Bloomberg Tax

Tax Management
International Journal™

Reproduced with permission from Tax Management International Journal, Vol. 49, No. 02, 02/14/2020. Copyright © 2020 by The Bureau of National Affairs, Inc. (800-372-1033) http://www.bna.com

EB or Not EB? That Is the Question Treasury Must Answer After Brexit

By David W. Rubin[*]
Gibson, Dunn & Crutcher
Los Angeles, CA

I. INTRODUCTION: WILL U.K. RESIDENTS STILL BE EQUIVALENT BENEFICIARIES AFTER BREXIT?

In recent years, skepticism about international institutions and multinational collaboration has reached a fever pitch. While Brexit — the prospective withdrawal of the United Kingdom (U.K.) from the European Union (EU) — is the most monumental example, we have also seen African nations threaten to leave the International Criminal Court,[1] President Trump's consideration of U.S. withdrawal from NATO,[2] and the renegotiation of the North American Free Trade Agreement (NAFTA).[3] Suddenly, the current state of affairs is marked by an uncertainty about the makeup of international organizations and the endurance of global cooperation that the world has not contended with for at least a quarter of a century. Due in large part to the precipitousness of its rise, this uncertainty has decision makers scrambling to contend with heretofore unanswered questions that could have enormous consequences in international law, including in the realm of income tax treaties.

Brexit could have a significant effect on international and U.K. domestic taxation. It will likely impact aspects of the United Kingdom's value added tax and withholding tax regimes, customs and excise taxes, State Aid determinations, and double tax treaties.[4] This article investigates one discrete issue that has not yet been decided by the U.S. Department of the Treasury ("Treasury"), but that could have dramatic consequences for entities currently claiming the benefit of U.S. double taxation treaties: whether the United Kingdom's withdrawal from the European Union means that U.K. shareholders will no longer be considered equivalent beneficiaries ("EB") for purposes of the derivative benefits test in the limitation on benefits (LOB) provision in U.S. tax treaties.

In this article, I intend to explore the arguments on both sides of the question, contextualize the issue in the proper legal framework, and explore Treasury's permissible courses of action. First, I illustrate with examples common situations where loss of equivalent beneficiary status would have negative consequences for entities with U.K. owners. Second, I explore the arguments for and against the extension of equivalent beneficiary status to U.K. residents, in light of both the purposes of the derivative benefits test and the hurdles presented by the rules of treaty interpretation. Third, I consider the few historical analogs that might be helpful in this conversation. Finally, I consider how Treasury could legally continue to extend equivalent benefits to companies with U.K. ownership who fail

---

[*] David W. Rubin is an associate with Gibson, Dunn & Crutcher in the Los Angeles office and a 2019 graduate of the University of Virginia School of Law. This paper was the winner of the International Fiscal Association USA's 2019 Student Writing Competition and will be presented at IFA-USA's annual conference in Boston on February 27, 2020. The author would like to thank Professor Ruth Mason, who served as his faculty sponsor.

[1] Franck Kuwonu, *ICC: Beyond the Threats of Withdrawal*, Africa Renewal (May-July 2017), https://www.un.org/africarenewal/magazine/may-july-2017/icc-beyond-threats-withdrawal.

[2] Emily Stewart, *Trump Has Reportedly Discussed Withdrawing From NATO. That Would Be Great for Russia*, Vox (Jan. 15, 2019), https://www.vox.com/policy-and-politics/2019/1/15/18183759/trump-pull-out-of-nato-nyt-mattis .

[3] Felix Salmon, *Trump Channels Theresa May's Brexit Plan for NAFTA 2.0*, Axios (Jan. 13, 2019), https://www.axios.com/nafta-donald-trump-brexit-theresa-may-f85a2f4a-24e7-43fc-bd1c-a0bffa8030fa.html.

[4] Robert W. Misey, Jr., *Brexit Impacts Treaty Benefits Analysis*, J. of Tax Practice & Proc. (Apr.-May 2017), https://www.reinhartlaw.com/wp-content/uploads/2015/09/Brexit-Impacts-Treaty-Benefits-Analysis.pdf .

the derivative benefits test post-Brexit via the competent authority process, avoiding both a strained interpretation of the definition of equivalent beneficiary and a Senate that is presently unlikely to ratify amendments to tax treaties for the foreseeable future.[5]

II. THE LIMITATION ON BENEFITS ARTICLE AND DERIVATIVE BENEFITS TEST

The LOB article in U.S. tax treaties is intended to prevent ''treaty shopping,'' whereby residents from third countries not party to the treaty manipulate treaty residence rules or corporate shareholdings in order to obtain treaty benefits.[6] Activity deemed to be treaty shopping can run the gamut from operating as part of a conduit structure (the prototypical form of abusive treaty shopping that provisions like the LOB primarily target) to operating as part of a structure organized solely for substantive business purposes.[7] Given the LOB's mechanical and objective nature, even entities structured with no treaty shopping purpose whatsoever can run afoul of its requirements.

