

University of Michigan Law School

University of Michigan Law School Scholarship Repository

Articles

Faculty Scholarship

2020

Tax Treaties, the Constitution, and the Noncompulsory Payment Rule

Reuven S. Avi-Yonah

University of Michigan, aviyonah@umich.edu

Available at: <https://repository.law.umich.edu/articles/2426>

Follow this and additional works at: <https://repository.law.umich.edu/articles>



Part of the [International Law Commons](#), [Taxation-Transnational Commons](#), and the [Tax Law Commons](#)

Recommended Citation

Avi-Yonah, Reuven S. "Tax Treaties, the Constitution, and the Noncompulsory Payment Rule." *International Tax Journal* 47, no. 3 (2021): 41-42, 59.

This Article is brought to you for free and open access by the Faculty Scholarship at University of Michigan Law School Scholarship Repository. It has been accepted for inclusion in Articles by an authorized administrator of University of Michigan Law School Scholarship Repository. For more information, please contact mlaw.repository@umich.edu.

Tax Treaties, the Constitution, and the Noncompulsory Payment Rule

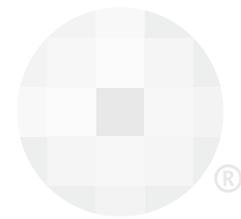
By Reuven S. Avi-Yonah

U.S. tax treaties have been regarded as self-executing since the first treaty (with France) was ratified in 1932.¹ Rebecca Kysar has argued this raises a doubt on whether the treaties are constitutional, because tax treaties (like other treaties) are negotiated by the executive branch and ratified by the Senate with no involvement by the House, and all tax-raising measures must originate in the House under the Origination Clause (U.S. Const. Art I, section 7, clause 7). Her preferred solution is to make tax treaties non-self executing, *i.e.*, to require them to be incorporated in legislation, as is the practice in many other countries (*e.g.*, the UK).²

Kysar's solution would reverse the universal practice since 1932 and is therefore unlikely to be implemented. Moreover, tax treaties are generally precluded from affecting revenue from U.S. taxpayers by the Saving Clause (Art. 1(4)). Under the Saving Clause, "this Convention shall not affect the taxation by a Contracting State of its residents (as determined under Article 4 (Resident)) and its citizens." The Saving Clause is generally regarded as required by the Origination Clause because if a U.S. tax treaty were to affect taxation of U.S. citizens, this would violate the rule that all tax measures must originate in the House.³

But Kysar's argument raises another question in regard to the noncompulsory payment rule (Reg. §1.901-2(e)(5)). The noncompulsory payment rule, which has no statutory basis in the Code, states that:

An amount paid is not a compulsory payment, and thus is not an amount of tax paid, to the extent that the amount paid exceeds the amount of liability under foreign law for tax. An amount paid does not exceed the amount of such liability if the amount paid is determined by the taxpayer in a manner that is consistent with a reasonable interpretation and application of the substantive and procedural provisions of foreign law (including applicable tax treaties) in such a way as to reduce, over time, the taxpayer's reasonably expected liability under foreign law for tax, and if the taxpayer exhausts all effective and practical remedies, including invocation of competent authority procedures available under applicable tax treaties, to reduce, over time, the



REUVEN S. AVI-YONAH is a Irwin I. Cohn Professor of Law and Director, International Tax LLM at the University of Michigan.

taxpayer's liability for foreign tax (including liability pursuant to a foreign tax audit adjustment). Where foreign tax law includes options or elections whereby a taxpayer's tax liability may be shifted, in whole or part, to a different year or years, the taxpayer's use or failure to use such options or elections does not result in a payment in excess of the taxpayer's liability for foreign tax. An interpretation or application of foreign law is not reasonable if there is actual notice or constructive notice (*e.g.*, a published court decision) to the taxpayer that the interpretation or application is likely to be erroneous. In interpreting foreign tax law, a taxpayer may generally rely on advice obtained in good faith from competent foreign tax advisors to whom the taxpayer has disclosed the relevant facts. A remedy is effective and practical only if the cost thereof (including the risk of offsetting or additional tax liability) is reasonable in light of the amount at issue and the likelihood of success. A settlement by a taxpayer of two or more issues will be evaluated on an overall basis, not on an issue-by-issue basis, in determining whether an amount is a compulsory amount. A taxpayer is not required to alter its form of doing business, its business conduct, or the form of any business transaction in order to reduce its liability under foreign law for tax.

Two of the examples given in the regulation for non-compulsory payments do not involve tax treaties (Reg. §1.901-2(e)(5), Examples 1 and 5). Examples 2, 3 and 4 do involve a tax treaty that embodies the arm's length standard, but it is not clear that the existence vel non of the treaty affects the result, because the arm's length standard would usually apply to related party transactions under both U.S. and foreign law in the absence of a treaty.

