A nonresident alien individual may reduce his United States federal tax from the thirty percent bracket to zero percent in some cases merely by forming a foreign corporation, which also may be called a treaty corporation, in a foreign country which has a tax treaty with the United States. That individual’s overall tax liability can be further reduced if he incorporates in a foreign country which offers a relatively low tax burden. For some individuals, forming a treaty corporation in a treaty country for tax advantages is an acceptable form of international tax planning. To others, such as the United States Treasury Department (the Treasury), this practice is known as “treaty shopping” and is an unintended benefit of this country’s tax policies.
One provision, Article 16 of the United States Model Treaty\(^6\) (1977 U.S. Model), attempts to deal with the practice of treaty shopping and is the subject matter of this paper. Article 16 excludes treaty corporations from benefits when those corporations enjoy special tax benefits in the treaty country\(^8\) or when those corporations are owned by a substantial number of shareholders who are not residents of either treaty country (third country residents).\(^10\) The first test of exclusion is the "preferred tax rate" test; the second test of exclusion is the "ownership" or "control" test.\(^11\)

In June 1981, the Treasury announced a proposed new draft (the June draft) of Article 16 that apparently responded to the extensive use\(^12\) and abuse of tax treaties by third country residents.\(^13\) The June draft was the most encompassing version of Article 16 ever formulated, because it denied tax treaty benefits to treaty corporations that had borrowed substantial amounts of capital from third country residents.\(^14\) With the announcement of the June draft the Treasury initiated a new period of development in the evolution of Article 16.

After the announcement of the June draft, the United States Senate had an opportunity to indicate its views regarding Article 16 during the ratification process of the Argentina tax treaty.\(^15\) In

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\(^6\) 1 Tax Treaties (CCH) ¶ 153 (May 7, 1977). A model treaty is one that has been announced or adopted by a country, such as the United States Model Treaty, or by an organization, such as either the United Nations Model or the Organization for Economic Cooperation and Development Model. See R. Rhoades & M. Langer, Income Taxation of Foreign Related Transactions 9-14 (1981). Even though the 1977 U.S. Model is a blueprint to be followed rather than an actual treaty, the discussion that follows indicates that United States tax treaties generally conform to the United Nations Model.

\(^8\) The term "treaty country" here means the country with which the United States has a tax treaty.

\(^10\) The term "third country resident" means those foreign individuals or alien corporations that have formed alien corporations in treaty countries, of which they are neither citizens nor residents, in order to utilize the tax treaty benefits of the treaty country. See R. Rhoades & M. Langer, supra note 8, at 11-34.

\(^11\) Id.

\(^12\) 1 Tax Treaties (CCH) ¶ 158 (June 16, 1981). For text of the June Draft's Article 16, see infra note 99. The Chairman of Touche Ross International Tax Specialty Group noted that "... in 1978, $3.9 billion of income was paid to residents of tax treaty countries. ... (representing) 87% of the income earned by foreign persons on U.S. investments. If one assumes a 10% return on investment, this means U.S. investments held by or through treaty country residents totaled at least $39 billion in 1978. ..." Steven P. Hannes, Third Country Use: Is Time Running Out?, 28 Tempo 23 (1983).

\(^13\) Id.

\(^14\) Id.

\(^15\) 1 Tax Treaties (CCH) ¶ 335 (May 7, 1981).
December 1981, after the ratification of treaties with Jamaica and Argentina, the Treasury announced another draft of Article 16 (the December draft).

This paper traces the evolution of Article 16 through the three stages of development during its twenty year history. Through the first stage of the 1960's, the Treasury searched for justifications for adopting Article 16. This paper considers those justifications and examines whether they are valid today. The second stage in the development of Article 16 occurred during the 1970's. This period saw the informal adoption of Article 16, the formal announcement of the 1977 U.S. Model, and the subsequent application of the Model. Finally, the third stage of development of Article 16 is the current transitional period which was initiated with the announcement of the June draft. The current transitional period indicates that the Treasury is reconsidering the tough anti-treaty shopping position found in its June draft.

I. THE FIRST STAGE: IN SEARCH OF JUSTIFICATION

Treaty shopping in its simplest form involves two corporations: a domestic corporation and a treaty corporation, which is an alien corporation organized under the laws of a foreign country that has a tax treaty with the United States. The treaty corporation is owned by a third country resident who is neither a resident nor a citizen of the United States nor a citizen of the other treaty country. If the treaty corporation is considered a resident of the treaty country, an alien corporation will be entitled to the investment returns flowing from the domestic corporation to the alien corporation. This configuration usually results in a greatly reduced United States federal tax on dividends, interest, royalties, and capital gains for the alien corporation. The existence of an Article 16

16 See infra notes 75, 107.
17 See infra note 113.
19 "Domestic corporation" means a corporation "created or organized in the United States or under the law of the United States or of any state." 26 U.S.C. § 7701(a)(4) (1976).
20 Under most treaties, a resident corporation is one organized under the treaty country laws. See e.g., Convention with Respect to Taxes on Income, Extension to Netherlands Antilles, June 24 - Aug. 7, 1952, Nov. 4 - Nov. 10, 1955, United States-Netherlands, art. 11, para. 1(d), 6 U.S.T. 3703, T.I.A.S. No. 3367, Additional Protocol, 15 U.S.T. 1900, T.I.A.S. No. 5665 [hereinafter cited as Netherlands Antilles Convention].
21 Some treaties have allowed reduced rates of taxation for capital gains; this, however, has been curtailed to a great extent by the Foreign Investment in Real Property Tax Act
type provision, however, generally denies the treaty corporation treaty benefits. Benefits are denied under the "preferred tax rate" test where that corporation also enjoys a reduced tax rate in the treaty country and under the "ownership" test where a substantial number of its shareholders are not individual residents of the treaty country. The United States signed four tax treaties during the 1960's, each containing an Article 16 provision. A review of each treaty establishes a framework for understanding the United States policy regarding treaty shopping.

A. Article XV of the Luxembourg Tax Treaty

More than fifteen years before the Treasury announced the 1977 U.S. Model, the United States signed a tax treaty with Luxembourg. That treaty included an Article XV entitled "Holding Companies." Article XV provided that the treaty benefits were subject to compliance with the "preferred tax rate" test and the "ownership" test. It stated that a Luxembourg corporation, taxed at a special reduced rate by Luxembourg, would be unable to enjoy lower United States tax treaty rates. The treaty also provided, however, that a special reduced Luxembourg tax rate for dividends earned in the United States would not affect the lower United States tax treaty rate where the Luxembourg corporation owned twenty-five percent or more of the stock of the United States dividend paying corporation.

Treaty supporters offered three justifications for the special provision in the Luxembourg Tax Treaty. The first justification was based on the Treasury's concern that Luxembourg's tax laws permitted third country residents to escape taxation altogether.


22 There are two variations in the language of Article 16 provisions which require that a certain percentage of shareholders be individual residents from the treaty country. One variation limits third country ownership to no more than twenty-five percent. The other variation directs that seventy-five percent of the treaty corporation ownership be in the hands of treaty country residents. See, e.g., Article 16 of the 1977 United States Model, as discussed at note 8 and accompanying text, and para. 1, subpara. (a) of Article 16 in the June 1981 draft, as discussed at notes 12-14 and accompanying text.


24 Id. art. XV.

25 Id.

26 1 TAX TREATIES (CCH) ¶ 5348 (Dec. 18, 1962). At the hearings for this treaty, the Treasury testified that Luxembourg exempted from all Luxembourg taxes those holding companies which only held investments and did not engage in business nor maintain an office open to the public in Luxembourg. The Treasury argued that since these companies did not pay
ond, supporters argued that the adoption of such a provision would not affect the United States because, at the time, there were not a large number of foreign-based investment holding companies in the United States. Finally, supporters argued that the special provision would not affect the United States balance of payments.\textsuperscript{27}

\section*{B. Article IXA of the Netherlands Antilles Tax Treaty}

A few months after signing the Luxembourg tax treaty, the United States and the Netherlands agreed to extend their 1955 tax treaty to the Netherlands Antilles.\textsuperscript{28} The treaty included a new provision, Article IXA, entitled "Investment or Holding Companies."\textsuperscript{29} As in Luxembourg's Article XV, this provision contained a "preferred tax rate" test and an "ownership" test.\textsuperscript{30} It provided that treaty benefits would be denied to those Netherlands Antilles business entities which enjoyed a lower Netherlands Antilles tax rate.\textsuperscript{31} The treaty also provided, however, that most of the benefits would not be denied where a Netherlands Antilles corporation owned twenty-five percent or more of the stock of the United States paying corporation.\textsuperscript{32} Treaty benefits also would not be denied where all of the stock of a Netherlands Antilles corporation was owned by individual residents of the Netherlands or the Netherlands Antilles, or by the Netherlands corporation.\textsuperscript{33}

\section*{C. Article XI of the Canadian Tax Treaty}

The original Canadian tax treaty provided that the United States could tax United States sources of non-earned income of a Canadian corporation with no permanent establishment in the United States at a maximum rate of fifteen percent.\textsuperscript{34} In 1966, any taxes to Luxembourg, it was not appropriate to grant them the same exemptions granted to those companies that did pay taxes to Luxembourg. \textit{Id.}

\textsuperscript{27} \textit{Id.} A memorandum from the Joint Committee of Internal Revenue Taxation noted that "...since the use of the Luxembourg holding companies to invest in the United States has not been widespread...denial of the convention benefits to those companies should not adversely affect the U.S. balance-of-payments position...." \textit{1 Tax Treaties (CCH), supra} note 26.

