because for a provision to be treaty compatible it has to comply with the treaty in all possible scenarios, the special foreign tax credit limitation rule for capital gain remains a good example of an intracategory combination of exemption and credit. Note that the one-year repatriation tax holiday of the American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 422, 118 Stat. 1418, 1514–19 (2004) (codified as amended at I.R.C. § 965), which effectively exempted 85 percent of covered foreign source dividends and allowed a scaled down foreign tax credit for the taxable portion, is a clear example of an intracategory combination of exemption and credit. This provision, however, is of no significance for our purposes because of its elective nature, which makes it treaty compatible regardless of it being a perfect combination of exemption and credit. Because multinationals could still benefit from the normal foreign tax credit regime by choosing not to benefit from the holiday, the United States was still in full compliance with the treaty obligations to *allow* a credit. *See also infra* discussion accompanying notes 176–177.

147. A simple example of an outright floating combination of exemption and credit would be a variation on Option Z where the exemption portion would be a floating percentage, say x ($0 \leq x \leq 1$), which depends on the effective foreign tax rate, and the credit portion would be $1 - x$. The dependence of x on the effective foreign tax rate could be determined by any reasonable formula. For example, x could equal 150 percent of the applicable effective tax rate.

148. In the example of footnote 147, if the applicable effective foreign tax rate on an item of foreign source income is 20 percent, the exemption portion (x) with respect to that item would be 30 percent, and the credit portion ($1 - x$) would be 70 percent.

on U.S.-taxable foreign-source income by the amount of foreign taxes paid, subject to any limitation on cross crediting that is not stricter than a transactional (item-by-item) limitation.

C. Variations on Intracategory Combinations of Exemption and Credit

Building on Warren's credit and deduction interchangeability analysis,[149] the following discussion examines the treaty compatibility of the remaining reform proposals and lays out a uniform method for identifying proposals that are or can be expressed as outright fixed or floating combinations of exemption and full credit. Warren's analysis focuses on the interchangeability of a credit and a deduction, and allows for less than a dollar-for-dollar credit (partial creditability). Following a similar methodology, the analysis here focuses on the interchangeability between outright combinations of exemption and full credit on the one hand, and other structures on the other hand but without allowing for partial credit. The importance of exemption and full credit combinations for treaty purposes is that such combinations preserve the general principle of Article 23(2) of allowing a dollar-for-dollar reduction (but not below zero) in the amount of U.S. tax on U.S.-taxable foreign-source income by the amount of foreign taxes paid, which is the key for treaty compatibility. Consequently, the general argument is that any system that is or can be expressed as an outright fixed or floating combination of exemption and full credit is treaty compatible regardless of how it is actually labeled or expressed. That is so because, as discussed above,[150] even under the most literal and formalistic application of treaties, such a system does not change the general principle of Article 23(2) when applied on an overall basis, transactional basis, or any basis in between. That is, any system that is, or can be expressed as, an outright fixed or floating combination of exemption and full credit reduces (dollar of dollar, but not below zero) the U.S. tax that would otherwise be imposed on foreign-source income by the amount of foreign taxes paid, and therefore is treaty compatible. Again, such a harmonizing interpretation is mandated when no treaty or statutory language is

149. Warren, Jr., *supra* note 10.
150. *See supra* discussion accompanying notes 108–115.

violated,[151] especially where, like here, the treaty language (Article 23(2)) allows, or even mandates, a substance-over-form approach.[152] Rejecting the government's literal approach for determining whether a foreign tax is creditable and restating that U.S. "tax law deals in economic realities, not legal abstractions,"[153] the Supreme Court in *PPL Corp. v. Commissioner* treated a onetime backward-looking U.K. windfall tax as a creditable income tax for U.S. tax purposes because, for nearly all the companies subject to the tax, the windfall tax was the algebraic equivalent of a creditable income tax.[154] The same logic applies here, because in the same way that the Supreme Court found that "algebraic reformulations illustrate the economic substance of [a] tax,"[155] algebraic reformulations also illustrate the economic substance of a tax system.

