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If Not Now, When? U.S. Tax Treaties with Latin America After TCJA

By Reuven S. Avi-Yonah

1. The Traditional View

Since the 1990s, the U.S. tax treaty network has expanded to include most large developing countries, such as China and India, and many smaller ones, such as Kazakhstan. However, there remains a glaring exception: The United States only has two tax treaties in Latin America, both with oil exporting countries (Mexico and Venezuela), and one pending tax treaty (Chile).[1]

The traditional explanation for why the United States has no treaty with, for example, Argentina or Brazil is the U.S. refusal since 1957 to grant tax sparing credits to developing countries. In 1957, the U.S. negotiated a tax treaty with Pakistan that included a tax sparing provision, *i.e.*, a credit for taxes that would have been paid to Pakistan but for a tax holiday to attract investment. Stanley Surrey, who was then a Harvard law professor but was later to become the first Assistant Secretary for Tax Policy, testified against the Pakistan treaty. His main argument was that granting tax sparing credits would effectively reduce U.S. tax on U.S. source income, but there are also indications that he was opposed to double non-taxation in general.[2]

The Senate rejected the Pakistan treaty, and ever since then it has been inflexible U.S. policy not to grant tax sparing credits, contrary to the position of many European countries and Japan, who view these credits as a tool in helping development. The OECD came out with a paper critical of tax sparing in 1998.[3] The United States occasionally promises a treaty partner (*e.g.*, Israel) that if it ever granted tax sparing to anyone it will extend the policy to that partner, but it does so in the knowledge that it is very unlikely to have to fulfill this promise.

The lack of tax sparing is the traditional reason given by Latin American countries such as Argentina and Brazil for not entering into tax treaties with the United States. The argument is that in the absence of tax sparing, tax incentives granted to U.S. multinationals (MNEs) would result in a transfer of revenue from the host country to the United States, without any benefit to the U.S. MNE.[4]

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2. Why the Traditional View Was Wrong

This traditional narrative was wrong before TCJA, for two reasons. First, before 2017, U.S. MNEs generally enjoyed deferral on active income, so that a U.S. MNE with a controlled foreign corporation (CFC) in Argentina or Brazil would not pay current U.S. tax on its earnings even if there was no host country tax. Second, pre-TCJA law allowed for cross-crediting, so that to the extent the U.S. MNE had high tax active foreign source income anywhere, it could average the foreign tax rate with a zero tax in a host country. Cross-crediting created an incentive to invest in a host country that grants a tax holiday for any U.S. MNE in an excess credit position (*i.e.*, with foreign taxes that exceed the U.S. tax rate).[5]

Thus, I believe that before TCJA, tax sparing was a red herring, and not the real reason for the lack of U.S. tax treaties with Latin America. The real reason was presumably uneven investment flows that meant that there would be one-sided revenue losses for the host country. It is no accident that the only two treaties in force are with Mexico and Venezuela, two oil exporting countries with more even investment flows with the United States.

3. TCJA: Exemption

This analysis is now obsolete, because the TCJA has changed the background U.S. rules. The first major change is the adoption of a partial participation exemption. Under TCJA, to the extent a CFC of a U.S. MNE earns active income that is below a deemed 10% return on its basis in tangible assets, there is no U.S. tax imposed not just when the income is earned, but also when it is repatriated to the United States as a dividend.

This provision is better than tax sparing, because tax sparing as a foreign tax credit is limited to the U.S. tax rate (currently 21%). Instead, if a U.S. MNE now builds a factory in Argentina or Brazil and earns a return up to 10% of its basis, and the factory enjoys a tax holiday, then the income is exempt from U.S. tax even when repatriated, regardless of what the pre-tax holiday host country tax rate was.[6]

This provision clearly acts as an incentive for U.S. MNEs to shift actual production facilities in response to tax holidays abroad. However, for reasons set out below, the incentive would be increased if there were a tax treaty in place. Since the tax sparing argument no longer applies, the exemption should encourage negotiation of tax treaties between the United States and Latin America.

4. TCJA: GILTI and Cross Crediting

If the return on the foreign investment exceeds 10% of the basis in tangible assets, then the investment is subject to current U.S. tax under the global intangible low-taxed income (GILTI) provision.[7] Since most U.S. MNEs rely heavily on intangibles, GILTI limits the scope of the participation exemption. And since GILTI eliminates deferral, then old tax sparing argument becomes more valid: If there are no other sources of foreign income and GILTI applies, then an investment that benefits from tax sparing would be subject to U.S. tax at 10.5%, so that the value of the tax holiday is diminished (but not eliminated if the foreign tax rate absent the tax holiday exceeds 10.5%).

