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An Examination of the O.E.C.D. and U.N. Model Tax Treaties: History, Provisions and Application to U.S. Foreign Policy

Donald R. Whittaker*

I. Introduction

This article examines the roles of treaties in the field of international taxation and the uses which such treaties might have in United States foreign policy. International tax treaties were developed to avoid the assertion of taxing jurisdiction by more than one country over the same person or item of income. Tax treaties attempt to provide a rational solution to the problems of such double taxation. In addition, tax treaties provide a cogent operating base for two nations dealing with tax problems: they define the terms that are a part of the operative provisions of the treaty and generally provide a commentary to the text of the treaty. Most treaties also include statements that assure nondiscriminatory treatment between residents of the signatory jurisdictions. Recent treaties have also begun to include procedures for consultation between the taxing authorities of the two countries and procedures for the exchange of tax information.

Because of the need for international conformity among tax treaties, the League of Nations first sponsored several groups of experts who drafted model treaties.¹ Those drafters and their model treaties were later used by the Organization for Economic Co-operation and Development (OECD) in drafting its influential model treaty in 1963 (OECD Model).² The OECD Model, which was revised and amended in 1977,³ has served as a working model for the developed European and North American countries for the last two decades. In the early 1970's, the United Nations (U.N.) instituted a similar drafting session to develop a model tax treaty, but the U.N. goal was to write guidelines adaptable to

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¹ *See, e.g.*, Report by the Government Experts on Double Taxation and Evasion of Taxation Annex I, League of Nations Doc. F. 50. 1923 II (1923).

² Organization for Economic Co-operation and Development, Draft Double Taxation Convention on Income and Capital (1963) [hereinafter cited as 1963 OECD Draft].

³ Organization for Economic Co-operation and Development, Model Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital (1977) [hereinafter cited as 1977 OECD Model].

tax treaties between developed and developing nations (U.N. Guidelines).⁴ Thus, in the tax treaty arena, two sets of guidelines are available for negotiating tax conventions: the OECD Model and the U.N. Guidelines.

Part I of this article examines some of the basic operative assumptions of tax treaties. In Part II, selected provisions of the OECD Model and the U.N. Guidelines are examined and compared. This examination points out the many similarities and some of the crucial differences between the two drafts, and notes the assumptions that gave rise to each draft. In addition, the United States model tax treaty developed by the Department of the Treasury is also examined.

In the final section of this article, the current United States position on tax expenditures for developing nations is examined. Then, with reference to the provisions of the model treaties, and with a knowledge of the policy which shaped these provisions, a form of foreign aid through tax treaty negotiation is suggested which is both consistent with United States international tax policy and feasible in the current political environment.

II. Basic Operative Assumptions of Tax Treaties

Tax treaties are bilateral conventions which are negotiated between sovereign states for the primary purpose of resolving problems of double taxation.⁵ The problem of double taxation arises from the assertion, by more than one country, of jurisdiction to tax the same item of income. Double taxation of the same item of income occurs since most countries exercise jurisdiction to tax an item of income from two bases—jurisdiction may be asserted because of the source of the income⁶ or because of the residence of the recipient of the item of income.⁷ A third jurisdictional base, exercised in the international arena primarily by the United States, is assertion of the right to tax because of the citizenship of the individual.⁸ An easy illustration of the principle of double taxation may be found in examining the treatment of interest income which is received on a loan by a lender who is a resident in Canada, a citizen of the United States, and which is earned on a loan to a resident of Guatemala. This interest might be taxed in the United States on the receipt of the interest

⁴ Guidelines for the Formulation of the Provisions of a Bilateral Tax Treaty Between a Developing Country and a Developed Country, in *Manual for the Negotiation of Bilateral Tax Treaties Between Developed and Developing Countries*, U.N. Doc. ST/ESA/94 (1979) [hereinafter cited as U.N. Guidelines]. An earlier incomplete version of the Guidelines is also available. See *Guidelines for Tax Treaties Between Developed and Developing Countries*, U.N. Doc. ST/ESA/14 (1974) [hereinafter cited as 1974 Guidelines].

⁵ See *INCOME TAX TREATIES* 1-2 (J. Bischel ed. 1978).

⁶ J. ADAMS & J. WHALLEY, *THE INTERNATIONAL TAXATION OF MULTINATIONAL ENTERPRISES IN DEVELOPED COUNTRIES* 42 (1977).

⁷ *Id.*

⁸ See, e.g., U.S. Treasury Department's Model Income Tax Treaty, art. 1, para. 3, 1 *Tax Treaties (CCH)* ¶ 153 (May 17, 1977) [hereinafter cited as U.S. Model].

payment because of the citizenship of the lender; it might be taxed in Canada because of the residence of the lender; Guatemala might also assert source jurisdiction upon the payment of that interest. Similar situations present this issue of double taxation and tax treaties seek to resolve the problem.

Generally, a country will assert source jurisdiction over items of income which arise within the country. Such source jurisdiction is generally of either of two types when asserted upon a non-resident's income. In one situation, the non-resident individual or entity is present in the tax jurisdiction in a significant and meaningful way—the non-resident may be engaged in business activity in the jurisdiction or performing personal services there. This type of source jurisdiction is a form of *in personam* jurisdiction which is asserted because of participation in the source country's economy. The assertion of jurisdiction reflects a cost-benefit principle and seems to be a fundamentally fair application of the power of taxation.

In the second situation, the non-resident taxpayer has none of the personal connections with the taxing country as he does above, but still receives a specific item of income through the economy of the source country. The most common items of income in such a case would be royalties, interest or dividends. The source country would then assert in *rem* jurisdiction over the items of income and impose a tax regardless of the residency status of the recipient. This assertion of jurisdiction is more difficult to justify because there is not a clear-cut cost-benefit relationship. Rather, the justification of taxation seems to be that the distributing entity, the borrower of money, the corporation, or the licensee, were beneficiaries of government services and the income derived through them should thus be taxed. The economy of a country which is the beneficiary of a loan or corporate investment, however, will generally benefit from the loan or the investment, and for that reason the justification for such in *rem* taxation is weakened.⁹ This reasoning is significant in tax treaty negotiating, particularly among developed countries. Many current treaties exempt interest and royalties from source country tax and dividends are taxed at a reduced withholding rate.¹⁰

In addition to source country jurisdiction, most countries assert domiciliary jurisdiction, which taxes an individual or entity on its residency. Thus, a country will impose an income tax on residents, individuals who bear a relationship to the taxing country. Although different countries define residence in different ways, it is generally construed to include a person living in the country on a more or less permanent basis. The application of the cost-benefit principle of taxation is clear in the

⁹ See INCOME TAX TREATIES, *supra* note 5, at 39 for a discussion of general treaty provisions concerning investment income.