In any event, here too, if one were still to worry about strict formalism in interpreting and applying Article 23(2), any proposal that can be expressed as a perfect fixed or floating combination of exemption and full credit could simply be redrafted as such, utilizing the uniform method used below for identifying such proposals.

1. Global Minimum Tax—Option Y

Option Y would exempt foreign-source business income from U.S. taxation if the income is subject to an effective foreign tax rate of 80 percent or more of the U.S. rate, but otherwise would tax such income at 80 percent of the U.S. tax rate and allow a full foreign tax credit. It is hard to imagine a reasonable treaty-compatibility concern about this proposal because, depending on the applicable effective foreign tax rate, it would either exempt foreign-source business income or tax it at the threshold rate with the allowance of full foreign tax credit. Still, this proposal is helpful for introducing the uniform method developed here for identifying proposals that are or can be expressed as outright fixed or floating combinations of exemption and full credit, and thus treaty compatible.

151. *See supra* text accompanying note 108.
152. *See supra* discussion accompanying notes 108–115.
153. PPL Corp. v. Comm'r, 133 S. Ct. 1897, 1905 (2013) (citing Comm'r v. Sw. Expl. Co., 350 U. S. 308, 315 (1956)).
154. *Id.* at 1897.
155. *Id.* at 1905.

Option Y is, or can be expressed as, a floating combination of exemption and credit. If the effective foreign tax rate is not less than 80 percent of the U.S. rate, the exemption portion with respect to business income is 100 percent. When the effective foreign tax rate drops below 80 percent of the U.S. rate, the exemption portion drops below 100 percent in a defined direct relationship to the effective foreign tax rate. If the full U.S. tax rate is t and the effective foreign tax rate is t^*, where $1 > t$ and $.8t > t^* \geq 0$, the U.S. tax under Option Y on $1 of before-foreign-tax foreign-source business income would be $.8t - t^*$. The U.S. tax on the same $1 under an outright floating combination of exemption and credit would be $\alpha(t - t^*)$, where α is the credit portion and therefore a value between 0 and 100 percent inclusive (that is, $0 \leq \alpha \leq 1$). Equivalence between the two tax results is reached when $\alpha = \frac{.8t - t^*}{t - t^*}$.[156] Because $.8t > t^* \geq 0$, the numerator of the right hand side of the condition is smaller than the denominator and both are greater than zero at all times. Therefore, equivalence can always be reached for any α between zero and one ($0 < \alpha < 1$), which is within the permissible range for α as the credit portion ($0 \leq \alpha \leq 1$). The exemption portion $1 - \alpha$ would therefore be $\frac{.2t}{t - t^*}$,[157] which clearly bears a defined direct relationship to t^* and, like the credit portion, is also determinable at all times. Therefore, Option Y is a perfect floating combination of exemption and credit and as such is treaty compatible.

2. Minimum Tax Variations—the Altshuler and Grubert Proposal

Altshuler and Grubert would impose a 15 percent per-country minimum tax on foreign-source active income with expensing for real investment in the country and a credit for the effective foreign tax rate up to the 15 percent threshold. They also consider varying the proposal by disallowing the expensing and/or by calculating the minimum tax on an overall, instead of country-by-country, basis.[158] Altshuler and Grubert also envision a reduction in the general corporate tax rate (t) from 35 percent to 30 percent. All variations of this proposal use the same 15 percent

156. $.8t - t^* = \alpha(t - t^*) \Leftrightarrow \alpha = \frac{.8t - t^*}{t - t^*}$.
157. $1 - \alpha = 1 - \frac{.8t - t^*}{t - t^*} = \frac{.2t}{t - t^*}$.
158. Grubert & Altshuler, *supra* note 14.

reduced rate creditability method for "eliminating double taxation," and therefore can all be modeled identically for treaty purposes.