\textsuperscript{28} Netherlands Antilles Convention, \textit{supra} note 20.

\textsuperscript{29} \textit{Id.}

\textsuperscript{30} \textit{Id.}

\textsuperscript{31} \textit{Id.} art. IXA(1).

\textsuperscript{32} \textit{Id.} art. IXA(2)(a).

\textsuperscript{33} \textit{Id.} art. IXA(2)(b).

\textsuperscript{34} Convention for the Avoidance of Double Taxation, June 12, 1950, United States-Canada, 2 U.S.T. 2236, T.I.A.S. No. 2347.
however, the treaty was amended to include a “preferred tax rate” provision.\textsuperscript{35} The justifications for signing the amendment to the Canadian tax treaty were the same as those presented for signing Article XV of the Luxembourg tax treaty. Proponents argued that the interaction of the Canadian tax laws and the treaty would permit third country residents to escape taxation altogether\textsuperscript{38} and that the amendment to the treaty would not affect the United States balance of payments.\textsuperscript{37}

D. Article 16 of the Brazilian Tax Treaty

In 1967, the United States signed and ratified a tax treaty with Brazil that never went into effect.\textsuperscript{38} The treaty included an Article 16 provision entitled “Investment or Holding Companies,” which contained the “preferred tax rate” and “ownership” requirements.\textsuperscript{39} The section provided that treaty benefits would be denied if the other participating treaty country granted reduced tax rates and if twenty-five percent or more of the stock of the corporation in question was owned by persons who were not individual residents of the treaty country.\textsuperscript{40} Although this treaty was signed ten years prior to 1977, it was the version adopted in the 1977 U.S. Model, and it became the standard anti-treaty shopping provision until 1981.\textsuperscript{41}

\textsuperscript{35} Id. art. XI(6). The amendment excluded those Canadian corporations that also were exempt from taxation in Canada. Id.

\textsuperscript{36} Tax Conventions with Brazil, Canada, and Trinidad and Tobago: Hearing Before the Comm. on Foreign Relations, 90th Cong., 1st Sess. 2 (1967) [hereinafter cited as Tax Convention]. Professor Stanley Surrey, Assistant Secretary of the Treasury, told the Senate Committee on Foreign Relations that “[t]he proposed convention...would modify the existing...treaty by denying the reduced rate of U.S. withholding tax...to certain...corporations which are nothing more than conduits for investment in the United States by persons who are not residents of...and who would not otherwise be entitled to the benefits of the tax treaty. They are persons whom the tax treaty...was not intended to benefit...The effect of this amendment is to eliminate unintended preferential treatment accorded to persons living outside both countries...resulting from the interaction of...[the treaty]...and domestic law of Canada...” Id.

\textsuperscript{37} Id. Surrey also testified that “there are unlikely to be any adverse consequences...We have explored the questions whether the change might adversely affect the volume of foreign investment in the United States and have concluded that it would not. Alternative portfolio investment opportunities for (non-treaty) residents are limited...” Id.

\textsuperscript{38} 1 Tax Treaties (CCH) ¶ 819 (March 13, 1967).

\textsuperscript{39} Id.

\textsuperscript{40} Id.

\textsuperscript{41} Article 16 of the Brazilian tax treaty reads as follows:

INVESTMENT OR HOLDING COMPANIES

A corporation of one of the Contracting States deriving dividends, interest or roy-
E. Summary and Criticism

A review of these four treaties indicates that the United States primarily concerned itself during the 1960's with the internal tax policies of the treaty countries. The United States believed such attention was necessary to correct an undesirable "loophole" in the internal tax laws of those treaty countries. Arguably, though, the United States should not feel the need to rewrite the tax law of a foreign country which desires to attract foreign investment through tax benefits. Thus, the inclusion of these anti-treaty shopping provisions in the tax treaties was no more than a civilized version of gun-boat diplomacy.

The justifications for the adoption of such provisions merit observation. The United States believed that it was "not appropriate" to grant the same tax treaty benefits to all treaty corporations of a country when some of those treaty corporations were also exempt from the tax laws of the participating treaty country. In fact, that belief was so strong that on at least one occasion the United States urged a foreign country to change its tax laws in

alties from sources within the other Contracting State shall not be entitled to the benefits of Article 12, Article 13, or Article 14 if (a) by reason of special measures granting tax benefits to investment or holding companies the tax imposed on such corporation by the former Contracting State with respect to such dividends, interest or royalties is substantially less than the tax generally imposed by such Contracting State on corporate profits, and (b) 25 percent or more of the capital of such corporation is held of record or is otherwise determined, after consultation between the competent authorities of the Contracting States, to be owned, directly or indirectly, by one or more persons who are not individual residents of the former Contracting State (or, if residents of Brazil, are citizens of the United States).  

Id. See also 1977 U.S. Treasury Department's Model Income Tax Treaty, supra note 8. The Treasury proffered a new justification at the Brazilian treaty hearing for including an anti-treaty shopping provision, arguing that limiting treaty benefits to third country residents helped eliminate double taxation. 1 TAX TREATIES (CCH) ¶ 852 (Mar. 13, 1967). The Treasury also contended that

"the purpose of this provision is to prevent residents of third countries from using a corporation in one treaty country, which is preferentially taxed in that country, to obtain the tax benefits in the other treaty country....This accords with the purpose of an income tax convention between two countries which is to lessen or eliminate the amount of double taxation of income derived from within one country by a resident of the other country...."  Id. At the time this treaty was signed, however, Brazil did not have any law granting reduced rates to any companies. Id. Thus, the Treasury also stated that "at the present time, neither Brazil nor the United States grants to investment or holding companies the type of tax benefits...which would make this provision...applicable...."

Id.

*See supra note 26.*
order to correct the problem. In that case, when Canada did change its laws, the United States felt that the revision did not go far enough; thus, further amendment of the treaty was required.\(^4\) In the Canadian example, the appropriate legislative body of a foreign government adopted specific tax laws for the benefit of that foreign country, yet the executive branch of the United States government and the appropriate branch of the foreign country circumvented those laws through treaty negotiations.

Another argument in support of the adoption of Article 16 provisions has been that there were not a substantial number of foreign investment holding companies in the United States at the time such provisions were first adopted.\(^4\) Proponents also argued that such provisions would not affect the United States balance of payments.\(^4\) If, in fact, such a scenario were present, the limitations of an Article 16 provision should not have been imposed before a tax treaty was signed with any foreign country.\(^6\) Given the dramatic increase in both the number and dollar of United States investments held by treaty country corporations in recent years,\(^7\) the adoption of anti-treaty-shopping policies may adversely affect both the United States balance of payments and the overall interna-

\(^{4}\) See supra note 36. At the Senate hearings on the Canadian treaty amendment, Professor Surrey testified that "the existence of this loophole was called to the attention of the Canadian Government. . . and legislation was enacted in Canada. . . however, the legislation applied only to newly created Canadian corporations. . . preexisting Canadian corporations continued to retain their tax exempt status. . . At about the same time. . . the income tax treaty. . . [with the Netherlands Antilles]. . . was modified to eliminate a similar loophole for foreign investors arising out of the interaction of that tax treaty and the Antilles tax laws. This. . . placed a premium on Canadian tax-exempt corporations. . . (and) trafficking developed in dormant Canadian corporations created prior to the change in Canadian law. . . ." Tax Conventions, supra note 36 (statement of Stanley S. Surrey, Assistant Secretary of the Treasury). When Canada did change its laws, the United States felt that the change did not go far enough and, eventually, the treaty was amended to reflect the desired situation. Given that the law making body of a country is the appropriate body in which to legislate tax laws that the country deems necessary for its national interest, the executive branch should not be permitted to blatantly circumvent those tax laws. It was not until 1981 that the United States abandoned its concern for "loopholes" in the tax laws of other countries. See text accompanying note 116.

\(^{4}\) See supra note 27 and accompanying text.

\(^{4}\) See supra notes 27 and 37 and accompanying text.

\(^{6}\) 2 TAX TREATIES (P-H) ¶ 110,011 (1983).