¹⁰ See *infra* discussion accompanying notes 51-72.

case of residents: residents consume government services and should be taxed in order to bear the costs of these services.

Finally, a few countries, particularly the United States, tax the worldwide income of citizens.¹¹ Tax jurisdiction based on citizenship generally is justified by a cost-benefit analysis—a citizen of a country receives the protection of that country regardless of where the citizen resides and should therefore help defray the costs of such protection.

In the case of multinational corporations, it is very difficult to pinpoint a particular country as being the residence or home of the corporation.¹² The application of the cost-benefit analysis fails since such corporations typically consume services in a great number of places. Thus, in determining the residence or citizenship of a multinational corporation, a variety of tests are used. For example, the United Kingdom considers a corporation a resident if it is “managed and controlled” in the United Kingdom.¹³ The United States, however, considers a corporation to be domestic only if it is created or organized in the United States.¹⁴ Thus, a corporation incorporated in the United States and managed in the United Kingdom will be deemed a resident of both jurisdictions. A corporation incorporated in the United Kingdom and managed and controlled in the United States will be a non-resident of both states.

As noted earlier, the dual nature of source jurisdiction may cause income to be taxed by two or more different jurisdictions. One country may tax the income of an enterprise because it was earned by a resident and another country may tax the very same income because its source was within the taxing country's economy. It is also clear, as illustrated above by the United States/United Kingdom corporation, that two countries may claim domiciliary jurisdiction over the same entity. Similarly, because of differences between internal taxing laws, two countries may also claim to be the source of a particular item of income.

Through their internal laws, some countries have begun to deal unilaterally with the problem of double taxation. A variety of methods have been adopted. First, primarily through the codification of international custom, source jurisdiction is generally accorded priority—the domiciliary country does not tax income which has already been taxed at the source. The domiciliary country exempts such income from tax in one of two ways: it may exempt from tax any income which has been subject to a foreign tax or it may reduce its tax on income derived from abroad by the amount of tax imposed by the source country. The former system is generally labelled an “exemption system” and the latter is known as a “foreign tax credit system.” The exemption system is losing popularity,

¹¹ I.R.C. § 61 (1976).

¹² See J. ADAMS & J. WHALLEY, *supra* note 6, at 1-2.

¹³ See INCOME TAX TREATIES, *supra* note 5, at 264, 265 n.185.

¹⁴ I.R.C. § 7701(a)(4) (1976).

despite the fact that a credit system is usually accompanied by a fair amount of regulatory detail.¹⁵ It has been generally a matter of accident and historical antecedent which direction a country took. Only recently has a systematic analysis of both economics and equity altered the approach in many countries.¹⁶

As in the case of many national laws which operate in an international context, both the exemption system laws and the foreign tax credit system laws were found to be inadequate solutions to a complex problem, and double taxation continued to be a problem. In cases where a continued conflict was present between the laws of two nations, tax treaties were negotiated.

In addition to resolving problems of double taxation, tax treaties cover a broad range of topics of interest to a taxing jurisdiction. First, and perhaps foremost, they define terms which are used in the operative provisions of the treaty. Most treaties also include statements which assure nondiscriminatory treatment between residents of the two jurisdictions. Furthermore, recent treaties have also begun to include procedures for consultation between the taxing authorities of the two countries and also procedures for the exchange of tax information. Such procedures are adopted to promote more efficient and effective enforcement of the tax laws.¹⁷

In the early part of the twentieth century, countries in the League of Nations began to believe that a uniform system of tax treaties would aid economic development. To that end, the League of Nations studied a multitude of income tax treaty provisions and developed several model drafts of tax treaties.¹⁸ Two major tax treaty models grew out of the work of the League of Nations—the Mexico Model of 1943 (Mexico draft) and the London Model of 1946 (London draft).¹⁹ The Mexico draft was drawn up during World War II and was basically the work of authors from the Western Hemisphere. As such it represented the views of the less-developed nations toward controversial tax issues, particularly in regard to source jurisdiction.²⁰ The later London draft reflected the

¹⁵ See Surrey, *United Nations Group of Experts and the Guidelines for Tax Treaties Between Developed and Developing Countries*, 19 HARV. INT'L. L.J. 1, 4 (1978). See also I.R.C. §§ 901-908 (West & West Supp. 1982) and accompanying regulations at Treas. Reg. §§ 1-901 to -905 (1982) (as amended). Many practitioners consider these sections, the operative provisions of the U.S. foreign tax credit, to be among the most complex of the Internal Revenue Code.

¹⁶ Surrey, *supra* note 15.

¹⁷ Liebman, *A Formula for Tax-Sparing Credits in U.S. Tax Treaties with Developing Countries*, 72 AM. J. INT'L L. 296, 302 (1978).

¹⁸ See *supra* note 1.

¹⁹ League of Nations Doc. C.88M.88 1946.IIA, London and Mexico Model Tax Conventions, Commentary and Text.

²⁰ The viewpoint of many developing countries has been summarized as follows:

The overwhelming majority [of the Latin American countries] were in favor of taxing income derived from non-residents exclusively at the source in their territories. They preferred the concept . . . of taxing income from any industrial, commercial or agricultural business and from any other gainful activity only in

views of the developed nations.²¹ However, as noted above, the two documents, with their respective commentaries, were published side by side and were the principal guides for tax treaties until the OECD Model²² was published in 1963.

The OECD Model was developed in response to the needs of the developed nations to have a firm and solid treaty base to use in negotiations.²³ Thus, over the past two decades, the OECD Model and its 1977 revision²⁴ has served as a point of negotiation for member nations. Although a number of countries associated with the OECD have entered formal reservations, it would be nearly impossible for a participating state to negotiate a treaty substantially different from the OECD Model. Even the United States Treasury in its published model treaty (U.S. Model)²⁵ has been substantially influenced by the OECD Model.²⁶ Despite the years of work required to develop the OECD draft, however, at least one author has noted its similarity to the 1946 London League of Nations Model.²⁷

In recent years, apparently in response to the preferential bias of the OECD draft toward negotiations between developed nations, the developing nations have sought to promulgate their own model treaty. Through the guidance of the United Nations, an ad hoc group of tax experts met and developed a different set of guidelines for the negotiation of treaties between developed and developing nations.²⁸ In promulgating its own pattern of treaty terms, the United Nations group utilized the OECD Model as a reference only.²⁹

the state where the business or activity is carried out, rather than the traditional principle of where the taxpayer has a permanent establishment.