This proposal is a perfect floating combination of exemption and credit. If the effective foreign tax rate is not less than 15 percent, the exemption portion is 100 percent. When the effective foreign tax rate drops below 15 percent, the exemption portion drops below 100 percent in a defined direct relationship to the effective foreign tax rate. When $.15 > t^* \geq 0$, the U.S. tax under the proposal on a taxable \$1 of before-foreign-tax foreign-source active income would be $.15 - t^*$. The U.S. tax on the same \$1 under an outright floating combination of exemption and credit would be $\alpha(t - t^*)$. Equivalence between the two tax results is reached when $\alpha = \frac{.15-t^*}{t-t^*}$.[159] Because $t > .15 > t^* \geq 0$, the denominator is greater than the numerator, and both are greater than zero, which means that $0 < \alpha \leq 1$. Therefore, there will always be a permissible credit portion ($0 \leq \alpha \leq 1$) to satisfy the floating combination of exemption and full credit. Because the floating credit portion (α) bears a defined inverse relationship to t^*, the floating exemption portion, $1 - \alpha = \frac{t-.15}{t-t^*}$, bears a defined direct relationship to t^* and both are determinable at all times. As a result, the Altshuler and Grubert proposal is a perfect combination of exemption and full credit, and therefore is treaty compatible.

3. Reduced Rate with Partial Credit—the Obama Administration Proposal

The Obama administration's proposal would impose a per-country residual minimum tax on covered foreign source business earnings at a rate of 19% reduced (but not below zero) by 85% of the effective foreign tax rate.[160] The proposal, therefore, taxes foreign-source business income at a reduced rate (19%), which is about 54% of the general 35% full corporate tax rate (t), and allows a limited credit for 85% of the foreign taxes paid on that income.

This proposal is a floating combination of exemption and credit. If the effective foreign tax rate is not less than .19/.85 (about 22.35 percent), the exemption portion is 100 percent.

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159. $.15 - t^* = \alpha(t - t^*) \Leftrightarrow \alpha = \frac{.15-t^*}{t-t^*}$.

160. GENERAL EXPLANATION 2016, *supra* note 13; GENERAL EXPLANATION 2017, *supra* note 13.

When the effective foreign tax rate drops below .19/.85, the exemption portion drops below 100 percent in a defined direct relationship to the effective foreign tax rate. When $\frac{.19}{.85} > t^* \geq 0$, the U.S. tax under the proposal on $1 of before-foreign-tax foreign-source business income would be $.19 - .85t^*$. The U.S. tax on the same $1 under an outright floating combination of exemption and credit would be $\alpha(t - t^*)$. Equivalence between the two tax results is reached when $\alpha = \frac{.19-.85t^*}{t-t^*}$.[161] Because $t^* < \frac{.19}{.85} < t$ by definition, the denominator $(t - t^*)$ is always greater than the numerator $(.19 - .85t^*)$ and both are greater than zero. That is, $0 < \alpha \leq 1$ and there will always be a permissible credit portion $(0 \leq \alpha \leq 1)$ to satisfy the floating combination of exemption and credit. Because the floating credit portion bears a defined inverse relationship to t^*, the floating exemption portion, $1 - \alpha = \frac{t-.19-.15t^*}{t-t^*}$, bears a defined direct relationship to t^* and both are determinable at all times. Therefore, the Obama administration's proposal is a perfect combination of exemption and full credit and, as such, is treaty compatible.

4. Reduced Rate Deductibility and Shaviro's Proposal

Shaviro's first suggested method for implementing his proposal, the reduced rate deductibility method, is a harder treaty-compatibility case. Under this method, foreign-source business income would be taxed at a reduced U.S. rate after deducting foreign taxes from the taxable base. If βt is the reduced rate $(0 < \beta < 1)$, the U.S. tax on $1 of before-foreign-tax foreign-source business income would be $\beta t(1 - t^*)$. To reach the same result under a combination of exemption and full credit, the condition $\alpha = \beta t \frac{1-t^*}{t-t^*}$ must be satisfied.[162] The problem here is that when t^* exceeds, within its permissible range $(0 \leq t^* < t < 1)$, a certain value that inversely depends on β, the credit portion α would exit its permissible range $(0 \leq \alpha \leq 1)$ and exceed one.[163] That is, reduced rate deductibility matches a floating combination of exemption and credit for any foreign tax rate that ranges from zero up to a ceiling that inversely depends on the applicable reduced U.S. rate (βt). This result makes sense. Because a credit

161. $.19 - .85t^* = \alpha(t - t^*) \quad \Leftrightarrow \quad \alpha = \frac{.19-.85t^*}{t-t^*}$.