\(^{7}\) See supra note 12. Netherlands Antilles Minister Harold Henriquez indicated that "over 200 leading U.S. corporations have established international finance subsidiaries in the Netherlands Antilles to issue Eurobonds to foreign investors because the protocol to the Tax Treaty exempts interest paid to those foreigners from withholding tax. . . ." Tax Treaties, supra note 46.
tional financial sector. Such policies, therefore, may no longer be justifiable.

The last argument presented during the 1960's for the adoption of Article 16 provisions was that limiting treaty benefits to third country residents helped eliminate the threat of double taxation. Arguably, however, the prevention of benefits to third country residents is irrelevant to the issue of avoiding double taxation. While a tax treaty may eliminate double taxation of corporations doing business in more than one country, the denial of a tax treaty benefit does not always decrease double taxation. On the contrary, the denial of a tax treaty benefit probably will increase the corporation's tax burden in the country where the tax benefit is denied.

Professor Stanley S. Surrey, then Assistant Secretary of the Treasury, said in 1967 that taxes present a barrier to the international mobility of labor and capital and that such a barrier can be overcome through the implementation of tax treaties. Fourteen years later, the same opinion was voiced by Assistant Secretary of the Treasury, John E. Chapoton. While tax treaties help the international exchange of labor and capital, adoption of a tightly written Article 16 provision may not promote such a policy. As Minister Henriquez indicated, the utilization of the Netherlands Antilles tax treaty has not only contributed to the movement of international capital, but it also has helped to deter the devaluation of the dollar, to channel capital into the United States, to pro-

48 Tax Treaties, supra note 46. In response to criticism directed at the Netherlands Antilles for its role in treaty-shopping, Minister Henriquez noted that "in the mid nineteen sixties... borrowing was encouraged [and required] by the various U.S. balance of payment programs... [and in] the nineteen seventies... the U.S. continued to encourage its companies to use the Netherlands Antilles finance route to issue Eurobonds on the Eurodollar market..." Id.

49 See supra note 41.

50 Tax Conventions, supra note 36 (statement of Stanley S. Surrey, Assistant Secretary of the Treasury). Assistant Secretary Surrey testified that "the need for solutions to these types of international tax problems is unquestionable. Taxes can be an effective barrier restricting the international mobility of capital, labor, and skills, a mobility which economically is highly desirable. We have to proceed to achieve such solutions by means of bilateral agreements which conform as closely as possible to the standards considered to represent the most rational international treatment of each type of income-generating transaction..." Id.

51 Tax Treaties: Hearing Before the Senate Comm. on Foreign Relations, 97th Cong., 1st Sess. 7 (1981) (statement of John E. Chapoton, Assistant Secretary of the Treasury) (hereinafter cited as Foreign Relations Hearing). Assistant Secretary Chapoton said that "we view tax treaties as an important element in the overall international economic policy of the United States. One of the fundamental objectives of this policy is to minimize impediments to the free international flow of capital and technology..." Id.
mote the United States housing and construction industries, to lower the cost of borrowing in the United States, and to maintain the value of United States stocks.\textsuperscript{52}

In conclusion, the Treasury during the 1960's presented many justifications for Article 16 provisions that, in retrospect, are at least suspect. As will be seen from the material that follows, the Treasury during the 1960's decided that the official justification behind the adoption of an Article 16 type provision simply would be preventing unintended benefits.

II. THE SECOND STAGE: FROM AN UNPUBLISHED STANDARD TO AN OFFICIAL MODEL

While the 1960's was a period of policy formulation, the 1970's saw the development of an informal standard provision and the adoption of the official Article 16 of the 1977 U.S. Model.

A. The Treaties

The United States signed a total of nine tax treaties during the 1970's. First it signed a treaty with Finland in 1970. The Finland treaty contained an Article 27 which was essentially the same as Article 16 of the Brazilian tax treaty discussed above.\textsuperscript{53} The Treasury again indicated that the rationale behind the adoption of such an article was the prevention of unintended benefits to third country residents.\textsuperscript{4}

The Treasury also signed a tax treaty with Trinidad and Tobago in 1970.\textsuperscript{54} While the language of its Article 16 was similar to the Brazilian language, the Trinidad and Tobago treaty was more lenient in that the treaty corporation's twenty-five percent ownership requirement was defined as any type of "residents" rather than as

\textsuperscript{52} See supra note 47.

\textsuperscript{53} Convention on Taxes on Income and Property, Mar. 6, 1970, United States-Finland, art. 27, 22 U.S.T. 40, 72, T.I.A.S. No. 7042. See also text accompanying notes 38-41.

\textsuperscript{54} See supra note 39. The rationale for such a provision was stated by the Treasury when it stated that "... the purpose of this Article is to deal with a potential abuse which could occur if one of the States provided preferential rates of tax for investment or holding companies. In such a case, residents of third countries could organize a corporation in the State extending the preferential rates for the purpose of making investments in the other State. The combination of the low tax rates in the first State and the reduced rates or exemptions in the other State would enable the third-country residents to realize unintended benefits. ..." Tax Conventions with Belgium, Finland, Trinidad and Tobago and the Netherlands: Hearing Before the Comm. on Foreign Relations, 91st Cong., 2d Sess. 88 (1970).

"individual residents" of the treaty country.\textsuperscript{58}

The Treasury signed a second tax treaty with Norway in 1971 that contained an Article 16 provision.\textsuperscript{57} This treaty differed from the one it replaced in two respects. First, for the first time in any tax treaty, favored treatment for capital gains was one of the benefits denied. Second, twenty-five percent of the capital of the treaty corporation had to be owned by "individual residents" rather than mere "residents."\textsuperscript{58}

The United States in 1975 signed tax treaties with the United Kingdom,\textsuperscript{59} Iceland,\textsuperscript{60} and Israel.\textsuperscript{61} The versions of Article 16 found in these treaties were essentially the same as the Article 16 provision in the 1971 treaty with Norway.\textsuperscript{62} The Treasury's rationale for the version of Article 16 in the Iceland and Israel treaties was the rationale proffered during the 1970 hearing on the Finland treaty.\textsuperscript{63}

In 1976, the United States signed tax treaties with South Korea\textsuperscript{64} and the Phillippines.\textsuperscript{65} The Korean treaty's version of Article 16 was identical to those of the treaties with Israel, Iceland, and Norway,\textsuperscript{66} using the standard language and including capital gains in the list of possible tainted benefits.\textsuperscript{67} As with the Brazilian tax treaty of 1967, when the Korean treaty was signed Korea had no

\textsuperscript{58} Id.
\textsuperscript{59} Id.
\textsuperscript{56} Id.
\textsuperscript{61} Agreement on Economic Cooperation, May 13, 1975, United States-Israel, 26 U.S.T. 1674, T.I.A.S. No. 8127, \textit{reprinted in} 1 \textsc{TAX TREATIES} (CCH) ¶ 44,228 (Nov. 20, 1975).
\textsuperscript{62} See supra note 57. The only significant difference between the 1975 treaties and the 1971 Norwegian treaty was that the treaty with the United Kingdom did not include capital gains in its list of tainted income, as the Norwegian, Icelandic, and Israeli treaties did. See supra notes 57, 59-61.
\textsuperscript{63} See supra notes 53, 54; 1 \textsc{TAX TREATIES} (CCH) ¶ 3739 (1975); \textsc{Tax Treaties: Hearing Before the Senate Comm. on Foreign Relations}, 97th Cong., 1st Sess. 305-6 (1981) (technical explanation of the convention between the United States and Israel).
\textsuperscript{64} Convention on Double Taxation-Taxes on Income, June 4, 1976, United States-Korea, art. 17, 30 U.S.T. 5253, 5288, T.I.A.S. No. 9506.
\textsuperscript{65} 2 \textsc{TAX TREATIES} (CCH) ¶ 6635 (Oct. 1, 1976).
\textsuperscript{66} See supra note 57.
\textsuperscript{67} See supra note 62.
law providing for special benefits to some corporations. That prohibition was added, however, since a special rate might arise in the future.68

The tax treaty signed with the Phillipines in 1976 was unusual in that it did not contain an Article 16 provision.69 The Senate did not ratify this treaty until five years later and specifically requested that the Treasury negotiate an anti-treaty shopping provision with the Phillipines.70

In 1977, the Treasury signed a tax treaty with Morocco.71 Article 24 of the Moroccan treaty contained the same Article 16 provisions found in the treaties with Korea, Israel, Iceland, and Norway.72 As far as enforcement was concerned, however, Morocco appeared to believe that collection of taxes from third country residents using Moroccan addresses was solely a concern of the United States.73

Also in 1977, the U.S. Model was introduced.74 Even though it emerged ten years and ten tax treaties after the Brazilian treaty was signed, Article 16 of the 1977 U.S. Model was the same as Article 16 of the Brazilian treaty.75 As in the Brazilian treaty, the 1977 U.S. Model contained both the “preferred tax rate” and