Similarly, most of the case law under the noncompulsory payment rule does not involve tax treaties, or if it does it only involves the arm's length standard, and the IRS has largely been unsuccessful in applying the rule to deny foreign tax credits.⁴ The exception is *Procter & Gamble*, in which the taxpayer paid tax on the same royalties to both Korea and Japan, and was held to have violated the noncompulsory payments rule because it only tried to challenge the Korean tax under the applicable treaty but not the Japanese tax, so it could not get credit for the Japanese tax.⁵ But in this case as well, it is not clear that the treaty by itself changed the result.

However, the regulation also contains the following example:

Example 6.

The internal law of country X imposes a 25 percent tax on the gross amount of interest from sources in country X that is received by a nonresident of country X. Country X law imposes the tax on the nonresident recipient and requires any resident of country X that pays such interest to a nonresident to withhold and pay over to country X 25 percent of such interest, which is applied to offset the recipient's liability for the 25 percent tax. A tax treaty between the United States and country X overrides internal law of country X and provides that country X may not tax interest received by a resident of the United States from a resident of country X at a rate in excess of 10 percent of the gross amount of such interest. A resident of the United States may claim the benefit of the treaty only by applying for a refund of the excess withheld amount (15 percent of the gross amount of interest income) after the end of the taxable year. A, a resident of the United States, receives a gross amount of 100u (units of country X currency) of interest income from a resident of country X from sources in country X in the taxable year 1984, from which 25u of country X tax is withheld. A does not file a timely claim for refund. 15u of the amount withheld (25u - 10u) is not a compulsory payment and hence is not an amount of tax.

On its face, this is a justified application of the noncompulsory payment rule, because the taxpayer could under the specified facts easily obtain a refund of the extra 15u by filing a refund claim. It is unclear whether any actual taxpayer is ever so negligent. More commonly, the taxpayer faces a foreign withholding agent that ignores the treaty by applying the higher withholding amount, and the taxpayer's efforts to obtain a refund may be unavailing in many countries that follow the principle that a tax withheld can never be refunded.

But the example raises an interesting question: Suppose there was no treaty, what would the result have been? The answer is clearly that in that case there would be withholding of 25u with no refund and a full foreign tax credit. So here we have a situation in which the tax treaty by its very existence and by the terms of the relevant article raises the U.S. taxpayer's U.S. tax liability because it now has to pay 25u to X and another 15u to the United States. What about the ability of the U.S.

Continued on page 59

Debt Push Downs and Debt-Netting Rule

Continued from page 10

obtained a Code Sec. 904 benefit from locating an equal amount of interest-bearing debt at the CFC and U.S. Parent level commensurate with the relative assets.

⁶ Reg. §1.861-10(e). One condition of the debt-netting rule's application is that the U.S. shareholder increase both its external debt at the U.S. shareholder level and its loans receivable from related CFCs during the base period. In the Example above, U.S. shareholder's receivables from CFCs increase by \$500, but the debt-netting rule would not apply if U.S. shareholder indebtedness were constant relative to the base period. See Reg. §1.861-10(e)(1)(ii).

⁷ The debt-netting rules specially allocate interest expense to foreign source income to the extent of income on so-called "allocable RGI." Allocable RGI is equal to an amount of RGI equal to the lesser of its excess RGI and excess USSI. See Reg. §1.861-10(e)(4)(ii). Where only some of the taxpayer's RGI is allocable RGI, only a ratable portion of the interest income on such RGI gives rise to a special allocation of interest expense. For simplicity, the examples in the text above assume that all of the CFC-level RGI is allocable RGI, so that interest expense equal to all interest income on the U.S. shareholder's loan to the CFC is subject to the special allocation.

⁸ See Reg. §1.904-5(c)(2).

⁹ The loan receivable would be in the passive basket to the extent related-person interest expense is allocated against passive basket income under Reg. §1.904-5(c).

¹⁰ See Reg. §1.861-8(d)(2)(ii)(A).

¹¹ In addition, under Code Sec. 951A(b)(2), if the Parent has a positive QBAL position in its CFCs, this interest expense would reduce 10% of QBAL return that is exempt from tax.

¹² Reg. §1.861-10(e)(4)(v).

¹³ See Code Sec. 954(c)(6); Notice 2007-9.

¹⁴ From the perspective of the debt-netting regulation, this hybrid scenario does not give rise to allocable RGI or a direct allocation of interest expense against foreign source income. A special rule in Reg. §1.861-10(e) treats the additional \$500 of equity investment in CFC1 as an increase in RGI. However, the income on the CFC stock (here, the GILTI inclusion attributable to CFC1) is not treated as income from RGI subject to a special allocation. See Reg. §1.861-10(e)(8)(v). Additionally, to prevent the application of this rule from distorting the normal allocation fraction under Code Sec. 861, proposed regulations issued in November 2020 (REG-101657-20) would repeal this special rule effective for taxable years ending on or after November 2, 2020. See Proposed Reg. §1.861-10(h). See also Reg. §1.861-10(e)(8)(vi) (making a similar change for the rules for hybrid debt effective in December 2018).