They contended that the European definition of a permanent establishment was too restrictive and they wanted to reach any activity that gave rise to income.

Carroll, *International Tax Law: Benefits for American Investors and Enterprises Abroad*, 2 INT'L LAW. 692, 708 (1968).

²¹ *Id.*

²² 1963 OECD Draft, *supra* note 2.

²³ At the time of publication of the original OECD Model in 1963, the following countries were OECD members: Austria, Belgium, Canada, Denmark, France, the Federal Republic of Germany, Greece, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. 1963 OECD Draft, *supra* note 2, at 4.

²⁴ 1977 OECD Model, *supra* note 3.

²⁵ U.S. Model, *supra* note 8.

²⁶ See INCOME TAX TREATIES, *supra* note 5, at 5, 59.

²⁷ Carroll, *supra* note 20, at 720.

²⁸ U.N. Guidelines, *supra* note 4.

²⁹ Professor Surrey has summarized the basic orientation of the U.N. group:

When the Group commenced its work, it had before it the 1963 [OECD] Draft Convention. This model was being used by the developed countries as the framework for their negotiations. . . . The developed countries, largely through habit, were also using this OECD model in the negotiations that were commencing in the 1960's with developing countries. However, the developing countries, coming new to these negotiations and without having participated in the formulation of the OECD draft, were rather suspicious of it as a basic guide. Moreover, a number of these countries had a different ideological approach to international tax issues. These attitudes were the impetus for the formation of the U.N. Group

III. The OECD Model and the U.N. Guidelines

This section of the article will examine in detail the major provisions of the 1977 OECD Model Tax Treaty and the United Nations Model Double Taxation Convention Between Developed and Developing Countries (U.N. Model).³⁰ Reference will also be made to the U.S. Model. For historical perspective, provisions from the League of Nations model treaties, both the 1943 Mexico draft and the 1946 London draft, will be examined as well.

Before starting an article by article examination of the 1977 OECD Model and the U.N. Model, it is important to understand the basic approach of each of the two groups in greater detail. A general examination of the OECD Model shows that two themes provide the essential bases for the provisions of the treaty. First, the country where the individual or entity is resident will bear the burden of eliminating double taxation by instituting either a foreign tax credit or by merely exempting foreign source income from taxation altogether. Second, the source country will considerably limit both the extent of its jurisdiction to tax income as it arises at the source and also the rate of tax which is ultimately imposed where jurisdiction is retained.³¹ It must also be realized in examining the OECD Model that it was drafted exclusively by developed countries, primarily European and North American, for use among themselves.³² Thus, in most instances, no thought was given to the problems faced by countries which are essentially capital importers and, as such, source income exporters.

Contrary to the presumptions and assumptions which governed the OECD Model negotiations, the U.N. Guidelines, on which the U.N. Model Treaty is based, were developed specifically with an orientation toward developing nations. Their very title, *Guidelines for the Formulation of the Provisions of a Bilateral Tax Treaty Between a Developing Country and a Developed Country*, indicated the precise purpose and stance which predominated during the formulation of the U.N. Guidelines. In general, the developing nations have echoed one of the major suppositions of

as a focal point for frank exploration of the differing attitudes. The U.N. Group decided the most expeditious way to proceed was to use the *1963 Draft Convention* as a reference for orderly discussion. There was, however, to be no presumption of correctness for the policy positions adopted in that model or for its language and commentaries. The Group also decided that, in addition to its recommendations for guidelines, there should also be developed a full description of the issues that underlay those guidelines, so that countries in considering the guidelines could fully appreciate the issues, factors, and nuances of tax treaty negotiations. The reports therefore contain, in addition to the guidelines recommended, full coverage of the background discussion and summaries of the issues involved in and the bases for the conclusions reached by the Group. As a consequence, the reports offer very considerable guidance to countries desirous of negotiating tax treaties.

Surrey, *supra* note 15, at 6-7.

³⁰ U.N. Doc. ST/ESA/102 (1980) [hereinafter cited as the U.N. Model].

³¹ *Id.* at 8.

³² See *supra* note 23.

the OECD Model: they believe that the country of residence should in fact work to eliminate double taxation either through a foreign tax credit or by exemption.³³ The general stance of the developing countries, however, was to oppose the yielding of source jurisdiction recommended by the OECD Model. It seems somewhat ironic to note that the first major proposition of the OECD is a basic yielding of jurisdiction to source, while the second proposition merely modifies this stance. In effect, the developing countries seek an almost total yielding to source jurisdiction by the country with residence jurisdiction. In the U.N. Guidelines negotiations, then, the important question was really the scope which was to be given to source jurisdiction and what modifications were appropriate. Professor Surrey aptly described the quest that followed:

This focus [on source jurisdiction] compelled, in turn, a full exploration of the factors involved in the appropriate exercise of source jurisdiction. Thus, credit or exemption for foreign source income is seen as a responsibility in international taxation to be accepted by the country of residence. The question then becomes: what, in turn, are the responsibilities in international taxation to be accepted by a country of source, especially when that country is accorded primary jurisdiction?³⁴

The United Nations group wrestled with the problem created by these two opposing views on source jurisdiction. In the final analysis, a compromise viewpoint was reached that in many ways reflected the majority of the goals of each side of the discussion. Thus, the primacy of source jurisdiction was conceded by all, but it did not remain the exclusive criterion of tax jurisdiction.³⁵

A. Coverage of the Treaty

The first important item of any law, including tax treaties, is coverage. The language of both the U.N. Model and the OECD Model, contained in article I, is identical. Both state, "[t]his Convention shall apply to persons who are residents of one or both of the Contracting States."³⁶ Thus, taxation is based on the place of residence of an individual. This concept has gone through several evolutionary stages as evidenced by the commentary to the OECD Model and the language of the Mexico and London drafts. The OECD commentary on article I indicates that "[w]hereas older Conventions in general were applicable to 'citizens' of the Contracting States, recent Conventions usually apply to 'residents' of one or both of the Contracting States, without distinction of nationality."³⁷ The earlier League of Nations drafts were much broader in their applicability than the OECD Model, covering "taxpayers of the Con-

³³ 1974 Guidelines, *supra* note 4, at 7 para. 30; U.N. Guidelines, *supra* note 4, at 91-92.

³⁴ Surrey, *supra* note 15, at 9.

³⁵ 1974 Guidelines, *supra* note 4, at 7 para. 28.