162. $\beta t(1 - t^*) = \alpha(t - t^*) \Leftrightarrow \alpha = \beta t \frac{1-t^*}{t-t^*}$.

163. Because $0 \leq t^* < t < 1$, the fraction $\frac{1-t^*}{t-t^*}$ is always greater than one and increasing in t^*. Therefore, the value for t^* at which $\alpha = \beta t \frac{1-t^*}{t-t^*}$ exceeds one inversely depends on β.

system reduces the home-country tax liability by foreign taxes on a dollar-for-dollar basis, Shaviro describes such a system as having a 100 percent "marginal reimbursement rate" ("MRR") for foreign taxes.[164] As Shaviro notes, however, the MRR for standard exemption or deduction systems is the marginal tax rate ("MTR"), which in the case of exemption is zero.[165] Now, to understand the reduced rate deductibility method, consider first a straightforward combination of exemption and deduction. Under such a system, the exempt portion of foreign-source income is not subject to U.S. taxation, but a U.S. tax at the full rate is imposed on the remaining taxable portion of foreign-source income, determined on an after-foreign-tax basis. The deduction for foreign taxes will have the same effect taken either before or after the bifurcation into the exempt and taxable portions. If the deduction is taken after the bifurcation, however, only the allocable portion of foreign taxes should be allowed as a deduction from the taxable portion.[166] Reduced rate deductibility has the exact same effect: applying a reduced rate to all income is algebraically identical to applying a full rate to part of the income.[167] Therefore, because reduced rate deductibility is effectively a combination of exemption and deduction (with full rate) in proportion to the reduction in the U.S. tax rate, reduced rate deductibility causes the overall MRR to be somewhere between zero (the MRR of the exemption portion) and the full MTR (the MRR of the deductibility portion). A combination of exemption and credit, however, sets the MRR somewhere between zero (the MRR of the exemption portion) and 100 percent (the MRR of the credit portion). As a result, the MRRs of these two combinations

164. *See, e.g.*, SHAVIRO, *supra* note 9, at 11–12, 49.

165. *Id.* at 11–12.

166. If, for example, pretax foreign-source income is $100, the foreign tax rate is $20, and the U.S. tax rate is 35%, a 60%/40% bifurcation may be equally effected either before or after the deduction of the $20 of foreign taxes. If the foreign tax deduction is taken first, 60% of the $80 after-foreign-tax amount (or $48) is exempt and the remaining 40% (or $32) is taxable at the full 35% rate for a total U.S. tax liability of $11.20. If the bifurcation is done first, 60% of the $100 before-foreign-tax amount (or $60) is the exempt portion, and the remaining 40% (or $40) is the taxable portion. Before applying the U.S. tax, the $8 allocable foreign taxes (40% of $20) are deducted for a taxable amount of $32 and a total U.S. tax of $11.20.

167. The same U.S. tax result of $11.20 in the example of footnote 166 is reached by applying a 14% U.S. tax rate (which is 40% of the full 35% rate) to the $80 amount of after-foreign-tax foreign-source income.

may or may not match. With a lower tax rate under reduced rate deductibility, the exemption portion will be higher, the MRR will be closer to zero, and the potential matching range with the exemption-credit combinations will be greater. An absolute match occurs only if the reduced rate (βt) is zero, but then that would become a full exemption system. Therefore, reduced rate deductibility cannot be expressed as a perfect combination of exemption and full credit in all circumstances. This means that there are situations in which reduced rate deductibility does not allow a dollar-for-dollar credit with respect to the fully taxable portion. These situations are those in which the applicable foreign tax rates exceed the above-mentioned ceiling.