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68 See supra note 64.
69 See supra note 65.
70 Id.
71 1 TAX TREATIES (CCH) ¶ 5127 (Aug. 1, 1977).
72 Id.
73 Letter from Secretary of State Cyrus Vance to President James Carter (Apr. 25, 1978), reprinted in 1 TAX TREATIES (CCH) ¶ 5633 (Aug. 1, 1977). Given Morocco's attitude, the Treasury should not expect much cooperation from Morocco in preventing treaty shopping. Id. Morocco, like other nations who were party to similar anti-treaty shopping provisions, did not grant tax benefits to investment or holding companies at the time of the treaty signing. Id. at ¶ 5627.
74 1 TAX TREATIES (CCH) ¶ 153 (May 7, 1977).
75 Compare id. with supra note 41. The 1977 version of Article 16 of the United States Model Treaty stated as follows:

Article 16
Investment or Holding Companies
If 25 percent or more of the capital of a company which is a resident of a Contracting State is owned directly or indirectly by individuals who are not residents of that State, and if by reason of special measures the tax imposed by that State on that company with respect to dividends, interest or royalties arising in the other Contracting State is substantially less than the tax generally imposed by the first-mentioned State on corporate business profits, then, notwithstanding the provisions of Article 10 (Dividends), 11 (Interest), or 12 (Royalties), that other State may tax such dividends, interest or royalties. For the purposes of this Article, the source of dividends, interest or royalties shall be determined in accordance with paragraph (3)(a), (b), or (c) of Article 23 (Relief from Double Taxation).

TAX TREATIES (CCH), supra note 74.
"ownership" requirements.\textsuperscript{76}

The wording of Article 16 in the 1977 U.S. Model should not have been a surprise to tax treaty followers because previous treaties contained the same approach. The surprise should have been that the 1977 U.S. Model's Article 16 did not include capital gains as one of the treaty benefits that could be denied to foreign taxpayers.\textsuperscript{77} In addition, while previous treaty provisions used the word "shall" when referring to the times in which treaty benefits were to be denied, the 1977 U.S. Model changed the language to a more lenient "may."\textsuperscript{78}

After the announcement of the 1977 U.S. Model, the United States failed to sign any tax treaties until 1980 when it signed tax treaties with Malta,\textsuperscript{79} Cyprus,\textsuperscript{80} Jamaica,\textsuperscript{81} Denmark,\textsuperscript{82} Egypt,\textsuperscript{83} and Bangladesh.\textsuperscript{84} All six tax treaties generally followed the 1977 U.S. Model's version of Article 16; some of the treaties, however, merit specific attention.

The tax treaty with Cyprus\textsuperscript{85} contains a provision not previously encountered. Article 26 of the Cyprus treaty contains a legal presumption regarding the required number of resident shareholders. The treaty provides that where the stock of the treaty corporation is traded in a recognized stock exchange, it will be presumed that the required number of shareholders own the stock of the treaty

\textsuperscript{76} Tax Treaties (CCH), supra note 74.

\textsuperscript{77} Id.; see supra notes 60-63 and accompanying text.

\textsuperscript{78} See supra note 75.

\textsuperscript{79} Agreement Between the United States of America and the Republic of Malta with Respect to Taxes on Income, Mar. 31, 1980, United States-Malta, \textsuperscript{--} U.S.T. \textsuperscript{--}, T.I.A.S. No. \textsuperscript{--}, reprinted in 2 Tax Treaties (CCH) \$ 5403 (Mar. 31, 1980).

\textsuperscript{80} Convention with Respect to Taxes on Income, Mar. 26, 1980, United States-Cyprus, \textsuperscript{--} U.S.T. \textsuperscript{--}, T.I.A.S. No. \textsuperscript{--}, reprinted in 1 Tax Treaties (CCH) \$ 2003 (Mar. 26, 1980).

This treaty was superseded by the Convention with Respect to Taxes on Income, Mar. 19, 1984, United States-Cyprus, \textsuperscript{--} U.S.T. \textsuperscript{--}, T.I.A.S. No. \textsuperscript{--}, reprinted in 1 Tax Treaties (CCH) (P 200)3 (Mar. 19, 1984).


\textsuperscript{82} Convention with Respect to Taxes on Income, June 17, 1980, United States-Denmark, \textsuperscript{--} U.S.T. \textsuperscript{--}, T.I.A.S. No. \textsuperscript{--}, reprinted in 1 Tax Treaties (CCH) \$ 2053 (June 17, 1980).

\textsuperscript{83} Convention with Respect to Taxes on Income, Aug. 24, 1980, United States-Egypt, \textsuperscript{--} U.S.T. \textsuperscript{--}, T.I.A.S. No. \textsuperscript{--}, reprinted in 2 Tax Treaties (CCH) \$ 8003 (Aug. 24, 1980).

\textsuperscript{84} Convention with Respect to Taxes on Income, Oct. 6, 1980, United States-Bangladesh, \textsuperscript{--} U.S.T. \textsuperscript{--}, T.I.A.S. No. \textsuperscript{--}, reprinted in 1 Tax Treaties (CCH) \$ 573 (Oct. 6, 1980).

\textsuperscript{85} See supra note 80.
The original treaty between the United States and Denmark did not contain an Article 16 provision.\textsuperscript{86} The United States and Denmark’s 1980 renegotiation resulted in an Article 17 entitled “Investment and Holding Companies,”\textsuperscript{87} which was almost identical to Article 16 of the U.S. Model. The first Article 17, however, eventually was deleted and replaced with a new Article 17 by a Protocol signed on August 23, 1983.\textsuperscript{88}

The Senate hearings on the Egyptian tax treaty\textsuperscript{90} reveal that in the 1980’s the Treasury was using, almost verbatim, the same arguments it used in the hearings held for both the 1967 treaty with Brazil and the 1970 treaty with Finland. The Treasury again contended that prevention of benefits to third country residents “accords with the purpose” of the elimination of double taxation\textsuperscript{91} and the prevention of unintended benefits to third country residents who utilize a treaty country’s tax laws along with the treaty in order to minimize their tax burden.\textsuperscript{92}

\textsuperscript{86} Id.
\textsuperscript{87} Convention between the United States and Denmark, May 6, 1948, 62 Stat. 1730, T.I.A.S. No. 1854.
\textsuperscript{88} See supra note 82.
\textsuperscript{90} Foreign Relations Hearing (statement of John E. Chapoton, Assistant Secretary of the Treasury), supra note 51.
\textsuperscript{91} Id. “U.S. tax treaties also include anti-abuse provisions designed to prevent residents of third countries from channeling investments into the United States through the treaty country, thereby, deriving treaty benefits to which they are not justifiably entitled.” Id. This argument essentially mirrored the one presented in 1967 during the Canadian Tax Treaty Hearings. See supra note 36.
\textsuperscript{92} Foreign Relations Hearing (technical explanation of the convention between the United States and Egypt), supra note 51. The statements made at the Senate hearings in support of this provision were noteworthy because they no longer mentioned that foreign holding companies are not in widespread use in the United States, nor that such provisions will have a minimum effect on the United States balance of payments. Id. Instead the rationale now presented by the Treasury is one of preventing “unintended benefits.” Id. Treasury officials testified that:

the purpose of this Article is to deal with potential abuse which could occur if one of the Contracting States provided preferential rates of tax for investment or holding companies. In the absence of this Article, residents of third countries could organize a corporation in the Contracting State extending the preferential rates for the purpose of making investments in the other Contracting State. The combination of low tax rates in the first-mentioned Contracting State would enable the third country residents to realize unintended benefits. . . .

\textit{Id.} This statement was the same statement made in 1970 at the Finland treaty hearings, see
The 1980 Bangladesh treaty was significant in that the Senate ratification hearings on this treaty took place after the Treasury announced the June 1981 draft which proposed a revision to Article 16 of the 1977 U.S. Model. The treaty is also notable because the Senate specifically stated its intention that the term "capital" receive a broad construction so that it might include preferred stock and convertible debt in addition to common stock.

The Senate comments on the Bangladesh treaty also contained the first statements about the June draft. The June draft contained the most encompassing provision ever included in any Article 16. The June draft provided that the income realized by the treaty corporation may not substantially be used to pay debts and royalties to third country residents. Although after the June draft the Senate indicated in the Bangladesh hearings that the term "capital" was to include preferred stock and convertible debt, no reference to straight "debt" was made in the June draft. This omission served as an indication that third country creditors might continue to lend funds to treaty corporations without fear that treaty benefits would be denied to the treaty corporation.