³⁶ U.N. Model, *supra* note 30, art. 1; 1977 OECD Model, *supra* note 3, art. 1.

³⁷ Organization for Economic Co-operation and Development, Double Taxation of Income and Capital, 33 (1977) [hereinafter cited as OECD Commentary].

tracting States, whether nationals or not"³⁸ The OECD Model recognizes this historical precedent:

Some Conventions are of even wider scope [than the OECD Model] inasmuch as they apply more generally to 'taxpayers' of the Contracting States; they are, therefore, also applicable to persons, who, although not residing in either State, are nevertheless liable to tax on part of their income or capital in each of them. The Convention is intended to be applied between Member countries of the OECD and it has been deemed preferable for practical reasons to provide that the Convention is to apply to persons who are residents of one or both of the Contracting States.³⁹

The OECD Commentary, article I, para. 11, notes an important conceptual difference in taxation between OECD member countries. This paragraph, a reservation, states, "The United States reserves the right to tax its citizens and residents (with certain exceptions) without regard to the Convention."⁴⁰ This reservation underscores an important policy difference between the United States and most members of the international community. The United States has unilaterally, and without exception, refused to yield the right to tax the income of its citizens. This stance is reflected in the U.S. Model, which provides as follows:

Notwithstanding any provision of this Convention except paragraph 4 of this Article, a Contracting State may tax its residents . . . and by reason of citizenship may tax its citizens, as if this Convention had not come into effect. For this purpose the term 'citizen' shall include a former citizen whose loss of citizenship had as one of its principal purposes the avoidance of income tax, but only for a period of 10 years following such loss.⁴¹

One of the basic policy reasons for the above reservation is the importance accorded citizenship by the United States. Economic factors, however, also seem to predominate. Retaining tax jurisdiction over citizens discourages a wealthy U.S. citizen from establishing his permanent residence in a low tax rate country and thus obtaining substantial income tax relief because of a tax treaty provision. Also, concern for "flight" of the dollar and the preponderance of tax haven countries mitigates toward retaining tax jurisdiction over citizens.⁴²

Articles 2 and 3 of the U.N. Model and the OECD Model are identical. Both articles are definitional. Article 2 defines those taxes that are

³⁸ See League of Nations Fiscal Committee, London and Mexico Model Tax Conventions Commentary and Text Annex, Model Bilateral Convention for the Prevention of the Double Taxation of Income, League of Nations Doc. C.88.M.88.1946.II.A. (1946); League of Nations Fiscal Committee, London and Mexico Model Tax Conventions Commentary and Text Annex, Model Bilateral Convention for the Prevention of the Double Taxation of Income (Mexico Draft) art. I, League of Nations Doc. C.88.M.88.1946.II.A. (1946) [hereinafter cited as Mexico Draft]; *id.*, Model Bilateral Convention for the Prevention of the Double Taxation of Income and Property (London Draft) art. I [hereinafter cited as London Draft].

³⁹ OECD Commentary, *supra* note 37, at art. I para. 1.

⁴⁰ *Id.* para. 11.

⁴¹ U.S. Model, *supra* note 8, art. 1 para. 3.

⁴² Kragen, *Double Income Taxation Treaties: The O.E.C.D. Draft*, 52 CAL. L. REV. 306, 310-11 (1964).

covered by the treaty. Article 3 defines certain terms of art, including "person," "company," "enterprise," and "international traffic."⁴³

Since article 1 of each treaty places a significant emphasis on the term "resident," its definition has been accorded an entire article in both treaties. Article 4 of the OECD Model provides as follows:

Fiscal Domicile

1. For the purpose of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature

2. Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then his status shall be determined in accordance with the following rules:

(a) He shall be deemed to be a resident of the Contracting State in which he has a permanent home available to him. If he has a permanent home available to him in both Contracting States, he shall be deemed to be a resident of the Contracting State with which his personal and economic relations are closest (centre of vital interests);

(b) If the Contracting State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either Contracting State, he shall be deemed to be a resident of the Contracting State in which he has a habitual abode;

(c) If he has an habitual abode in both Contracting States or in neither of them, he shall be deemed to be a resident of the Contracting State of which he is a national;

(d) If he is a national of both Contracting States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident of the Contracting State in which its place of effective management is situated.⁴⁴

The only significant difference between article 4 of the OECD Model and article 4 of the U.N. Model is that the second sentence of the first paragraph of the OECD Model is omitted in the U.N. Model.⁴⁵ This sentence provides that the term resident does not include "any person who is liable to tax in that State in respect only of income from sources in that State of capital situated therein."⁴⁶ In a country which asserts only source jurisdiction, this language would characterize certain residents, particularly diplomats, as non-residents. Such a characterization would then deprive these residents of the benefits of the treaty. Insertion of the sentence would be appropriate if both countries tax residents on a world-wide basis.

The United States has entered a reservation to the OECD Model that is reflected in the U.S. Model. A company which is a resident of

⁴³ U.N. Model, *supra* note 30, arts. 2, 3; 1977 OECD Model, *supra* note 3, arts. 2, 3.

⁴⁴ 1977 OECD Model, *supra* note 3, art. 4.

⁴⁵ U.N. Model, *supra* note 30, art. 4.

⁴⁶ 1977 OECD Model, *supra* note 3, art. 4.

both Contracting States is treated as a resident of the state in which it is organized.⁴⁷ This employs a mechanical objective test of residency which seems superior to the subjective test employed by the OECD. One potential drawback of this test, however, is that a company can be a resident of both states under paragraph 1 of article 4 of the U.S. Model, but because of incorporation in a non-contracting state, not a resident of either under paragraph 3. This problem is more effectively dealt with under the OECD language.

The final definitional articles of the OECD and U.N. Models deal with the definition of a "permanent establishment."⁴⁸ The major difference between the two treaties involves the range of activities encompassed in the term "permanent establishment."⁴⁹ The concept of a permanent establishment is essentially jurisdiction limiting, and any excluded activity remains untaxed in the host country. The U.N. drafters, at the impetus of the developing countries, sought to expand the scope of activities encompassed in the definition. The group expanded the limits of source jurisdiction to the extent that some activities that were excluded by the OECD definition were included in the U.N. Model.