The LOB includes, depending on the treaty, up to five discrete safe harbors: the publicly traded companies/subsidiary test, the tax-exempt organization and pension funds test, the stock ownership and base erosion test, the active trade or business test, and the derivative benefits test.[8] The derivative benefits test is intended to grant treaty benefits to a treaty state resident if its nonresident owners would be granted the same benefits if the income flowed directly to them.[9] Essentially, the test extends treaty benefits to a resident entity that nonetheless fails the other LOB tests on the basis that its ownership structure is not abusive if its shareholders could have received the same treaty benefits without locating the entity in the treaty state. These nonresident owners are considered ''equivalent beneficiaries'' for purposes of the test.

Currently, 16 U.S. tax treaties include derivative benefits tests in their LOB provisions.[10] Most of these clauses limit the grant of equivalent beneficiary status to some combination of residents of EU and European Economic Area (EEA) member states and parties to NAFTA.[11] Taxpayers with any U.K. shareholders hoping to rely on the derivative benefits test when applying for benefits under any of these treaties that restrict equivalent beneficiary status to EU, EEA, and NAFTA membership need to be aware that they might fail the test post-Brexit, in which case they will be denied all treaty benefits entirely.[12]

[5] Prior to July 17, 2019, no new tax treaty or protocol had entered into force for a decade, due in large part to Sen. Rand Paul's (R-Ky.) objections based on taxpayer privacy considerations. *See* https://www.pwc.com/us/en/services/tax/us-inbound-tax/doing-business-in-the-united-states/us-tax-treaties.html. On July 17, 2019, the Senate approved four amended treaties. *See* https://www.bloomberg.com/news/articles/2019-07-17/u-s-senate-ratifies-long-delayed-international-tax-treaties. Currently, there are four treaties or protocols dealing with taxation pending in front of the Senate, the earliest of which was submitted in November 2010. *See* https://www.state.gov/s/l/treaty/pending/ (Sept. 27, 2019).

[6] https://www.irs.gov/pub/irs-utl/Tax_Treaty_Table_4.pdf.

[7] Reuven Avi-Yonah and Christiana Hji Panayi, *Rethinking Treaty Shopping: Lessons for the European Union*, U. of Mich. L. & Econ., Empirical Legal Studies Center Paper No. 10-002, U. of Mich. Pub. L. Working Paper No. 182 (2010) at 23, https://repository.law.umich.edu/cgi/viewcontent.cgi?article=1077&context=book_chapters.

[8] https://www.irs.gov/pub/irs-utl/Tax_Treaty_Table_4.pdf.

[9] Reuven Avi-Yonah and Oz Halabi, *U.S. Treaty Anti-Avoidance Rules: An Overview and Assessment*, U. of Mich. L. & Econ, Empirical Legal Studies Center Paper No. 12-001, U. of Mich. Pub. L. Working Paper No. 261 (2012) at p. 17, https://repository.law.umich.edu/cgi/viewcontent.cgi?article=1155&context=law_econ_current.

[10] Belgium, Canada, Denmark, Finland, France, Germany, Iceland, Ireland, Jamaica, Luxembourg, Malta, Mexico, Netherlands, Sweden, Switzerland, United Kingdom. *See* https://www.irs.gov/pub/irs-utl/Tax_Treaty_Table_4.pdf. Note, however, that some treaties that the table suggests do not feature derivative benefits tests actually do include them in their LOB provisions. Tax Treaty Table 4 suggests that the following U.S. tax treaties do not include derivative benefits tests: Belgium, Denmark, Finland, France, Germany, Malta, Netherlands, Sweden, and the United Kingdom. The derivative benefits test in the U.S.-France treaty is listed under the ''Other'' category. The table lists the derivative benefits tests in the other aforementioned treaties under the ''Stock Ownership and Base Erosion Test'' category.

[11] *See* Table One.

[12] 2016 U.S. Model Income Tax Convention (U.S. Model Treaty), art. 23(7)(e).