If reduced rate deductibility is theoretically not treaty compatible, could it still be practically compatible when, for example, all potential applicable effective foreign tax rates are within the ceiling? For example, with 5%, 8%, or 10% reduced U.S. tax rates (βt), reduced rate deductibility would perfectly match combinations of exemption and credit up to effective foreign tax rates of approximately 31%, 29%, and 28%, respectively. If in reality all relevant effective foreign tax rates were to fall below these ceilings (and that is a question), reduced rate deductibility would perfectly match exemption and credit combinations within the actual foreign tax rate range. Would that make the particular reduced rate deductibility treaty compatible? As noted,[168] in rejecting the government's literal approach for determining whether a foreign tax is creditable, the Supreme Court in *PPL Corp. v. Commissioner* treated a onetime backward-looking U.K. windfall tax as a creditable income tax for U.S. tax purposes because, for nearly all the companies subject to the tax, the windfall tax was the algebraic equivalent of a creditable income tax.[169] As the Court indicated, however, outliers were ignored in light of the legal standard of U.S. Treasury regulation §1.901-2 that creditability is an all or nothing determination that turns on the "predominant character" of a tax.[170] Therefore, even

168. *See supra* note 154 and accompanying text.

169. PPL Corp. v. Comm'r, 133 S. Ct. 1897 (2013).

170. The concurring opinion kept open the question of whether the regulation's all-or-nothing approach means that "a tax's predominant character must be as an income tax for *all* taxpayers," because the government also seemed to be taking a contrary position. *Id.* at 1910.

though the regulation codified a longstanding common law doctrine on creditability,[171] the *PPL Corp.* decision is not sufficient to support an argument that outliers can be ignored also for treaty compatibility purposes. Putting the tax-on-value versus tax-on-income issue aside, it is also doubtful that the Court could have ignored the outliers in *PPL Corp.* if the U.K. windfall tax was not a onetime backward-looking tax. That is so because it is much harder, if at all possible, to determine ex ante whether an "outlier" will remain an outlier or become the standard. Such is the case of the treaty compatibility inquiry of reform proposals. The treaty inquiry is mainly a forward-looking inquiry, which, in the case of reduced rate deductibility, would depend on future effective foreign tax rates.

If, as Shaviro indicates,[172] his proposal can be implemented through Option Z,[173] which is a combination of exemption and full credit, then, based on the analysis of this article, any system that is or can be expressed as a fixed or floating combination of exemption and credit could be designed to implement his proposal in a treaty-compatible manner. The bottom line of Shaviro's proposal in this context is that (i) each of the effective U.S. tax rate and the MTR on foreign-source income should probably be somewhere between zero and the full domestic rate (full MTR) and (ii) while the MRR should be somewhere between 100 percent and zero, if foreign-source income booked in tax havens is suspect of in fact being domestic source income, then the MRR should be somewhere between the MTR and 100 percent.[174] Again, any system that is or can be expressed as a perfect fixed or floating combination of exemption and full credit would have (i) an MTR between zero (the MTR of the exemption portion) and the full MTR (the MTR of the full credit portion) and (ii) an MRR between zero (the MRR of the exemption portion) and 100 percent (the MRR of the full credit portion). Designing the system to effectively have a sufficient credit portion would bring the MRR above the MTR, if one so desires.

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171. Biddle v. Comm'r, 302 U.S. 573, 578–79 (1938); *see PPL Corp.*, 133 S. Ct. at 1901.

172. *See supra* note 17.

173. Although not necessarily with the 60%/40% split.

174. Shaviro, *Crossroads*, *supra* note 10, at 21.

D. Full Rate Deductibility

As demonstrated by Warren,[175] a foreign tax deduction system with a full U.S. tax rate is the equivalent of a partial credit system in which, limitations aside, a credit is given on less than a dollar-for-dollar basis. As discussed above, a partial credit would be a violation of the general credit principle of Article 23(2). Therefore, a move to such a system, which in any event is not really suggested by anyone, would not be treaty compatible.