B. Treatment of Immovable Property

The taxation of income from immovable property is dealt with in a traditional manner. In both the OECD Model and the U.N. Models, article 6 states that income from immovable property is taxable in the state where the property is located. The U.S. Model is in accord.⁵⁰ Both the Mexico and London drafts also take this stance, and perhaps phrase the matter most succinctly in article II: "Income from real property shall be taxable only in the State in which the property is situated."⁵¹ This uniformity of position is probably the result of a consistent view of in rem taxing jurisdiction by the developed countries, and a preference for source jurisdiction by the developing countries. Textually, neither the OECD Model nor the U.N. Model indicates whether tax should be imposed on gross or net income, but the U.N. Guidelines note that "the taxation of income . . . should have as its appropriate objective the taxation of profits rather than gross income."⁵² This appears to be a concession to developed countries which believe that expenses should be offset in taxing such income.

⁴⁷ U.S. Model, *supra* note 8, art. 4 para. 3.

⁴⁸ See generally Income Tax Treaties, *supra* note 5, at 208-245.

⁴⁹ *E.g.*, a building site is considered a permanent establishment under the OECD Model if it lasts more than 12 months. 1977 OECD Model, *supra* note 3, art. 5 para. 3. The U.N. Model shortens this period to 6 months. U.N. Model, *supra* note 30, art. 5 para. 3.

⁵⁰ U.S. Model, *supra* note 8, art. 6.

⁵¹ Mexico and London Drafts, *supra* note 38, art. II. These articles literally apply to real property only, in contrast to the broader category of "immovable" property.

⁵² U.N. Guidelines, *supra* note 4, at 53.

C. *Taxation of Dividends*

The taxation of dividends generated by a corporation in one country and paid to a citizen of another country has been a consistent concern of tax treaties. The Mexico draft is quite straightforward in its source jurisdiction over dividends: "income from movable capital shall be taxable only in the Contracting State where such capital is invested."⁵³ In contrast, the London draft taxes dividends only at the fiscal domicile of the company that is paying the dividends.⁵⁴ An exception is made, however, when the company in one Contracting State has a "dominant participation in the management of capital of the company paying dividends." In that case the dividends are exempt from tax in the state of source.⁵⁵ The OECD model takes a slightly different approach to the problem of dividend taxation. It proposes taxation by the country when the company is a twenty-five or greater percent subsidiary of the company paying dividends; in all other cases, a fifteen percent limit on withholding tax is utilized.⁵⁶ The U.S. Model approach to the taxation of dividends is identical to that of the OECD Model, except that the five percent rule becomes applicable if the parent owns only ten percent of the subsidiary paying dividends.⁵⁷

The U.N. Model adopts a compromise view of the above drafts. Article 10, which directs the taxation of dividends, allows both the country of source and the country of residence to tax dividends from investments in the source country.⁵⁸ The major differences between the OECD Model and the U.N. Model relate to the withholding rate and the percentage of ownership which is considered direct investment. The U.N. Model, rather than fixing uniform rates for all parties, leaves the rate open to negotiation between the two states.⁵⁹ The Guidelines state that this allows the two Contracting States to "work out through negotiation the appropriate level of withholding rates on dividends . . . that [i]s conducive to the movement of investment capital desired, considering the basic corporate taxes in the two countries and the double-taxation relief offered by the negotiating residence countries."⁶⁰ This stance was acceptable to the developing countries since it tends to aid the investor of capital and does not add revenue to the government of the residence country.

D. *Treatment of Interest*

The various models treat interest in a manner similar to dividends. The Mexico draft language of article IX, which provides that "[i]ncome

⁵³ Mexico Draft, *supra* note 38, art. IX.

⁵⁴ London Draft, *supra* note 38, art. VIII para. 1.

⁵⁵ *Id.* para. 2.

⁵⁶ 1977 OECD Model, *supra* note 3, art. 10 paras. 1, 2.

⁵⁷ U.S. Model, *supra* note 8, art. 10 paras. 1, 2.

⁵⁸ U.N. Model, *supra* note 30, art. 10 paras. 1, 2.

⁵⁹ *Id.* para. 2.

⁶⁰ 1974 Guidelines, *supra* note 4, at 41.

from movable capital shall be taxable only in the Contracting State where such capital is invested," is, of course, applicable to interest payments as well as to dividends. Thus, the treatment under the Mexico draft is wholly a source-based test. The London draft, in article IX, takes a contrary view on the taxation of interest:

1. Interest on bonds, securities, notes, debentures or on any other form of indebtedness shall be taxable only in the State where the creditor has his fiscal domicile.
2. The State of the debtor is, however, entitled to tax such interest by means of deduction or withholding at source.⁶¹

The OECD Model has further developed the theme enunciated in the London draft. Following the lead of the London draft, the OECD Model allows interest to be taxed in the state where the recipient is resident. Additionally, as in the London draft, the source country may tax the interest through withholding, but it must limit the rate to ten percent.⁶² However, if the beneficial owner of the interest carries on business in the other state through a permanent establishment, and the debt on which the interest is being paid is effectively connected with this permanent establishment, the rules regarding interest are not applied, and the business profits or personal services rules apply.⁶³ Furthermore, if a special relationship exists between the payer and the beneficial owner of the interest, and the interest payments are excessive, the excessive amount will not be taxed under the interest provisions of the treaty.⁶⁴ This last qualification reflects a theory of allocation of income similar to section 482 of the United States Internal Revenue Code.⁶⁵ The U.S. Model is quite similar to the OECD Model, except that it contemplates exclusive jurisdiction by the residence jurisdiction and does not provide a withholding rate.⁶⁶ The other provisions are essentially identical to those of the OECD.

In taxing interest, the U.N. draft follows the same guidelines that are present in the taxation of dividends. Both the source jurisdiction and the residence jurisdiction may tax the interest payments. The rate of withholding is left open for negotiation between the two Contracting States.⁶⁷

⁶¹ London Draft, *supra* note 38, art. IX.

⁶² 1977 OECD Model, *supra* note 3, art. 11 paras. 1, 2.

⁶³ *Id.* art. 4.

⁶⁴ *Id.* art. 6.

⁶⁵ I.R.C. § 482 (1976) (giving Secretary of Treasury power to allocate income, deductions, credits, or allowances in order to prevent tax evasion or to clearly reflect actual income).

⁶⁶ U.S. Model, *supra* note 8, art. 10.