Table One: Current List of Equivalent Beneficiaries in U.S. Treaties with Derivative Benefits Tests

U.S. Treaty	EU?	EEA?	NAFTA?	Other?
Belgium	Yes	Yes	Yes	Switzerland
Canada*	n/a	n/a	n/a	n/a
Denmark	Yes	Yes	Yes	Switzerland
Finland	Yes	Yes	Yes	Switzerland
France	Yes	No	Yes	
Germany	Yes	Yes	Yes	
Iceland	Yes	Yes	Yes	EFTA ^
Ireland	Yes	No	Yes	
Jamaica **	n/a	n/a	n/a	n/a

© 2020 The Bureau of National Affairs, Inc.
ISSN 0090-4600

Table One: Current List of Equivalent Beneficiaries in U.S. Treaties with Derivative Benefits Tests				
Luxembourg	Yes	No	Yes	
Malta	Yes	Yes	Yes	Australia
Mexico	No	No	Yes	
Netherlands	Yes	Yes	Yes	
Sweden	Yes	Yes	Yes	Switzerland
Switzerland	Yes	Yes	Yes	
United Kingdom	Yes ^^	Yes	Yes	

* The test in the U.S.-Canada treaty does not use geography or membership in an international organization as a qualifier.

** The test in the U.S.-Jamaica treaty does not use geography or membership in an international organization as a qualifier.

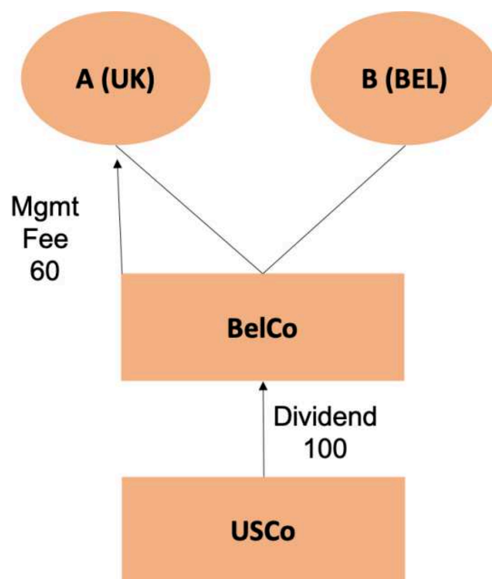
^ Parties to the European Free Trade Agreement

^^ Written as "European Community," which was rolled into the EU in 1993

III. EXAMPLES

A. Example A

Suppose that individuals A and B are U.K. and Belgian residents, respectively. They decide to enter into a partnership to manufacture and sell widgets in the United States. For nontax reasons, they want to avoid direct ownership of shares of a U.S. corporation, so they form BelCo, a Belgian company that will hold 100% of the shares of USCo (which will carry on the actual business activities in the United States). A and B each own 50% of the shares of BelCo. A will oversee the day-to-day operations and long-term strategy of the joint venture. Accordingly, BelCo will pay A a management fee of $60 per year.



In 2020, USCo pays a dividend of $100 to BelCo. BelCo pays A a management fee of $60. These make up all of BelCo's items of income and expenses for 2020. BelCo applies for the reduced withholding rate on dividends under Article 10 of the U.S.-Belgium tax treaty.[13]

The LOB provision in the U.S.-Belgium treaty is found in Article 21. It states that a resident of a contracting state is entitled to benefits only if it meets certain requirements.

Because BelCo is neither an individual nor state nor political subdivision, it fails the tests laid out in paragraphs (2)(a) and (b) of Article 21. BelCo fails the publicly traded test in paragraph (2)(c) because its shares are not traded on a stock exchange. BelCo also fails the base erosion test found in paragraph (2)(e) because it paid more than 50% of its gross income to A (who is not a resident of either contracting state) in the form of the management fee. BelCo fails the active trade or business test in paragraph 3, because it is not engaged in the active conduct of a trade or business in Belgium.

Aside from competent authority relief, the derivative benefits test in paragraph (3) is BelCo's last resort. Paragraph (8)(g) defines an equivalent beneficiary as a member state of the EU, an EEA state, a party to NAFTA, or Switzerland, as long as the equivalent beneficiary resident would be entitled to all of the benefits of a tax treaty between such states and the state in which treaty benefits are claimed.

If the United Kingdom is an EU member state or member of the EEA, then BelCo satisfies the derivative benefits test and is entitled to the reduced withholding rate on the outbound dividend. This is because more than 95% of BelCo shares are owned by less than eight residents of equivalent beneficiary states, and A would be entitled to all of the benefits of the treaty if it were applying under the U.K.-U.S. tax treaty.[14] If, however, the United Kingdom is no longer a member of the EU or EEA, then BelCo fails the 95% ownership requirement in the derivative benefits test, and, barring any competent authority relief, BelCo will be expected to withhold at the 30% domestic dividend withholding rate.