That a U.S. move to a foreign tax deduction system would not be treaty compatible does not mean that the existing elective foreign tax deduction regime is not treaty compatible. As noted,[176] §§164(a)(3) and 275(a)(4) allow a taxpayer to take a foreign tax deduction instead of a foreign tax credit under §901. Because this foreign tax deduction is elective and the taxpayer may still choose to take a foreign tax credit instead, the United States is in full compliance with its treaty obligations to *allow* a foreign tax credit.[177]

III. WHO CARES ANYWAY?

Even if this article is incorrect about the treaty compatibility of any of the proposals, it seems very unlikely for taxpayers or treaty partners to object to any such moves. Tax treaties and the Code have the same status under U.S. law,[178] and therefore, generally, the later-in-time rule applies.[179] Although permissible under U.S. law, overriding a treaty obligation remains a violation of international law, yet—short of termination—with no practical remedy.[180]

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175. *See generally* Warren, Jr., *supra* note 10.

176. *See supra* note 2.

177. *See also supra* the second paragraph of note 146.

178. *See* U.S. CONST. art. VI, § 2; I.R.C. §§ 894(a), 7852(d).

179. STEINES, *supra* note 27, at 271–73.

180. *Id.*; Avi-Yonah, *supra* note 27. An interesting question is whether a mutual agreement procedure can help an affected taxpayer or the treaty partner in this context. Theoretically, the U.S. competent authority's power to reach any agreement under Article 25 is limited by the Code provision overriding the treaty. I.R.C. §§ 894(a), 7852(d). Although in practice the Treasury and the Internal Revenue Service (IRS) are free to deviate from the dictates of the Code if they do so in favor of the taxpayer (s*ee, e.g.*, Lawrence Zelenak, *Custom and the Rule of Law in the Administration of the Income Tax*, 62 DUKE L.J. 829 (2012)), an interesting question is whether the Treasury and the IRS, as part of the executive branch, could or would effectively restore overridden treaties

If Congress believes, however, that a reform proposal is treaty compatible, its enactment cannot be a treaty override,[181] and an affected taxpayer could then "challenge" the new law by claiming treaty benefits or by initiating a mutual agreement procedure under Article 25's equivalent of that treaty. But, what are the taxpayer's incentives to do so based on the argument that the reform is not compatible with Article 23(2)? If the taxpayer has little to no motivation to do so that would also mean that the harm in a treaty-incompatible reform would be limited to the very serious harm in any violation of international law, but without any direct harm to the affected taxpayer. That would clearly be the case with a move to an exemption system if, for whatever reason, such a move would be considered treaty incompatible. But, what about the other proposals discussed above?

As combinations of exemption and credit, the reform proposals discussed herein (other than the exemption proposal) are generally worse than exemption but better than treaty credit for taxpayers. Therefore, a taxpayer typically would object only if it could secure an exemption result, but that is unlikely to happen because securing an exemption result through Article 23(2) would require limitations under U.S. law that would not exist at the time. That leaves the taxpayer with the only possibility of claiming credit relief under Article 23(2) or its equivalent. But, in the absence of applicable foreign tax credit Code provisions at the time, the United States would grant a principle-based foreign tax credit under the treaty. Such principle-based relief would not include the loopholes in the current foreign tax credit provisions that could make a credit system better for taxpayers than it should be.[182] Therefore, it is highly unlikely for any taxpayer to object to a move to any of the proposals discussed (except for deductibility with the full U.S. rate, an idea that has not been seriously considered).

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through such giveaway deviations. To be sure, a mandatory arbitration procedure, if applicable, is part of the mutual agreement procedure, and an arbitration resolution would constitute a resolution by mutual agreement and, as a result, would also be limited by treaty-overriding Code provisions. *See* U.S. MODEL TREATY, *supra* note 5, art. 25, 25(9)(j).

181. Treaty override seems to be permissible under U.S. law only where the subsequent Code provision or its legislative history clearly indicates an intent to do so. STEINES, *supra* note 27, at 272.

182. *See, e.g.*, J. Clifton Fleming, Jr., Robert J. Peroni, & Stephen E. Shay, *Worse than Exemption*, 59 EMORY L.J. 79 (2009); Bret Wells, *The Foreign Tax Credit War*, BYU L. REV. (forthcoming 2016).