However, there is another important provision in TCJA: GILTI allows a foreign tax credit up to 80% of the foreign tax (*i.e.*, an effective foreign tax rate of 13.125% eliminates GILTI), and moreover allows for cross crediting.[8] Given that the U.S. tax rate was cut from 35% to 21%, there are a lot of U.S. MNEs in an excess credit position. In that case a tax holiday would still be helpful because of cross-crediting, as the following example shows:

1. Assume a U.S. MNE with no tangible assets and foreign income earned by a CFC in a country with a 25% tax rate (*see* Table 1).
2. Now assume the same MNE can earn an additional 100 in a foreign country with a tax holiday (*see* Table 2).

Thus, the investment in the tax holiday country reduced the effective overall tax rate and eliminated the excess credits (which cannot be used given that there are no carryforwards under GILTI). This means that even

TABLE 1.

Foreign income	100
Foreign tax	25
GILTI tax	10.5
FTC	20 (limited to 80% of foreign tax)
FTC limit	10.5 (U.S. tax rate × foreign source income)
U.S. tax	0
Excess credits	9.5 (lost, because no carryover)
Effective tax rate	25%

TABLE 2.	
Foreign income	200
Foreign tax	25
GILTI tax	21
FTC	20
FTC limit	21
U.S. tax	1
Excess limit	1
Effective tax rate	13%

under TCJA the tax holiday remains effective, and the tax sparing argument remains specious.

5. Conclusion: Why Should Latin American Countries Enter into Tax Treaties with the United States After TCJA?

There are three good reasons that Latin American countries should consider entering into tax treaties with the United States after TCJA.

First, as we have seen, to the extent that the participation exemption applies, the result is better than tax sparing for countries that offer tax holidays. To the extent GILTI applies, there is still an incentive to invest in a tax holiday country because of cross-crediting, so that even with GILTI there may not be a revenue shift. Many U.S. MNEs are now in an excess credit position because of the tax rate cut.

Second, there are good reasons to enter into treaties even with a revenue shift, such as attracting FDI and limiting tax evasion. There is an abundant empirical literature that shows that tax treaties encourage FDI, primarily because they serve an insurance function against sudden tax increases and provide for a mechanism to settle disputes.[9] In addition, tax treaties limit capital flight and tax evasion because of exchange of information; absent a tax treaty the United States becomes a tax haven for rich Latin Americans.

Third, Latin American countries are increasingly capital exporters, and the absence of a treaty hurts their multinationals. Argentina and Brazil in particular are now home to many MNEs, and in the absence of a treaty, dividends from their U.S. subsidiaries are subject to a hefty 30% withholding tax. Treaty shopping has become more difficult because of limitation on benefits (LOB) provisions as well as the new primary purpose test, which applies to Latin American treaties with countries like the Netherlands or Belgium that have traditionally served as conduits for their FDI into the United States.

Finally, now is an opportunity, because the entire U.S. treaty network needs to be updated to take account of TCJA. Under the U.S. treaty override rule, TCJA overrides earlier treaties, and it includes provisions like the BEAT that arguably violate treaties.[10] The United States would presumably be happy to negotiate new treaties with Latin American countries, and the actual withholding tax rates are negotiable, so that any revenue loss can be limited. There is no reason why China or India should have a tax treaty with the United States, while Argentina or Brazil do not have one.

ENDNOTES

1 All seven U.S. tax treaties signed since 2010 have not been ratified for unrelated political reasons, but they may now be moving forward. *See www.law360.com/articles/1168002/senate-to-vote-on-tax-treaties-this-year-lawmaker-says.*

2 Stanley S. Surrey, *The Pakistan Tax Treaty and "Tax Sparing,"* 11 NAT'L TAX J. 156, 157 (1958). For Surrey's support of the single tax principle *see* Reuven Avi-Yonah, *Who Invented the Single Tax Principle? An Essay on the History of US Treaty Policy*, 59 NYLS L REV 305 (2015).

3 OECD, *Tax Sparing, A Reconsideration* (February 24, 1998), available online at *www.oecd-ilibrary.org/taxation/tax-sparing_9789264162433-en.*

4 Reuven S. Avi-Yonah, *Double Tax Treaties: An Introduction* (December 3, 2007).

5 Reuven S. Avi-Yonah, *Making Sense of U.S. International Taxation: Six Steps Toward Simplification. Bull. for Int'l Fiscal Documentation* 55, no. 9 (2001): 493–497.

6 Reuven S. Avi-Yonah, *Guilty as Charged: Reflections on TRA 17*, 157 TAX NOTES 8 (November 25, 2017).

7 Section 951A, as enacted under P.L. 115-97 (the Tax Cuts and Jobs Act, or TCJA).

8 Reuven S. Avi-Yonah, *The International Provisions of the TCJA: A Preliminary Summary and Assessment* (December 23, 2017).

9 Karl P. Sauvant and Lisa E. Sachs, *The Effect of Treaties on Foreign Direct Investment: Bilateral Investment Treaties, Double Taxation Treaties, and Investment Flows* (Oxford U. Press, 2009).

10 *See* Avi-Yonah and Wells, *The BEAT and Treaty Overrides: A Brief Response to Rosenbloom and Shaheen*, 92 TAX NOTES INT'L 383 (October 22, 2018).