B. Example B

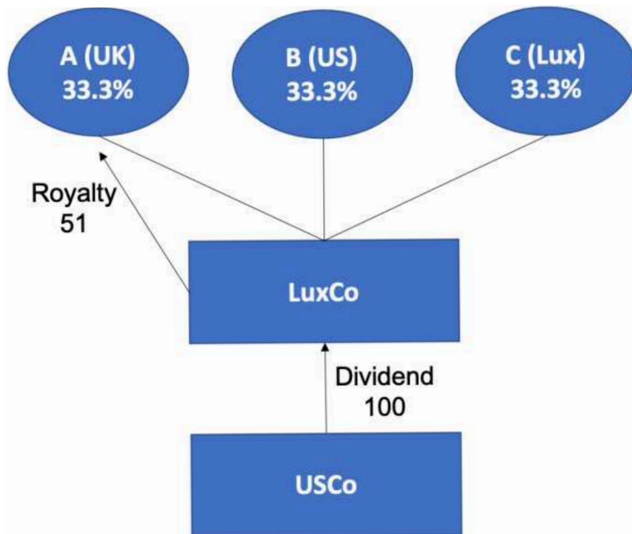
Suppose that three individuals — A, B, and C — are residents of the United Kingdom, the United

[13] U.S.-Belgium Tax Treaty, art. 10.

[14] U.S.-Belgium Tax Treaty, art. 21(3).

© 2020 The Bureau of National Affairs, Inc.
ISSN 0090-4600

States, and Luxembourg, respectively. They decide to enter into a joint venture to sell chemical products in the United States. For nontax reasons, they want to avoid the direct ownership of shares of a U.S. corporation, so they form LuxCo, a Luxembourg closely held company that will own 100% of the shares of USCo. Each of them owns one-third of the LuxCo voting stock (the company's only class of shares). Additionally, A transfers the patents for the chemical products to LuxCo, which enters into a sublicense agreement with USCo.



In 2020, USCo pays a dividend of $100 to LuxCo, which is LuxCo's only source of income. LuxCo pays $51 in royalties (deductible in Luxembourg) to A. LuxCo applies for the beneficial withholding rate on dividends under Article 10 in the U.S.-Luxembourg treaty.

The LOB provision in the U.S.-Luxembourg treaty is found in Article 24. It states that a resident of a contracting state is entitled to the treaty's benefits only if it is a ''qualified resident.''[15] Because LuxCo is neither an individual nor state nor political subdivision, it is not a qualified resident under paragraph (2), subparagraphs (a) and (b). LuxCo fails the base erosion test found in (2)(c) because it paid more than 50% of its gross income to A, who is neither a qualified resident nor a U.S. citizen. LuxCo fails the publicly traded test in paragraph (2), subparagraphs (d) and (e). And finally, LuxCo fails the active trade or business test in paragraph 3, because it is not engaged in the active conduct of a trade or business in Luxembourg.

LuxCo's only remaining safe harbor is the derivative benefits provision found in paragraph 4.[16] If the United Kingdom is an EU member state, then LuxCo satisfies the derivative benefits test and is entitled to the reduced withholding rate on the outbound dividend, which is found in Article 10.[17] This is because more than 95% of LuxCo shares are owned by less than eight residents of EU member states and/or NAFTA states, and it did not make any payments to nonresidents of an EU or NAFTA member state or to U.S. citizens.[18] If, however, the United Kingdom is not an EU member state,[19] then LuxCo fails the 95% ownership requirement in the derivative benefits test, and USCo will be expected to withhold at the 30% domestic dividend withholding rate.

C. Example C

Suppose that A, a U.K.-resident pension fund, is the sole investor in B, an entity resident in Luxembourg. B invests in U.S. government and corporate bonds, as well as other types of U.S.-originated debt. B has chosen Luxembourg as its home because of the flexibility of its tax laws and its robust treaty network. B does not have a permanent establishment in the United States. Under the U.S.-Luxembourg income tax treaty, B benefits from preferable withholding rates on interest payments.[20] If, after Brexit, A is no longer an equivalent beneficiary under the derivative benefits test, then B will no longer receive reduced withholding rates on the interest payments. Suppose further that the arrangement does not meet any other safe harbor tests in the LOB. A will likely be faced with one of two choices: (i) exit B and invest in U.S. debt through a U.K.-resident entity, or (ii) on-shore B so that it is a U.K.-resident entity. Both of these choices will result in the same reduced withholding rates on interest payments B was receiving prior to Brexit, because the U.S.-U.K. treaty grants the same benefits with respect to interest payments as the U.S.-Luxembourg treaty. Due to a provision that is supposed to target improper treaty shopping, A (and, ultimately, its pensioners) will bear the transactional costs of A's exit from B or B's on-shoring, all to arrive at the same position it would be in had it invested directly from the United Kingdom.