Again, other than terminating the treaty or (if the specific treaty includes such a provision) participating in a mutual agreement procedure that would lead to mandatory arbitration, there is nothing a treaty partner can unilaterally do about a U.S. move to any of the proposals discussed. Termination is too drastic an action to be seriously considered,[183] and a mutual agreement procedure that could lead to mandatory arbitration is unlikely to happen because it requires an initiation either by an affected taxpayer or by another person on a taxpayer-specific basis. Even if a mutual agreement procedure is initiated by or on behalf of a taxpayer, the motivation of a treaty partner to object to any of the reform proposals discussed above is very little. Indeed, beyond resolving the issue of double taxation, which, as noted, is nonexistent with respect to the reform proposals discussed, one reason treaty partners might prefer a U.S. move to an exemption system may be that such a move could make it easier for them to attract U.S. foreign direct investment by lowering their tax rates.[184] But, even in that case, other considerations would still diminish the treaty partner's incentives to pursue a U.S. exemption result. First, the chances of success are slim. Second, a U.S. move to an exemption system may, contrary to their interests, force foreign countries to race to the bottom. Third, a U.S. move from any of the proposals to an exemption system with a zero MRR would increase U.S. taxpayers' cost-consciousness with respect to foreign taxes, including the treaty partner's taxes.[185] Fourth, mutual agreement procedure resolutions, including mandatory arbitration determinations, have no precedential value and are not even published, thereby making a resolution's effect on future foreign direct investment questionable at best. With some opposed interests and slim chances to

183. *See* Avi-Yonah, *supra* note 27.

184. Joel Slemrod, *Effect of Taxation with International Capital Mobility*, *in* UNEASY COMPROMISE: PROBLEMS OF A HYBRID INCOME-CONSUMPTION TAX 115 (Henry J. Aaron, Harvey Galper, & Joseph A. Pechman eds., 1988).

185. Generally, taxpayers are more cost-conscious with respect to their foreign taxes under a home-country exemption system than they are under a home-country credit system without deferral. *See* SHAVIRO, *supra* note 9, at 51–53; Fadi Shaheen, *On Fixing U.S. International Taxation*, 9 JRSLM. REV. LEGAL STUD. 125, 128–30 (2014). Because all proposals discussed above would also eliminate deferral, the smaller the credit component in any proposal that combines exemption and credit the more cost-conscious U.S. taxpayers would be with respect to their foreign taxes.

reach a desired result, taxpayers' and treaty partners' motivations to object to any of the reform proposals discussed are seemingly negligible.

CONCLUSION

This article addresses the treaty compatibility aspect of proposals for reforming the U.S. international tax system. Finding that a reform proposal is treaty compatible obviates the need for renegotiating or overriding existing U.S. treaties to implement the proposal if enacted. After establishing that a U.S. move to an exemption system would be treaty compatible despite the literal reading of Article 23 of the U.S. Model Treaty as requiring a credit system, the article argues that any system that is or can be expressed as an outright fixed or floating combination of exemption and credit is treaty compatible regardless of how it is actually labeled or expressed. Article 23(2) of the U.S. Model Treaty subjects the U.S. credit obligation to limitations of U.S. law as may be amended without changing the general principle of Article 23(2). The argument of this article is that any tax system that is or can be expressed as an outright fixed or floating combination of exemption and credit is treaty compatible because such a system is but a post-treaty amendment that does not change the general principle of Article 23(2)—namely, the principle of allowing a dollar-for-dollar reduction (but not below zero) in the amount of U.S. tax on U.S.-taxable foreign-source income by the amount of foreign taxes paid, which can be applied on an overall basis, item-by-item basis, or any basis in between. The article also algebraically demonstrates, by employing a uniform method, that most recent proposals for reforming the U.S. international tax system are, or can be expressed as, perfect fixed or floating combinations of exemption and credit, and therefore are treaty compatible. The article then explains why it is unlikely that taxpayers or treaty partners would object to the enactment of any such proposals even if they were not treaty compatible.