⁶⁷ U.N. Model, *supra* note 30, art. 11 paras. 1, 2. The U.N. Group of Experts wrote the following guidelines to be used in negotiating the withholding rate:

- (a) In the absence of treaties, both the country of source and the country of the lender may tax the interest, subject to whatever unilateral double-taxation relief is granted by the country of the lender. In bilateral negotiations, there normally will be consideration of those two claims to taxation and the negotiations may accommodate those claims to the extent agreed upon;
- (b) The country of source, if establishing a withholding tax on gross interest

The U.N. Group of Experts used similar schemes of net interest payments and net dividend payments in the respective articles on interest and dividends. This reflects the process of negotiation that was an important part of formulating the U.N. Guidelines. It is probable that the developed nations started from the unilateral position of the London draft that dividends should be taxable only in the residence jurisdiction. Likewise, the language of the Mexico draft, favoring exclusive source jurisdiction, was urged by the developing nations. The developed nations' position was weakened by the language of the OECD Model. The final position of the U.N. draft, negotiating interest rates and allowing both countries taxing jurisdiction, is a viable compromise. Negotiating to determine net interest rather than gross interest allows for variations in the costs of doing business in various States.

E. Treatment of Royalties

The conflict between source jurisdiction and residence jurisdiction is also evident in the treatment of royalties. The Mexico draft adopts a strict source jurisdiction taxing mechanism:

1. Royalties from immovable property or in respect of the operation of a mine, a quarry, or other natural resource shall be taxable only in the Contracting State in which such property, mine, quarry, or other natural resource is located.
2. Royalties and amounts received as a consideration for the right to use a patent, a secret process or formula, a trademark or other analogous right shall be taxable only in the State where such right is exploited.⁶⁸

The London draft adopts source jurisdiction for royalties paid for the exploitation of natural resources, but adopts a strict residence jurisdictional stance concerning royalties for intangibles:

2. Royalties derived from one of the Contracting States by an individual, corporation or other entity of the other Contracting State in consideration for the right to use a patent, a secret process or formula, a trademark or other analogous right, shall not be taxable in the former State.

in a tax treaty, would, from the standpoint of the effect of expenses, presumably seek a rate that approximated the result which would apply, either over-all or by loan categories, under taxation at regular rates, but on net interest;

(c) From the approach indicated in paragraph (b), if an expense ratio were agreed upon in fixing the gross rate, it would appear to follow that the country of the lender, if following a credit method, would apply that expense ratio as the basis for determining its credit, whenever feasible. Therefore, the matter should be considered under article 23;

(d) Where this general approach to the taxation of interest resulted in a source tax higher than the credit allowed in the country of the lender because of a difference in tax rates, the source country would, in bilateral negotiations or otherwise, take that situation into account in establishing the final rate;

(e) Nothing in the foregoing would oblige the country of the lender to allow a credit equal to the regular rate of net income of the source country; the credit would be fixed in bilateral negotiations.

1974 Guidelines, *supra* note 4, at 45-46.

⁶⁸ Mexico Draft, *supra* note 38, art. X.

4. Royalties derived from one of the Contracting States by an individual, corporation or other entity of the other Contracting State, in consideration for the right to use an artistic, scientific or other cultural work or publication shall not be taxable in the former State.⁶⁹

Treatment of royalties under the OECD Model is identical to that of the London draft: "Royalties arising in a Contracting State and paid to a resident of the other Contracting State shall be taxable only in that other State."⁷⁰ This exclusive residence jurisdiction is waived if the property or right which gave rise to the royalty payment is effectively connected with a permanent establishment in the country of the licensee.⁷¹ The OECD Model also includes know-how sales as a right which is taxed under the royalty provisions.⁷² The final paragraph provides for arm's length dealing in the case of royalties, and declares that tainted transactions will be reallocated.⁷³

Royalties are treated under article 12 of the U.N. Model:

1. Royalties arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2. However, such royalties may also be taxed by the Contracting State in which they arise and according to the laws of that State, but if the recipient is the beneficial owner of the royalties, the tax so charged shall not exceed . . . percent (the percentage is to be established through bilateral negotiations) of the gross amount of the royalties. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.

3. The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific work including cinematograph films, . . . , any patent, trademark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial, or scientific equipment, or for information concerning industrial, commercial, or scientific experience.⁷⁴

In the same manner that the U.N. group reached a compromise on interests and dividends, it also reached a compromise on the subject of taxation of royalties. The article on royalties allows both the source and the residence country to tax royalties and, again, the rates are to be determined by negotiation rather than by having a fixed rate imposed.

F. Capital Gains Treatment

Capital gains are another source of income dealt with under the treaties. The OECD Model addresses capital gains in article 13:

1. Gains derived by a resident of a Contracting State from the

⁶⁹ London Draft, *supra* note 38, art. X.

⁷⁰ 1977 OECD Model, *supra* note 3, art. 12 para. 1.

⁷¹ *Id.* para. 3.

⁷² *Id.* para. 2.

⁷³ *Id.* para. 4.

⁷⁴ U.N. Model, *supra* note 30, art. 12.

alienation of immovable property referred to in Article 6 and situated in the other Contracting State may be taxed in that other State.

2. Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or a movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such fixed base, may be taxed in that other State.

3. Gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport or movable property pertaining to the operation of such ships, aircraft or boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

4. Gains from the alienation of any property other than that referred to in paragraphs 1, 2 and 3, shall be taxable only in the Contracting State of which the alienator is a resident.⁷⁵

This language, almost by omission, exempts gains of a non-resident derived from the sale of property, unless the gains are realized on the sale of real property or in connection with the sale of the business property of a permanent establishment. The U.S. Model takes an almost identical approach.⁷⁶

The U.N. Model is similar to the OECD Model except that the paragraph 4 catch-all exemption of unenumerated property was modified. Article 13, paragraph 4 provides that “[g]ains from the alienation of shares of the capital stock of a company the property of which consists directly or indirectly principally of immovable property situated in a Contracting State may be taxed by that State.” Paragraph 5 provides another basis for source jurisdiction: “Gains from the alienation of shares other than those mentioned in paragraph 4 representing a participation of . . . per cent (the percentage is to be established through bilateral negotiation) in a company which is a resident of a State may be taxed in that State.” These two modifications were added at the insistence of various groups. Developed countries were unhappy with the total exemption of sales of stock in the case where the basic asset of the corporation was real property located in the state; to avoid Article 6 taxation of immovable property under the OECD Model, nonresident aliens needed merely to place the real property in a corporate entity. The second additional basis of jurisdiction reflects similar concerns. It imposes a tax on the sale of a given percentage of participation in a company by the country where the company is resident, such percentage to be determined by bilateral negotiation.⁷⁷

⁷⁵ 1977 OECD Model, *supra* note 3, art. 13.

⁷⁶ U.S. Model, *supra* note 8, art. 22.

⁷⁷ Surrey, *supra* note 15, at 42.