---

[15] U.S.-Luxembourg Tax Treaty, art. 24, https://www.govinfo.gov/content/pkg/CDOC-104tdoc33/pdf/CDOC-104tdoc33.pdf.

[16] While the U.S.-Luxembourg treaty does not use the term ''equivalent beneficiary,'' its derivative benefits test operates in the same manner as those found in U.S. treaties that do use the term.

[17] Note, however, that paragraph 4(c) specifies that with respect to dividends, branch tax, interest, and royalties, LuxCo is only entitled to treaty benefits to the extent that they would be granted those same benefits under the U.K.-U.S. tax treaty. In this case, 4(c) does not limit treaty benefits because the U.K.-U.S. treaty grants the same benefits with respect to the aforementioned withholding tax rates as the U.S.-Luxembourg treaty. *See* https://www.irs.gov/pub/irs-utl/Tax_Treaty_Table_1_2019_Feb.pdf.

[18] *See* U.S.-Luxembourg Tax Treaty, art. 24(4)(a) and (b).

[19] Note that the U.S.-Luxembourg treaty does not grant derivative benefits to residents of non-EU member states who are nevertheless members of the European Economic Area. The majority of derivative benefits in bilateral U.S. tax treaties do extend benefits to residents of EEA member states.

[20] *See* U.S.-Luxembourg Tax Treaty, art. 12.

© 2020 The Bureau of National Affairs, Inc.
ISSN 0090-4600

IV. ARGUMENTS FOR AND AGAINST EXTENDING EQUIVALENT BENEFICIARY STATUS TO U.K. RESIDENTS

A. Arguments For Extension

1. The Purpose of the Derivative Benefits Test

The derivative benefits safe harbor is intended to disapply the LOB in cases where applying it would frustrate its purpose — i.e., when a resident of a third state that has a tax treaty with the United States is not entitled to treaty benefits if investing or earning income in the United States via an entity resident in another country that has a tax treaty with the United States that grants the same benefits as the treaty between the third state and the United States.[21] Revoking U.K. residents' status as equivalent beneficiaries would result in precisely such an outcome.

The purpose of granting equivalent beneficiary status to residents of states by reference to their membership in the EU/EEA and NAFTA is to identify a pool of states with strong tax treaty networks granting substantially similar benefits. Generally, EU/EEA and NAFTA states have bilateral tax treaties with each other that grant comparable benefits. The United Kingdom does not remove itself from this pool by exiting the EU. Only if EU states decided en masse to terminate and/or renegotiate their tax treaties with the United Kingdom would U.K. residents start to resemble the type of residents the derivative benefits test is not intended to save.

In negotiating these treaties, defining equivalent beneficiaries by reference to EU/EEA/NAFTA membership was one way to include all of the countries in the trading blocs that include residents who are deserving of equivalent beneficiary status. States that wanted to extend equivalent beneficiary status to residents of EU/EEA/NAFTA non-member states could also take the extra step of including additional states by name, as five states[22] chose to do with Switzerland. Or, they could take the approach that the United States took in the 2016 U.S. Model Income Tax Convention.

2. The 2016 U.S. Model Income Tax Convention

An even simpler way to accomplish the goals of the derivative benefits test would be to remove the geographic limitations entirely, which is exactly what Treasury chose to do in the 2016 U.S. Model Treaty. In the 2016 Model, the derivative benefits rule defines equivalent beneficiaries as a resident of ***any*** state, provided that they would be entitled to the same benefits under their resident state's tax treaty with the contracting state from which they seek to obtain benefits.[23] This is the most direct way to craft the derivative benefits test so that it grants benefits to those residents that it intends to and to avoid irrational outcomes. If the model treaty's version of the derivative benefits were applied to all U.S. tax treaties, then U.K. residents would obtain the benefits they ought to regardless of the United Kingdom's status as a member of the EU or EEA, due to the breadth of benefits granted in the U.S.-U.K. treaty.