Noncompulsory Payment Rule

Continued from page 42

taxpayer to choose not to invoke the treaty if this leads to a more favorable tax result?⁶

In my opinion, such a result is unconstitutional because the tax treaty raises the U.S. taxpayer's U.S. tax, in violation of the Origination Clause.⁷

More broadly, one may question the policy rationale behind the non-compulsory payment rule, which as far as I know is unique among countries that allow foreign tax credits, just as the fact that U.S. tax treaties are self-executing puts the United States in a small minority of countries that do not require any legislation for a tax treaty to come into effect.⁸ The noncompulsory payments rule is full of limitations that are difficult for taxpayers to navigate: When is "the cost thereof (including the risk of offsetting or additional tax liability) ... reasonable in light of the amount at issue and the likelihood of success?" The answer to that may be difficult for a taxpayer to ascertain. And how does a taxpayer distinguish transactions that fall under the rule from transactions that "alter its form of doing business, its business conduct, or the form of any business transaction?" Moreover, the IRS has lost most of the cases it litigated under the rule.

Perhaps it is time to eliminate the noncompulsory payment rule as too complex and not worth the effort it requires from both taxpayers and the IRS, as well as sometimes unconstitutional. In addition, the rule could be challenged if the Supreme Court does away with Chevron deference because it has no basis in the statutory text. If that outcome is considered too generous to taxpayers who would be tempted to be negligent at the

expense of the fisc, the solution may be to place limits on full creditability, as Dan Shaviro has long advocated and as Congress has done for GILTI.⁹

ENDNOTES

¹ U.S. treaties are self-executing if they do not require further Congressional action to implement once they are ratified by the Senate. See *Foster v. Neilson*, 27 US 253, 254 (1829) (holding that a treaty governing Spanish land grants in Florida was not self-executing).

² Rebecca M. Kysar, *On the Constitutionality of Tax Treaties*, 38 YALE J. INT'L LAW (2013). Brooklyn Law School, Legal Studies Paper No. 274, available at SSRN: <https://ssrn.com/abstract=2034904>.

³ See, e.g., Technical Explanation of the US-UK Tax Treaty (2003): "Paragraph 2 also means that the Convention may not increase the tax burden on a resident of a Contracting State beyond the burden determined under domestic law. Thus, a right to tax given by the Convention cannot be exercised unless that right also exists under internal law. It follows that, under the principle of paragraph 2, a taxpayer's U.S. tax liability need not be determined under the Convention if the Code would produce a more favorable result." See also, Jeffrey A. Schoenblum, *Bilateral Transfer Tax Treaties*, 851 TAX MGMT. PORTFOLIOS (BNA) (2012) (noting that it is routinely accepted among tax professionals that, in order to comply with the Origination Clause, tax treaties cannot increase tax liability).

⁴ For example, see *International Business Machine Corp.*, FedCl, 97-2 USTC ¶150,602, 38 FedCl 661, 675 (1997); *Schering Corp.*, 69 TC 579, 600-603, Dec. 34,929 (1978); *Coca-Cola Co.*, 149 TC 21, 15-16 (2017).

⁵ *The Procter & Gamble Co. and Subsidiaries*, DC-OH, 2010-2 USTC ¶150,593, 85,545.

⁶ In general, taxpayers may choose between the Code and the treaty, as long as they are consistent. See, e.g., Rev. Rul. 84-17, 1984-1 CB 308; Rev. Rul. 80-147, 1980-1 CB 16.

⁷ Kysar argues that based on the case law a treaty can be considered as falling under the Origination Clause even if it just changes the tax result, not just if it raises more revenue, but in this case the treaty actually raises more revenue. Kysar, *supra* note 2.

⁸ Kysar, *supra* note 2.

⁹ See Daniel Shaviro, *The Case Against Foreign Tax Credits*, NYU SCHOOL OF LAW, PUBLIC LAW RESEARCH PAPER NO. 10-12, NYU LAW AND ECONOMICS RESEARCH PAPER NO. 10-09 (Mar. 2013), available at SSRN: <https://ssrn.com/abstract=1547312> or <http://dx.doi.org/10.2139/ssrn.1547312>; Code Sec. 960(d) (imposing an 80% limit on foreign tax credits offsetting of U.S. tax under GILTI).

Reproduced with permission of copyright owner. Further reproduction prohibited without permission.