G. *Taxation of Personal Services*

The taxation of personal services has been a constant issue in international tax. Both the Mexico and London drafts contain substantially identical provisions for the taxation of personal services. The League of Nations drafts tax income from personal services in the State where the services are rendered. An exemption is granted, however, when the employee who is a resident of the one country works in the other country for less than 183 days. If he is in the other country for more than 183 days, he is taxable only in that country and his liability to the former country ceases. A professional is taxable only in the state where he has a permanent establishment. If the professional has a permanent establishment in each state, he is taxable in each state only on the income for services rendered there.⁷⁸

The OECD Model divides services into two types: independent and dependent.

Independent Personal Services

1. Income derived by a resident of a Contracting State in respect of professional services or other activities of an independent character shall be taxable only in that State unless he has a fixed base regularly available to him in the other Contracting State for the purpose of performing his activities. If he has such a fixed base, the income may be taxed in the other State but only so much of it as is attributable to that fixed base.

2. The term "professional services" includes especially independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants.⁷⁹

Dependent Personal Services

1. Subject to the provisions of Articles 16, 18 and 19, salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.

2. Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:

(a) the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in the fiscal year concerned, and

(b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the other State, and

(c) the remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other State.

3. Notwithstanding the preceding provisions of this Article, remuneration derived in respect of an employment exercised aboard a ship or aircraft operated in international traffic, or aboard a boat engaged in

⁷⁸ Mexico Draft, *supra* note 38, art. VII; London Draft, *supra* note 36, art. VI.

⁷⁹ 1977 OECD Model, *supra* note 3, art. 14.

inland waterways transport, may be taxed in the Contracting State in which the place of effective management of the enterprise is situated.⁸⁰

The U.N. Model's versions of these two articles are virtually identical. The U.N. Model allows taxation by the "other Contracting State" in two additional instances—when independent personal services are rendered by a resident of a Contracting State: when his stay in the other Contracting State exceeds 183 days, or if his remuneration for services exceeds a certain negotiated amount.⁸¹ Again the U.N. Model and Guidelines have placed a premium on the value of negotiation; in this case, if the payment for services exceeds a certain negotiated amount, then both states can tax a portion of the remuneration.

The U.S. Model is similar to the OECD Model, except that like the U.N. Guidelines, it also permits taxation in the "other State" if the individual is present there for an aggregate amount of time exceeding 183 days. The provisions of article 15 are substantially identical to those of article 15 of the OECD Model.

IV. U.S. Foreign Policy Considerations

With the completion of the U.N. Guidelines, the United States Treasury should begin to re-examine its policies in light of those adopted by the United Nations. In this portion of the article, an examination of the current United States position on tax expenditures to developing nations will be made, as well as an examination of treaties that reflect the current positions of several other developed nations that have extensive dealings with developing nations. Finally, policy reformulations that might be made by the Treasury that would not be inconsistent with its current positions will be considered.

At this point, the United States offers no special tax incentives for United States residents to invest in developing countries, nor does it offer any special tax-sparing for, or tax-sharing with, developing countries. Prior to 1976 certain benefits did exist for investment in "less developed countries." The provisions, which were repealed, included a favorable computation of the foreign tax credit with respect to dividends that were received from corporations in less developed countries. The formula computation allowed the U.S. corporate taxpayer a deduction for all of the foreign tax that was paid as well as a credit for a percentage of that tax.⁸²

A second provision that was eliminated was a portion of the capital gains tax under section 1248 of the Internal Revenue Code. Prior to 1976, the Code exempted from taxation earnings and profits accumu-

⁸⁰ *Id.* art. 15.

⁸¹ U.N. Model, *supra* note 30, art. 14; U.N. Guidelines, *supra* note 4, at 81.

⁸² I.R.C. § 902(b) (1963) (amended 1976). The Senate Report on the Tax Reform Act of 1976 reflects an interest in uniform treatment of U.S. corporate taxpayers. S. Rep. No. 938, 94th Cong., 2d Sess. 244 (1976). The amendment of § 902(b) was predicted to result in an estimated increase of \$64 million in budget receipts in fiscal year 1977 alone. *Id.* at 243.

lated by a foreign corporation while it was incorporated in a less developed country, as long as the stock had been held for more than ten years.⁸³ Under section 954, foreign base company income did not consist of dividends and interest received from, or gains realized from, the sale of qualified investments in less developed countries if the amount of the gain was offset by other investments in developing countries. This deferral provision was repealed in 1975.⁸⁴ Other, less important provisions that benefited investors in developing countries were also repealed. At this point, the United States offers no special tax incentives for investing in developing countries.

The only current U.S. concession to foreign investment is deferral of taxation until either dividends are remitted to shareholders or the stock is sold.⁸⁵ As long as the corporation continues to invest its profits in foreign operations and does not remit them to shareholders, no U.S. tax is imposed. Deferral does not inure solely to the benefit of developing countries, however. As a policy incorporated in the Internal Revenue Code, deferral is available for any foreign investment. Deferral also allows corporations to take advantage of local tax holidays by not remitting income until the tax holiday is exhausted.

The international tax policy of the United States is one of capital export neutrality. It is characterized by deferral of foreign base income until such income is remitted. Export neutrality is defined as neutrality among firms regardless of location; both foreign and domestic corporations will pay the same rate of tax.⁸⁶

Because of its position supporting capital export neutrality, the United States has not entered into any tax-sparing arrangements with developing countries. A tax-sparing provision would provide corporations with a significant tax incentive for investing in a foreign country. Provisions allowing tax-sparing operate in the following manner:

A tax-sparing credit is a credit granted by a capital-exporting country for the foreign taxes that would have been paid by its taxpayers earning income in a developing country were it not for a tax holiday or special concession accorded as an incentive for economic development. Thus, if the United States were to accede to the tax-sparing principle, it would allow a foreign tax credit not only for foreign taxes actually paid but for certain foreign taxes that have been "spared" by mutually agreed-upon tax concessions.

The reason for the resort to such credits lies in the workings of the foreign tax credit mechanism. If credit is only accorded for taxes actually paid, a tax holiday by a developing country will result in a lower credit commensurate with the lower taxes paid. The lower credit is di-

⁸³ I.R.C. § 1248(d)(3) (1963) (amended 1976).

⁸⁴ *Id.* § 954(b)(1) (repealed 1975). The Senate Finance Committee felt that investment in less developed countries should be encouraged in a more direct manner. S. Rep. No. 938, 94th Cong., 2d Sess. 228-29 (1976).

⁸⁵ *See, e.g.*, I.R.C. § 1248 (1976).