III. THE THIRD STAGE: A NEW PERIOD OF TRANSITION FOR ARTICLE 16

The June 1981 Treasury announcement which revealed the proposed draft with changes to Article 16 of the 1977 U.S. Model initiated a period of transition in the development of Article 16. The announcement was followed by the ratification of three tax treaties, a subsequent new December draft of Article 16, the ratifica-
tion of two additional tax treaties, and the signing of two protocols.

A. The June 1981 Draft

The draft of Article 16 proposed in June 1981 contained substantial changes to Article 16 of the 1977 U.S. Model Treaty. The most important provisions that emerged from the June 1981 draft were the following four requirements: the "preferred tax rate" requirement; the "ownership" or "stock exchange" requirement; the "business purpose" requirement; and the "prohibited payment" requirement.

The "preferred tax rate" requirement was unchanged from the provision that had appeared in the 1977 U.S. Model and in almost every treaty previously discussed. The "preferred tax rate" provision required that the treaty corporation could not enjoy a pre-

** See supra note 12. The June draft of Article 16 read as follows:

Article 16 Limitation of Benefits
1. A person (other than an individual) which is a resident of a Contracting State shall be entitled under this Convention to relief from taxation in the other Contracting State unless:
   
   (a) more than 75 percent of the beneficial interest in such person is owned, directly or indirectly, by one or more individual residents of the first-mentioned Contracting State; and
   
   (b) the income of such person is not used in substantial part, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons who are residents of a State other than a Contracting State and who are not citizens of the United States.

   For the purpose of subparagraph (a), a company that has a substantial trading in its stock on a recognized exchange in a Contracting State is presumed to be owned by individual residents of that Contracting State.

2. Paragraph 1 shall not apply if it is determined that the acquisition or maintenance of such person and the conduct of its operations did not have as a principal purpose obtaining benefits under the Convention.

3. Any relief from tax provided by a Contracting State to a resident of the other Contracting State under the Convention shall be inapplicable to the extent that, under the law in force in that other State, the income to which the relief relates bears significantly lower tax than similar income arising within that other state derived by residents of that other State.

Id.

The June draft included several revisions of the 1977 U.S. Model. The June draft entitled its Article 16 provision "Limitation of Benefits," as opposed to the 1977 U.S. Model's "Investment or Holding Companies". Compare supra note 14 with supra note 80. The June draft applied to all benefits received under a treaty, while the 1977 U.S. Model applied only to dividends, interest, and royalties. Compare supra note 75 with supra note 80. The June draft applied to all taxpayers except individuals, whereas the 1977 U.S. Model referred to corporations or companies. The June draft used the language "shall not be entitled" instead of the 1977 U.S. Model's less restrictive language of "may be entitled". See supra notes 75, 80.
ferred tax rate under a treaty country’s tax laws. While this provision has appeared in almost all previous treaties, the June draft marked the last time that the United States showed any concern for “loopholes” in the treaty country tax laws.

The “ownership” or “stock exchange” requirement of the June draft required that more than seventy-five percent of the “beneficial interest” of the treaty corporation be owned by individuals who are residents in the treaty country. This requirement was similar to the language of the 1977 U.S. Model which stated that treaty benefits would be denied if twenty-five percent or more of the capital of the treaty corporation was owned other than by individual residents of the treaty country. The Treasury here used the phrase “beneficial interest” instead of “capital.” If the Senate was prepared to use a very broad definition for the word “capital” in the Bangladesh treaty, as was discussed above, then it should be expected that the phrase “beneficial interest” will have an even broader meaning if a treaty using that phrase is ratified by the Senate.

Unlike the 1977 U.S. Model, the June draft provides for a “stock exchange” test as an alternative to the “ownership” test. This new provision is really more of a presumption than a requirement; if the stock of the treaty corporation is substantially traded in the treaty country’s stock exchange, then the treaty corporation will be presumptively owned by individual residents of the treaty country.

The “business purpose” test in the June draft requires that the treaty corporation be able to establish that the principal purpose of its existence is one other than utilization of treaty benefits. There are no similar provisions in the 1977 U.S. Model.

By the “prohibited payments” requirement, the June draft requires that the income of the treaty corporation not be used for certain prohibited purposes. The draft prohibits the income real-

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100 See June draft, supra note 99, at § 3.
101 See June draft, supra note 99, at § 1(a).
102 See supra note 75.
103 See supra notes 93-95 and accompanying text.
104 See June draft, supra note 99, at § 1(b).
105 Id. This provision was first seen in the 1980 Cyprus treaty. See supra notes 85 & 86 and accompanying text.
106 See June draft, supra note 99, at § 2.
108 See June draft, supra note 99, at § 1(b).
ized by the treaty corporation from being used substantially to pay interest or royalties to third country residents.\textsuperscript{109} There was no such requirement in the 1977 U.S. Model.\textsuperscript{110} Thus, under the 1977 U.S. Model, a third country resident could lend substantial funds to a treaty corporation and thereby receive substantial amounts of interest without jeopardizing the treaty benefits;\textsuperscript{111} that, however, is no longer possible under the June draft of 1981.\textsuperscript{112}

B. \textit{The Three Treaties Following the June Draft}

1. 1981 Protocol with Jamaica

The original Article 17 of the 1980 treaty with Jamaica\textsuperscript{113} was deleted and replaced with a new Article 17 by a Protocol signed July 17, 1981.\textsuperscript{114} Like the June draft of Article 16, Jamaica’s Article 17 entitled “Limitation of Benefits” is applicable to all treaty benefits, and to all persons other than individuals, and uses the phrase “shall not be entitled”,\textsuperscript{115} which indicates that the taxpayer is not entitled to relief from double taxation.

While Jamaica’s Article 17 contains the “ownership” or “stock exchange” test, the “business purpose” test, and the “prohibited payment” test, it does not contain the “preferred tax rate” test.\textsuperscript{116} This protocol is the first indication of the Treasury’s willingness to drop its concern for “loopholes” in the tax laws of the treaty country. In effect, by moving from a four-requirement to a three-requirement type of Article 16, the Treasury backed away from the tough anti-treaty shopping provision of the June draft.

The Jamaican protocol also provides for an alternative provision to meet the “business purpose” requirement which in effect permits third country resident ownership of a treaty corporation.\textsuperscript{117} Article 17 of the Jamaican protocol states that the “business purpose” requirement may be satisfied as long as the “prohibited payment” test is satisfied and one of two additional requirements are met. The two additional requirements are that any United States

\begin{itemize}
\item \textsuperscript{109} Id.
\item \textsuperscript{110} See \textit{ supra} note 75.
\item \textsuperscript{111} Id.
\item \textsuperscript{112} See June draft, \textit{ supra} note 99.
\item \textsuperscript{113} See 1980 Jamaica Convention, \textit{ supra} note 81.
\item \textsuperscript{114} See 1981 Jamaica Protocol, \textit{ supra} note 81 at art. 3.
\item \textsuperscript{115} Id.
\item \textsuperscript{116} Id.
\item \textsuperscript{117} Id., art. 17, § 3.
\end{itemize}
source income in question must be incidental to the business operations in Jamaica, or that third country residents owning the Jamaican company must be residents of a country which has a treaty with the United States providing the same benefits provided by the Jamaican treaty.\textsuperscript{118}

2. Senate Foreign Relations Committee Report on the Philippines Tax Treaty

A tax treaty with the Philippines was signed on October 1, 1976.\textsuperscript{119} That treaty, however, did not contain an anti-treaty shopping provision. A Senate Committee Report indicates that, while it was fully cognizant of the lack of such an article and the problems associated with not having such an article, the Committee still recommended ratification without reservation because ratification of the treaty was overdue and any reservation might cause further delay.\textsuperscript{120} The Committee, however, also requested that the Treasury negotiate an Article 16 type provision in accordance with the current United States Model.\textsuperscript{121} The Committee's choice of the word "current" should be emphasized because the committee appeared to be referring to the 1977 Model, rather than the June draft.

3. Senate Foreign Relations Committee Report on the Argentina Tax Treaty

On December 15, 1981, the Senate Foreign Relations Committee approved, with reservation, the Argentina Tax Treaty signed on May 7, 1981.\textsuperscript{122} The Committee included a reservation asserting that the treaty should include an article or provision limiting treaty benefits to third country residents.\textsuperscript{123} The Treasury did not ask for such an article even when it learned that Argentina had no objection. The Senate Committee Report stated that the Argentina

\textsuperscript{118} Id.
\textsuperscript{119} See supra note 69.
\textsuperscript{120} 2 Tax Treaties (CCH) ¶ 6635 (1980).
\textsuperscript{121} Id. The Committee Report requested that "the Treasury Department negotiate an anti-abuse provision that follows the principles of the provision in the current United States Model. ..." Id.
treaty did not offer significant opportunities to motivate "treaty shopping." In the past, however, that fact had not prevented the Treasury from insisting on such articles. As the committee acknowledged, such treaty shopping opportunities might develop later, and in fact it becomes difficult to renegotiate a new provision when abuses develop.