3. Economic Distortion

It is a commonly made argument that good domestic tax policy minimizes economic distortions. This argument also applies to international taxation. International tax policy that pressures taxpayers to take actions that are economically costly in the aggregate is something to be avoided. However, the focus on aggregate effects can blur when additional parties and competing interests get involved. In domestic tax, the parties involved are the tax authority and the taxpayers. In international tax, there are three parties — taxpayers and two tax authorities. A good outcome for one state may not be good for the other state.

That said, a policy that denies U.K. residents equivalent beneficiary status will likely have harmful effects on all parties involved. Companies that will lose their ability to claim treaty benefits will be economically harmed by facing either higher U.S. withholding tax or the costs involved in avoiding the higher rate (either by relocating the company or by transferring U.K. ownership to residents who do qualify as equivalent beneficiaries).

Brexit is predicted to have significant deleterious effects on states that have deep trade ties with the United Kingdom — many of which are members of the European Union.[24] A significant number of entities that would no longer be able to claim treaty benefits after Brexit may be forced to incur the expense of relocating or restructuring, expenses that would not be necessary but for the failure of U.S. treaties to reflect what the U.S. government itself considers to be model treaty provisions. An exodus of parent companies from a state — even ones that do not carry on a trade or business — will only add to Brexit's harmful economic consequences in these states. Of course, they will lose the revenues created by corporate formation and upkeep (incorporation fees, licenses, etc.), but there are broader consequences. Brexit is already likely to result in an immediate reduction of trade activity and U.K. business presence in EU states. International tax policy that amplifies these effects will only increase the economic harm.

---

[21] Reuven Avi-Yonah and Oz Halabi, *U.S. Treaty Anti-Avoidance Rules: An Overview and Assessment*, U. of Mich. L. & Econ, Empirical Legal Studies Center Paper No. 12-001, U. of Mich. Pub. L. Working Paper No. 261 (2012) at p. 23, https://repository.law.umich.edu/cgi/viewconten.

[22] Belgium, Denmark, Finland, Iceland (by reference to the EFTA), and Sweden.

[23] 2016 U.S. Model Treaty, art. 22(7)(e).

[24] Jan Willem Velthuijsen and Lorenz Bernard, *The Impact of Brexit on (Global) Trade*, PwC Brexit Monitor (2016), https://www.pwc.nl/nl/brexit/documents/pwc-brexit-monitor-trade.pdf.

© 2020 The Bureau of National Affairs, Inc.
ISSN 0090-4600

Put simply, denying U.K. residents equivalent beneficiary status will cause behavior that is unnecessarily costly to the companies that will lose the ability to claim treaty benefits and to the states whose treaties with the United States deny them benefits. This not only weighs in favor of granting equivalent beneficiary status to U.K. residents from a tax policy perspective; it also serves as evidence that these states would be in favor of renegotiating the derivative benefits tests in their treaties with the United States if only the amendments could get Senate approval.

B. Arguments Against Extension

1. Treaty Interpretation Under the Vienna Convention on the Law of Treaties

The primary argument against the extension of equivalent beneficiary status to U.K. residents is that a plain text reading of the definitions of equivalent beneficiaries in the treaties at issue clearly shows that they do not include former EU or EEA member states. This is important because a plain text reading of a treaty's terms is the primary means of treaty interpretation in customary international law. In most nations, the Vienna Convention on the Law of Treaties (VCLT) serves as the principal authority when it comes to treaty interpretation.

Article 31 of the VCLT states the general rule of treaty interpretation: that ''[a] treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.''[25] Thus, under the VCLT, the primary inquiry in interpreting treaty provisions is centered on what is contained in the four corners of the text. Prior to 1969, there was much disagreement over how much weight should be given to the subjective intent of the parties to a treaty; after the adoption of the VCLT, this dispute has generally been rendered moot.[26] The ''ordinary meaning'' of the specific terms of the treaty, and not the subjective intent of the parties or the overarching purpose of the treaty, is what governs. The reference to the ''object and purpose'' of the treaty does not mean provide an independent method of interpretation — the purpose of the treaty is only determinative to the extent that it sheds ''light'' on the terms of the treaty.[27] In defining the meaning of a treaty's terms, the treaty's purpose serves the same interpretive role as the context surrounding its terms.

The specific terms at issue in these derivative benefits are ''a member state of the European Union or of a European Economic Area state or of a party to the North American Free Trade Agreement.''[28] It is difficult to conceive of any interpretation of the term ''a member state of the [EU] or of a [EEA] state'' other than a member state of the EU or EEA ***at the time treaty benefits are claimed.*** The only way that these terms can be interpreted to include a post-Brexit United Kingdom would be if they were meant to refer to the member states of the EU and EEA ***at the time the treaty was signed.*** But if that were the meaning that the parties intended, then wouldn't they have listed the states by name? It is logical that states whose tax treaties with the United States list EU membership as a requirement for equivalent beneficiary status intended to grant benefits to residents of current EU member states — not former ones. If former member states were to be read into the term, then the requirement of EU membership for equivalent beneficiary status would be rendered meaningless.