⁸⁶ Anthoine, *Tax Systems of Major Capital Exporting Countries: An Examination of Incentive for Private Investment at Home and in Developing Countries*, 32 TAX L. REV. 323, 349 (1977).

rectly tied to the payment of higher taxes to the U.S. Treasury. Thus, the taxpayer-investor receives little or no benefit at all from the tax holiday. Rather, the U.S. Treasury receives revenue it would not have otherwise obtained in the absence of the holiday.⁸⁷

Other developed countries offer a variety of incentives to encourage private investment in developing countries. France and Germany, through their internal laws, exempt remitted profits of subsidiaries located in developing countries.⁸⁸ Canada also exempts such profits and willingly encourages investment through treaty arrangements.⁸⁹ Tax-sparing treaties have been approved by both England and Japan.⁹⁰ Finally, France, Germany and Japan offer direct tax incentives for investment in developing countries.⁹¹ A cursory examination of the incentives other countries offer clearly indicates that the United States has not followed the general trend in granting incentives toward investment or in giving tax aid to developing countries.

Before examining potential changes in U.S. policy, it is important to realize a shift in general public attitudes toward investment in, and aid to, developing countries. During the 1960s, when a world-wide economic boom was in full swing, investment flow and aid to developing countries were encouraged by the 1962 tax act.⁹² As increased oil prices plunged the world into a recession, concern for inflation, unemployment, and other economic developments at home became more important. Concern for American jobs and a balanced budget caused Congress to repeal most of the 1962 legislation in the 1976 tax reform act.⁹³ Public concern for the fate of developing nations seemed muted following the Southeast Asian crisis, nationalization of American industry in Chile, and manipulation of the oil supply by OPEC. Many countries no longer seemed even to welcome an influx of American dollars. Thus, the push to legislate for tax incentives for investment or tax aid for developing nations currently lacks popular political support.

With these attitudes in mind, an examination of possible changes takes on a different focus. Changes in the structure of the Internal Revenue Code that would benefit developing countries would be politically unfeasible. First, such changes would be viewed as subsidies to large corporations. Second, as outlined above, aid to developing nations is not a popular political topic; more and more Americans see such aid as counter-productive, particularly if it involves even a potential loss of American jobs. Thus, an overall legislative overhaul seems out of the question. The remaining method of using the tax system for aid to a developing nation is the tax treaty. The major advantages of a tax treaty

⁸⁷ Liebman, *supra* note 17, at 306.

⁸⁸ Anthoine, *supra* note 86, at 327.

⁸⁹ *Id.* at 330.

⁹⁰ *Id.* at 343-47.

⁹¹ *Id.* at 353.

⁹² Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960.

⁹³ Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520.

are obvious—the provisions are negotiated and can be varied from country to country; negotiation is discretionary so that incentives may be granted only to countries that have established favorable relationships with the United States; and treaties may be terminated on six months notice.⁹⁴

Under a strict economic analysis, tax-sparing provisions in a treaty offer the most valuable tax incentives for an American corporation to invest in a developing country. From a political standpoint, however, tax-sparing treaties are unpopular. The tax exemption of income earned in a developing country would alter the relative tax burden of foreign and domestic taxpayers in an undesirable way; it is inconsistent with foreign tax credit policies, which seek to maintain uniformity in the tax burden imposed on domestic and foreign earned income. Tax-sparing provisions also inure directly to the benefit of the corporation rather than to the country itself.⁹⁵ In addition, the United States Senate has once refused to ratify a treaty which contained tax-sparing provisions.⁹⁶

The final alternative for aiding developing countries through a tax mechanism is found in the terms of the U.N. Guidelines. In its suggestions for negotiating treaties with developing nations, the United Nations draft relies heavily on two concepts: primacy of source jurisdiction and the value of negotiating withholding rates. These two concepts, which are not at all foreign to United States tax policy, offer a valuable foreign aid device: tax-sharing.

Conceptually, the yielding of source jurisdiction is already a basic standard in U.S. foreign tax policy. Both the tax credit, which is part of U.S. internal laws, and the treaties to which the U.S. is party emphasize the primacy of source jurisdiction. A yielding of source jurisdiction on the items of interest, dividends and royalties would be a different posture from that already adopted by the United States, but such tax-sharing is feasible under our internal laws and policies.

In addition to being consistent with the concept of source jurisdiction, manipulating the withholding rate on dividends, interest, and royalties is consistent with capital export neutrality. The higher rate of withholding granted under a tax treaty does not benefit the corporation: rather it benefits the developing nation. The higher withholding tax yields a larger foreign tax credit to the corporation, which is then applied against its tax liability. The tax liability remains unchanged but the Treasury receives fewer tax dollars because of the tax credit.

The most important aspect of a negotiable withholding rate is its flexibility. The revenue loss to the Treasury, the cost of tax-sharing, can be estimated for any specific withholding rate; in negotiating a treaty,

⁹⁴ U.S. Model, *supra* note 8, art. 24.

⁹⁵ Surrey, *International Tax Conventions: How They Operate and What They Accomplish*, 23 J. TAX'N 366 (1965).

⁹⁶ Liebman, *supra* note 17, at 296.

the OECD rates can be used as a base and the amount of foreign aid to be granted through tax-sharing can be determined by adjusting upward from that base. A second advantage to this flexible rate lies in its attractiveness to the developing country. A country granted a high withholding rate will seek out American investors, since the more investors with capital situated there, the higher the taxes shared by the local fisc. The country itself would then be moving toward greater development with minimal foreign intrusion into its domestic affairs.

In addition to maintaining consistency with U.S. tax policy, adopting the U.N. Guidelines provisions on these subjects places U.S. action in conformity with U.N. recommendations. This may be of immeasurable psychological advantage in future dealings with the Third World.

Perhaps the greatest drawback to the adoption of the U.N. Guidelines lies in the adoption of two model tax treaties: the OECD Model and the U.N. Model. Although this will undoubtedly cause conflicts of varying degrees, it is important to note, first, that the U.N. Guidelines were developed from the OECD Model and many of the provisions are identical. Second, treaties with developed nations serve the single purpose of avoiding double taxation. Treaties with developing countries seek not only to avoid double taxation, but to aid the economic development of the nation.

The U.N. Guidelines provisions for interest, dividends and royalties outlined in Part III of this article should be adopted by the U.S. in its negotiations of tax treaties with developing nations. Through tax-sharing, these provisions offer aid to the economic development of the nation and add money to its internal treasuries. Although the provisions directly affect the tax revenues collected by the United States, they offer a form of foreign aid over which the recipient country has direct control.