Both the chairman of the House Ways and Means Committee and the ranking minority member of that committee expressed particular concern over the absence of anti-treaty shopping provisions in the treaty. The Report also contained the Senate's version of an anti-treaty shopping article. The Committee Report recommended approval of the treaty as long as the following article was included:

A person (other than an individual) which is a resident of a contracting state and which derives income from sources within the other contracting state shall not be entitled to the benefits under this convention accorded by that other contracting state if 25 percent or more of the beneficial interest in such person is owned, directly or indirectly, by individuals who are not residents of the first mentioned contracting state. For purposes of this paragraph, a corporation that has substantial trading in its stock on a recognized exchange in a contracting state is presumed to be owned by residents of that contracting state. This paragraph shall not apply if it is determined that the acquisition or maintenance of such person and the conduct of its operations did not have as a principal purpose obtaining benefits under the convention.

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124 Id.
126 Id. at 6.
127 Id.
128 Id.
129 Id. at 6-7. This provision applied to all treaty benefits, as did the June draft and the Jamaica treaty. Compare the Senate's phrase "a company... (that does the prohibited act)... shall not be entitled to the benefits under this convention...", id. with the 1977 Model language of "a person (that does the prohibited act)... may tax such dividends, interest or royalties...", supra note 8, and with the June draft phrase "... a person... shall not be entitled under this Convention to relief from taxation... (if the prohibited act takes place)... ", supra note 99. As did the June draft and the Jamaica treaty, the Argentina provision also applies to all persons other than individuals. Compare S. Rep. No. 49, 97th Cong., 1st Sess. 6 (1981) with supra notes 99 and 75. The Argentina provision uses the phrases "shall not be entitled." Compare S. Rep. No. 49, 97th Cong. 1st Sess. 6 (1981) with supra notes 99 and 75, and "beneficial interests." Compare the language in the Senate's version which prohibits "... 25 percent or more of the beneficial interest...", S. Rep. No. 49, 97th Cong., 1st Sess. 6 (1981) with the 1977 Model language which prohibits that "25 percent or more of the capital of a company... ", supra note 75 and the June 1981 language which requires that "more than 75 percent of the beneficial interest... ", supra note 99, of the entity in question be owned by parties defined in the provision.
The tests which the Senate included in its provision were significant. The provision contained the "ownership" or "stock exchange" test and the "business purpose" test. Unlike the 1977 U.S. Model and the June draft, but like the Jamaica treaty, the Argentina provision did not contain the "preferred tax rate" requirement. Furthermore, the most important requirement absent in the Argentina treaty was the "prohibited payment" requirement. The Senate's Argentina provision constituted the first time this requirement had been absent since its appearance in the June draft. The Senate did make reference to convertible debt in the Bangladesh ratification hearings; yet, it did not include straight debt in its commentaries about the word "capital". The absence of the "prohibited payment" test or of the "preferred tax rate" test in the Argentina provision represented a defeat to the Treasury. In its short history, the Treasury's tough anti-treaty shopping provision moved from the four-requirement provision first announced in the June draft to the three-requirement provision of the Jamaica treaty and then to the two-requirement provision of the Argentina treaty.

C. The December 1981 Revised Draft of Article 16 of the 1977 United States Model

On December 23, 1981 the Treasury announced a revised version of the proposed draft which had been announced the previous June. The December draft applies only to items of income,

128 See infra note 129.
129 Id.; see also supra notes 99 and 127 and accompanying text.
130 See supra notes 99, 122, and 127 and accompanying text.
131 Compare supra note 127 with supra notes 81, 75, and 99.
132 See supra note 127.
133 See supra notes 93-97 and accompanying text.
134 See December 1981 Draft of the 1977 U.S. Model, supra note 18. The December 1981 draft provides as follows:

Article 16 Investment or Holding Companies
1. A corporation which is a resident of a Contracting State shall not be entitled under this Convention to relief from taxation in the other Contracting State with respect to an item of income, gains or profits unless the corporation establishes that:
(a) its stock of any class is listed on an approved stock exchange in a Contracting State, or that it is wholly owned, directly or through one or more corporations each of which is a resident of a Contracting State, by a corporation the stock of which any class is so listed; or
(b) it is not controlled by a person or persons who are not residents of a Contracting State, other than citizens of the United States; or
(c) it was not a principal purpose of the corporation or of the conduct of its busi-
gains, or profits, while the June draft and its subsequent treaties refer to all benefits under the treaty.\textsuperscript{135} The December draft applies only to corporations, whereas the June draft and the treaties subsequent to the June draft apply to all taxpayers except individuals.\textsuperscript{136}

The most significant difference between the December draft and all other treaties is the number of requirements of the December draft. Instead of the June draft's four-requirement test, or Jamaica's three-requirement test, or Argentina's two-requirement test, the December draft contains only one requirement. The December draft states that a treaty corporation may satisfy Article 16 by meeting only one of three possible tests: the "stock exchange" test,\textsuperscript{137} the "business purpose" test,\textsuperscript{138} or the "control" test.\textsuperscript{139} The

\begin{itemize}
\item \textbf{1.} For the purpose of this Article:
\begin{itemize}
\item (a) an approved stock exchange in \textbf{--} means \textbf{--};
\item (b) an approved stock exchange in the United States means the NASDAQ System owned by the National Association of Securities Dealers, Inc. and any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for the purposes of the Securities Exchange Act of 1934;
\item (c) a person or persons shall be treated as having control of a corporation if under the income tax laws of the Contracting State in which the income arises the person or persons could be treated as having direct or indirect control of the corporation for any purpose;
\item (d) notwithstanding subparagraph (c) of this paragraph, a corporation is presumed to meet the requirements of subparagraph (b) of paragraph 1 of this Article if the corporation establishes that individuals who are: (i) citizens of the United States; (ii) residents of a Contracting State; or (iii) residents of States that have income tax conventions in force with the Contracting State from which relief from taxation is claimed and such conventions provide relief from taxation not less than the relief from taxation claimed under this Convention; own directly more than 75 percent of the total combined voting power of all classes of the corporation's stock entitled to vote and more than 75 percent of the number of shares of each other class of the corporation's stock;
\item (e) a corporation is presumed to meet the requirements of subparagraph (c) of paragraph 1 of this Article, in particular, where:
\begin{itemize}
\item (i) the reduction in tax claimed is not greater than the tax actually imposed by the Contracting State of which the corporation is resident; or
\item (ii) the corporation is engaged in business operations in the Contracting State of which it is resident and the relief from taxation claimed from the other Contracting State is with respect to income which is incidental to or derived in connection with such business.
\end{itemize}
\end{itemize}

\textsuperscript{135} Compare supra note 134, § 1 with text accompanying note 127.
\textsuperscript{136} Both the June and the December drafts used the phrase "shall not be entitled" instead of "may not be entitled." Compare supra note 134 with supra note 99.
\textsuperscript{137} See supra note 134, at § 1(a).
\textsuperscript{138} Id. § 1(c).
The first two tests essentially are the same as the previous versions of those requirements.

The third alternative requirement, the "control" test, is new and requires that the treaty corporation show that it is not "controlled" by third country residents.\textsuperscript{140} This is a significant departure from all previous treaties which generally object to having third country residents own, directly or indirectly, twenty-five percent of the treaty corporation. First, the new requirement does not use the words "capital" or "beneficial interest"; it instead specifically refers to voting and non-voting stock.\textsuperscript{141} Second, the December draft uses the word "control" instead of "ownership".\textsuperscript{142} Third, unlike the 1977 U.S. Model, the June draft, and the treaties with Jamaica and Argentina, the December draft does not specifically require that ownership of the shares be restricted to "individual" residents.\textsuperscript{143}

The fourth departure involves the meaning of the word "controlled". The December draft's use of the term "controlled" may be interpreted in two ways. First, the draft indicates that the term "controlled" is to be defined under the tax laws of the country in which the income is generated.\textsuperscript{144} While the draft makes no reference to a specific percentage of ownership in this context, the United States Internal Revenue Code defines the term "control" as having "more than 50 percent of the total combined voting power of all classes of stock entitled to vote. . . ."\textsuperscript{145} If the Treasury meant to adopt this fifty percent figure, it initiated a major departure from all previous treaties. Generally, all other Article 16 provisions have limited third country residents to no more than a twenty-five percent ownership.\textsuperscript{146} With the announcement of the recently signed Protocol with Denmark, the Treasury has shown that it is willing to use the fifty percent figure.\textsuperscript{147} In effect, the Treasury has indicated that the permissible third country ownership ratio may be raised from one-fourth to almost one-half.