In the NAFTA context, this interpretation could be more difficult. Does a state cease to be ''a party to [NAFTA]'' if NAFTA is renegotiated and renamed and the new agreement includes each, and only each, of the parties to NAFTA at the moment NAFTA ceased to exist? If all goes according to plan, none of the states will have withdrawn from the agreement — contrary to the facts in Brexit. The inquiry will revolve around whether the ''ordinary meaning'' of NAFTA includes successor agreements that are at some level its equivalent. But this is a question for a later time.

Back to Brexit: According to the VCLT, the most important inquiry in treaty interpretation is the ordinary meaning of its terms, and there is no good faith interpretation of the terms at issue that point to the inclusion of U.K. residents as equivalent beneficiaries post-Brexit. This would seem to be determinative.

2. Treaty Interpretation in U.S. Jurisprudence

U.S. Supreme Court jurisprudence governs Treasury's interpretation of these treaty provisions, rather than the VCLT or customary international law. The United States is a signatory to the VCLT but has not ratified it and is not a party to it. Thus, U.S. courts are not bound by its terms. Only four Supreme Court cases have ever specifically referenced the VCLT — and only once has the reference been made by the majority.[29] In the three dissents that have referred to the VCLT, only two have referred to the VCLT's provi-

---

[25] VCLT, art. 31 ¶1.

[26] Klaus Vogel, *Double Tax Treaties*, Berkeley J. of Int'l Law (1986) at p. 35 (''The intent of the parties is only important to the extent that it is found to be expressed in the text.''), https://scholarship.law.berkeley.edu/cgi/viewcontent.cgi?article=1039&context=bjil.

[27] *Id.* Also, note that the ''object and purpose'' of a treaty has been interpreted as one general concept, rather than two separate ones. *Id.*

[28] U.S.-Germany Income Tax Treaty as amended by Protocol, June 1, 2006, art. 28 ¶8(e), https://www.irs.gov/pub/irs-trty/germanprot06.pdf.

[29] *Weinberger v. Rossi*, 456 U.S. 25, 29 n.5, 102 S. Ct. 1510, 1514 (1982) (citing VLCT art. 2, ''Use of Terms'').

© 2020 The Bureau of National Affairs, Inc.
ISSN 0090-4600

sions concerning treaty interpretation.[30] The more forceful of the two is Justice Blackmun's dissent in *Sale v. Haitian Centers Council*, where he cites Article 31.1 of the VCLT for the proposition that ''[i]t is well settled that a treaty must first be construed according to its 'ordinary meaning.' ''[31]

In practicing its own form of treaty interpretation completely separate from the VCLT, the Court has not been entirely consistent on its guiding principles. In a 2014 case, *BG Group plc v. Republic of Argentina*, the Court focused on the intent of the parties, stating that ''[a] treaty is a contract between nations, and its interpretation normally is a matter of determining the parties' intent.''[32] In order to determine that intent when interpreting treaties, the Court will ''begin with the text of the treaty and the context in which the written words are used.''[33]

C. What Do the States Want?

If the plain text of the treaty is what governs, it seems pretty determinative that U.K. residents should not be considered equivalent beneficiaries by the terms of these derivative benefits tests. However, if intent is the main inquiry, let us imagine a world in which U.S. treaty renegotiation and passage in the Senate is plausible. Were the United States to propose amending the definition of an equivalent beneficiary to include residents of the United Kingdom (in the same manner that the U.S.-Belgium treaty includes residents of Switzerland alongside EU and EEA member states), what is the likelihood that states — especially those in the EU — would agree to such an amendment?

From a political perspective, it is not clear whether individual EU nations would be upset by Treasury's extension of equivalent beneficiary status to U.K. residents — or to South African or Australian residents, for that matter. It is not hard to imagine that an EU state, faced with the burdens of EU membership, might not want U.K. residents to continue to enjoy benefits of EU membership when they voiced, through referendum, that those benefits were not worth those burdens. In other words, decisions have consequences, and the previous discussion of treaty interpretation should make it clear that the loss of equivalent beneficiary status was a predictable consequence to exiting the EU.