The second possible interpretation of the term "controlled" fol-

\textsuperscript{139} Id. § 1(b).
\textsuperscript{140} Id.
\textsuperscript{141} See infra note 143, at § 2(d).
\textsuperscript{142} Id. § 1(b).
\textsuperscript{143} Compare id. with supra notes 75, 81, 99, 121 and accompanying text.
\textsuperscript{144} See supra note 134, at § 2(d).
\textsuperscript{145} I.R.C. § 957(a)(1976).
\textsuperscript{146} See, e.g., supra note 75.
\textsuperscript{147} See supra note 89; see infra notes 179-90 and accompanying text.
allows traditional Article 16 guidelines. The December draft indicates that a company is not “controlled” by third country residents when more than seventy-five percent of the company is owned by a permitted group of persons. The permitted owners under this provision are either United States citizens; United States or treaty country residents, since “individual” residents is not specified; or residents of a third country.

Another indication that the Treasury is retreating from its tough June draft position is the absence of the “preferred tax rate” and the “prohibited payment” requirements in the December draft. The “preferred tax rate” was dropped from both the Jamaica and the Argentina treaties. By omitting this requirement from the December draft the Treasury verified that while the “preferred tax rate” test was a major concern during the formative years of Article 16, the test was no longer a part of United States international tax policy.

The absence of the “prohibited payment” requirement from the December draft indicates that the Treasury has decided to follow the Senate’s leadership. Despite the inclusion of a “prohibited payment requirement in the June draft and in the treaty with Jamaica the Senate’s version of Article 16, as included in the Argentina treaty, does not contain a “prohibited payment” requirement.

In conclusion, the December draft represents a major retreat from the June draft and a substantial change of this country’s international tax policy. Not only has the Treasury moved from a four-requirement test to a single-requirement test, the Treasury also has indicated that it would permit the ratio of third country ownership to be raised from one-fourth to almost one-half and that it no longer advocates prohibition of the payment of interest and royalties by treaty corporations to third country residents.

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148 See supra note 134.
149 Id.
150 Id.
151 See supra note 116 and accompanying text.
152 See supra note 131 and accompanying text.
153 See, e.g., supra note 27 and accompanying text.
154 See supra note 99.
155 See supra note 116.
156 See supra note 127.
D. Treaties Reported after the Announcement of the December 1981 Draft

After the announcement of the December draft, the United States signed four additional tax treaties or protocols: the treaties with New Zealand and Australia,\(^{157}\) and the protocols with Canada\(^ {158} \) and Denmark.\(^ {159} \)

1. The 1982 Tax Treaty with New Zealand

The 1951 New Zealand treaty did not contain an Article 16 provision.\(^ {160} \) In July 1982, however, the Treasury and New Zealand signed a new treaty that contains an Article 16.\(^ {161} \) New Zealand’s Article 16 is a mixture of fragments from the June and December drafts. As do all treaties since the June draft, the New Zealand provision uses the phrase “shall not be entitled.”\(^ {162} \) In contrast to the December draft, however, the New Zealand treaty applies to all benefits and to all persons other than individuals.\(^ {163} \) The treaty follows the December draft in that it requires the treaty corporation to meet only one of three tests: the “stock exchange” test,\(^ {164} \)

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\(^ {157} \) Convention with Respect to Taxes on Income, Aug. 6, 1982, United States-Australia, ___ U.S.T. ___, T.I.A.S. No. ___, reprinted in 1 Tax Treaties (CCH) ¶ 402A (Aug. 6, 1982) [hereinafter cited as Australia Convention]. The 1982 treaty with Australia contained an Article 16 provision which was similar to the Article 16 proposed in the New Zealand treaty, discussed infra notes 160-78 and accompanying text. Consistent with other recent treaties, the “preferred tax rate” and the “prohibited payments” requirements were absent from the Australia treaty. Australia Convention, supra.

\(^ {158} \) Protocol Amending the Convention with Respect to Taxes on Income Signed at Washington on Sept. 26, 1980, June 14, 1983, United States-Canada, ___ U.S.T. ___, T.I.A.S. No. ___, reprinted in 1 Tax Treaties (CCH) ¶ 1317n (June 14, 1983). The Canadian protocol simply states that benefits under the treaty will be denied to investment corporations and to trusts where the owners of the corporations or the beneficiaries of the trusts are third country residents. Id. art. 29, § 6.

\(^ {159} \) 1983 Denmark Protocol, supra note 89.

\(^ {160} \) Convention between the United States and New Zealand, Jan. 1, 1951, United States-New Zealand, 2 U.S.T. 2379, T.I.A.S. No. 2360.


\(^ {162} \) Id.

\(^ {163} \) Compare the New Zealand Convention, id. with the June 1981 draft of Article 16, supra note 99; the 1981 Jamaica Protocol, art. 17, supra note 116 and accompanying text; the 1981 Argentina Treaty, see supra notes 122-33 and accompanying text; and the December 1981 Draft of the 1977 U.S. Model, art. 16, see supra notes 134-56 and accompanying text.

\(^ {164} \) See supra note 161. The Senate Foreign Relations Committee Report on the New Zealand Convention explained:

Under the [stock exchange] test, a company that is a resident of one of the cou-
the “business purpose” test, or the “ownership” test. The first two tests as promulgated in the treaty with New Zealand are basically the same as other previous “stock exchange” or “business purpose” requirements. The “ownership” test, however, has elements of both the June and the December drafts. The most important element is the New Zealand treaty’s use of the more traditional seventy-five percent figure instead of the fifty percent figure announced in the December draft. Using the seventy-five percent figure, a treaty corporation is not entitled to the treaty benefits unless more than seventy-five percent of the taxpayer’s beneficial interest (June draft language), or more than seventy-five percent of each class of the company’s shares, (December draft language) is owned by a permitted group of owners (December draft language). The permitted group of owners is essentially the same group outlined in the December draft: resident individuals of the United States and New Zealand (the December draft is not limited to individuals), United States citizens, companies whose shares are regularly traded in recognized exchanges, and the treaty countries themselves.

In addition to combining aspects of the June and December drafts, the New Zealand treaty contains unprecedented language requiring consultations between treaty countries where a treaty


165 See supra note 161. The Senate Foreign Relations Committee noted that: Under the [business purpose] test, denial of treaty benefits does not occur if it is determined that the acquisition, ownership and maintenance of an entity that is a resident of the United States or New Zealand and the conduct of its operations did not have as a principal purpose the purpose of obtaining benefits under the proposed treaty. Accordingly, the provision will not apply if there was no treaty shopping motive for forming the company and if its operation does not have as one of its principal purposes the purpose of obtaining the treaty benefits.


166 See New Zealand Convention, supra note 161.

167 Compare the New Zealand Convention, supra note 161 with the December 1981 Draft of the 1977 U.S. Model, supra notes 134-56 and accompanying text.


170 New Zealand Convention, supra note 161.
benefit is to be denied. Also included in the New Zealand treaty is a clause limiting treaty benefits obtained under a trust set up as a scheme to acquire such benefits.\textsuperscript{171}

The proposed treaty with New Zealand contains neither the "preferred tax rate" requirement,\textsuperscript{172} which was absent from the treaties with Jamaica\textsuperscript{173} and Argentina\textsuperscript{174} and from the December draft,\textsuperscript{175} nor the "prohibited payments" requirement,\textsuperscript{176} which was omitted from the Argentina treaty\textsuperscript{177} and the December draft.\textsuperscript{178}

2. The 1983 Protocol with Denmark

As is the case with the New Zealand and the Australia treaties, the 1983 Denmark Protocol contains a mixture of some of the general elements found in the June and the December drafts.\textsuperscript{179} The most significant elements of the Denmark Article 16 provision, however, are the tests or requirements that the treaty corporation must meet to enjoy the benefits under the treaty. The Denmark Protocol marks the appearance of a new version of the "prohibited payments" requirement.\textsuperscript{180} Like the December draft, the protocol

\textsuperscript{171} Id.
\textsuperscript{172} Id.
\textsuperscript{173} See 1981 Jamaica Protocol, supra note 81; see also supra note 116 and accompanying text.
\textsuperscript{174} See 1981 Argentina Treaty, supra notes 122 and 127.
\textsuperscript{175} December 1981 Draft of the 1977 U.S. Model, supra notes 18 and 134.
\textsuperscript{176} New Zealand Convention, supra note 161.
\textsuperscript{177} 1981 Argentina Treaty, supra notes 122 and 127.
\textsuperscript{178} December 1981 Draft of the 1977 U.S. Model, supra notes 18 and 134.
\textsuperscript{179} 1983 Denmark Protocol, supra note 89. For example, the Denmark Protocol's Article 17 applies to all treaty benefits, and to all taxpayers except individuals. Id. It contains the phrase "shall not be entitled", and a clause providing for consultation between the two countries if treaty benefits are to be denied. Id. § 4. The paragraph which provides for consultation between the two countries before treaty benefits are denied also appears in the recently ratified New Zealand treaty. Both provisions should be given the same interpretation. The Treasury Department's Technical Explanation of the New Zealand Convention explained that this provision:

provides that the competent authorities shall consult each other before Treaty benefits are denied under this Article. This consultation obligation is intended to benefit the governments of the two Contracting States; any failure of the competent authorities in a particular case so to consult does not result in the grant of benefits under the Convention where those benefits would otherwise be denied, e.g. by reason of this Article.

2 Tax Treaties (CCH) ¶ 5903D (1983).
\textsuperscript{180} 1983 Denmark Protocol, supra note 89. The language of the Denmark Protocol reads as follows:

1. A person (other than an individual) which is a resident of a Contracting State shall not be entitled under this Convention to relief from taxation in the other Contracting State unless:
with Denmark indicates that the treaty corporation needs only to meet one of the three following requirements: the “stock exchange” requirement, the “business purpose” requirement, or the “ownership/prohibited payments” requirement.

The first two requirements are the same as any other “stock exchange” or “business purpose” requirement; however, the third requirement is new. The new provision in the Denmark Protocol provides that the treaty taxpayer will not be entitled to the treaty benefits unless it can meet an “ownership” test and a “prohibited payment” test. The “ownership” test requires that more than fifty percent of the beneficial interest or more than fifty percent of the company shares be owned directly or indirectly by a permitted group of individuals. While the permitted group of owners is the same group indicated in the New Zealand and Australia treaties’ provisions, the Denmark Protocol was the first time the Treasury specifically used the fifty percent figure.

In the June draft and the treaties with Jamaica, Argentina, New Zealand, and Australia, the Treasury used the “more than seventy-

(a)(i) more than 50 percent of the beneficial interest in such person (or in the case of a company, more than 50 percent of the number of shares of each class of the company’s shares) is owned, directly or indirectly, by any combination of one or more of:
(A) individuals who are residents of one of the Contracting States;
(B) citizens of the United States;
(C) companies as described in subparagraph (b); and
(D) one of the Contracting States, its political subdivisions or local authorities and
(ii) in the case of relief from taxation under Articles 10 (Dividends), 11 (Interest), 12 (Royalties), or 22 (Other Income), not more than 50 percent of the gross income of such person is used to make payments of interest to persons who are other than persons described in clauses (A) through (D) of subparagraph (a)(i), whether directly or indirectly; or
(b) it is a company which is a resident of a Contracting State and in whose principal class of shares there is a substantial and regular trading on a recognized stock exchange.

2. Paragraph 1 shall not apply if the establishment, acquisition and maintenance of such person and the conduct of its operations did not have as a principal purpose the purpose of obtaining benefits under the Convention.

There is also a paragraph 3 defining the term “recognized stock exchange” and a paragraph 4 providing for consultation between the two countries before tax benefits are denied. Id.

181 See supra note 180, at § 1(b).
182 Id. § 2.
183 Id. §§ 1(a)(i), ¶ 1(a)(i).
184 Id.
185 Id. § 1(a)(i).
186 See supra notes 168 and 157 and accompanying text.
187 See supra note 180.
five percent” figure.\textsuperscript{188} The December draft did allude to a “more than fifty percent” figure by the use of the word “control”\textsuperscript{189} but, in the Denmark Protocol the Treasury left no doubt that it was willing to raise the permissible third country resident ownership ratio from one-fourth to almost one-half.

At the same time, however, the Treasury was not prepared to permit outright treaty shopping as was indicated by the reappearance of a new version of the “prohibited payment” requirement in the Denmark Protocol. The Denmark Protocol required that when the benefits in question involve dividends, interest, royalties, or other income, the treaty corporation may not use more than fifty percent of its gross income for interest payments except to the permitted group of owners.\textsuperscript{190}

The “prohibited payment” requirement first appeared in the June treaty draft. While the requirement also appeared in the Jamaican treaty, the Senate apparently did not approve of its inclusion. No reference to the “prohibited payment” requirement was made at the Bangladesh ratification hearings, and the requirement was not included in the Senate-created Argentina provision. The Treasury apparently saw the omission of the requirement as a signal and omitted the requirement from the December draft and from the treaties with New Zealand and Australia. This interplay between the Treasury and the Senate as to whether the “prohibited payment” requirement should be an element of the United States international tax policy signals that the two parties have yet to agree on a definitive model treaty provision.

Undoubtedly, the newly proposed “prohibited payments” requirement is less restrictive than its predecessor. The new requirement specifically permits that up to fifty percent of the treaty corporation’s gross income may be used for interest payments to third country residents. In addition, the new provision does not restrict the payment of dividends and royalties to third country residents.

3. Recent Activity

Recent treaties and protocols indicate that the “prohibited payment” protocol is not being readily adopted. In September 1983,

\textsuperscript{188} See supra notes 99, 116, 127, 168, and 157.

\textsuperscript{189} See December 1981 Draft of the 1977 U.S. Model, supra note 134; see notes 144-47 and accompanying text.

\textsuperscript{190} 1983 Denmark Protocol, supra notes 89 and 180.
the United States and France signed a protocol which later was amended by another protocol signed on January 17, 1984; neither protocol contained a "prohibited payment" requirement. The United States signed a new treaty and protocol with Italy on April 17, 1984. Under Article 2 of the Protocol, third country residents may own up to 49.99 percent of an Italian corporation and still utilize the benefits of the treaty. Like the French protocol, the Italian protocol does not contain a "prohibited payment" requirement.

On May 8, 1984, the Senate Foreign Relations Committee approved the Danish and the French protocols. On June 28, 1984, the Senate approved the French treaty and protocol. Without explanation, however, no vote was taken on the Danish protocol. In contrast to the protocols signed with France and Italy, the Danish protocol contained the "prohibited payment" requirement that limits the payments of dividends, interest, and royalties to third country residents. The Senate's failure to vote on the Danish protocol might be an indication that the "prohibited payment" requirement is not being readily accepted.

IV. Conclusion

In view of the history of Article 16, it is obvious that the Treasury may announce a third draft of Article 16. The new version should be substantially different from the version proposed in June 1981. It is expected that the third version will include the following provisions:

1. It will limit all benefits under the treaty. This limitation would be far more encompassing than the present wording found in the 1977 Model. Such a change was first proposed in the June 1981 draft, adopted by the Senate in its reservation to the Argentina treaty, confirmed by the Treasury in the language of the December draft, and confirmed by the Senate in the recent ratification of the treaties with New Zealand and Australia.

2. It will use mandatory language such as the treaty taxpayer's
"shall not be entitled" to the treaty benefits. While the 1977 Model uses the "may tax" optional language, this language has only been used in a few treaties.

3. It will apply to all taxpayers other than individuals. While the 1977 Model only applies to companies, the Argentine reservation and the ratification of the treaties with New Zealand and Australia indicate that there is support in the Senate for the more encompassing language found in the June draft. Additionally, in view of the two most recent treaties, the third or final draft of Article 16 can be expected to contain some language concerning trusts and how the benefits of such trusts could be denied to beneficiaries.

4. It will stipulate that one of three possible requirements be satisfied. As a review of the treaties indicate, there definitely will be a "stock exchange" and a "business purpose" requirement. In light of the August protocol with Denmark, however, there is some uncertainty as to the final form of the third requirement.

The third requirement undoubtedly will involve some kind of an "ownership" or "control" test. Traditionally, the Senate has ratified treaties containing a clause limiting ownership or control by third country residents to one-fourth of the treaty corporation. At the same time, however, the Senate appears to oppose a "prohibited payment" requirement. The Treasury has proposed raising the percentage from twenty-five to about fifty percent. The price to pay for raising the percentage of ownership as such is a "prohibited payment" clause. Thus, the Senate must decide whether it is necessary to raise the traditional percentage from twenty-five to almost fifty percent at the expense of including a "prohibited payment" clause.

The Treasury clearly is retreating from the proposed June draft; however, such a retreat does not show that the Treasury will condone treaty shopping. The change in position does indicate that the Treasury is willing to re-examine its original views on treaty shopping and that it might even be willing to permit some treaty shopping. The omissions also indicate that the Treasury feels that it no longer needs to justify its anti-treaty shopping policy based on its original concern over the loopholes provided in tax laws of foreign countries. The Treasury no longer needs to present arguments in support of the adoption of Article 16 provisions in tax treaties, because the Senate has indicated that the policy behind Article 16 is "the prevention of unintended benefits."

The Treasury and the Senate have demonstrated their faith that the United States, with its relatively stable government and econ-
omy, will continue to attract foreign capital from around the globe regardless of whether the foreign capital can be channelled through treaty countries. As long as the Treasury and Senate are convinced that the United States will continue to attract foreign capital regardless of our international tax policy, the United States government will continue its anti-treaty shopping efforts.
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