At the same time, however, these states may be comfortable granting equivalent beneficiary status to U.K. residents in order to prevent the exodus of businesses with U.K. ownership, which would only add to the damage Brexit is expected to inflict on trade between the U.K. and EU states. It is also in their interest not to invite repercussions by punishing U.K. residents by denying them treaty benefits that they would have received under the U.S.-U.K. treaty — in other words, to deny them equivalent beneficiary status even though it would violate the purpose of the derivative benefits test.

With respect to the desires of the states, they will become clear in their discussions with Treasury — whether through treaty protocol negotiation, Competent Authority Arrangements, or direct statements of disapproval with regard to extending equivalent beneficiary status.

D. Conclusion

There are persuasive arguments on both sides of the issue. Treating U.K. residents as equivalent beneficiaries is in line with the purpose of the derivative benefits test, while denying them benefits would result in irrational outcomes and potentially harmfully distortive taxpayer behavior. On the other hand, a clear reading of the derivative benefits provisions in the treaties that currently include them makes it painfully clear that the definition of equivalent beneficiary is not intended to include former EU member states. It seems that the most appropriate and least harmful outcome — in the absence of further negotiation — would be one where Treasury can treat U.K. residents as equivalent beneficiaries without violating the clear terms of these treaties. In the next section, I consider Treasury's choices in hopes of finding a method that meets these requirements.

V. HISTORICAL CASE STUDIES

Treasury could also seek guidance by studying analogous historical events where changes in the intergovernmental landscape created similar hazards with respect to tax treaty interpretation and applicability. Given the paucity of treaties that grant or deny benefits to a resident of a third state[34] based on that state's membership status with respect to specific intergovernmental organizations, there appear to be no clear historical analogs to Brexit and the effect it might have on the interpretation of derivative benefits tests. The United Kingdom is the first state to withdraw from the EU and/or EEA, and the current parties to NAFTA are the same as when the agreement was entered into. So, this is a question of first impression for Treasury.[35] More broadly, member state withdraw-

---

[30] *Abbott v. Abbott*, 560 U.S. 1, 40 n.11, 130 S. Ct. 1983, 2007 (2010) (citing VCLT, art. 32, ''Supplementary Means of Interpretation''); *Sale v. Haitian Ctrs. Council*, 509 U.S. 155, 191, 113 S. Ct. 2549, 2569 (1993) (citing VCLT, art. 31, ''General Means of Interpretation''); *cf. Sanchez-Llamas v. Oregon*, 548 U.S. 331, 391, 126 S. Ct. 2669, 2705 (2006) (citing VCLT, art. 27, ''Internal Law and Observance of Treaties'').

[31] 509 U.S. 155, 191, 113 S. Ct. 2549, 2569 (1993).

[32] *BG Grp. plc v. Republic of Argentina*, 572 U.S. 25, 26, 134 S. Ct. 1198, 1202 (2014) (quoting *Air France v. Saks*, 470 U.S. 392, 399, 105 S. Ct. 1338, 84 L. Ed. 2d 289).

[33] *Water Splash, Inc. v. Menon*, 137 S. Ct. 1504, 1508-09 (2017) (quoting *Volkswagenwerk Aktiengesellschaft v. Schlunk*, 486 U.S., at 699, 108 S. Ct. 2104, 100 L. Ed. 2d 722).

[34] VCLT, art. 2 defines ''third state'' as ''a State not a party to the treaty.''

[35] This is a good place to note that taxpayers (and Treasury) may face a similar problem if the U.S.-Mexico-Canada Agreement

© 2020 The Bureau of National Affairs, Inc.
ISSN 0090-4600

als from international organizations have rarely occurred since World War II.[36]

Despite the absence of clear historical analogs, there is no question that specific geopolitical events have had consequences on U.S. tax treaties in the last 30 years. This section will compare and contrast Treasury's current task with how it responded to two of these events — the collapse of the Soviet Union in 1991 and the United Kingdom's handover of control over Hong Kong to China in 1997 — in hopes of unearthing principles that could guide Treasury's decision and methods by which Treasury could implement that decision.

A. The Dissolution of the Soviet Union (1991)

The dissolution of the Soviet Union is certainly the most monumental event in recent history with respect to the issues of state and treaty succession. Procedurally, the dissolution of the U.S.S.R. was the result of Declaration 142-H of the Supreme Soviet of the Soviet Union[37] issued on December 26, 1991. The dissolution was incumbent upon the existence of the Commonwealth of Independent States (CIS), an intergovernmental organization consisting of the post-Soviet republics, created with the December 8, 1991 ''Agreement Establishing the Commonwealth of Independent States.'' The agreement, signed by the Republic of Belarus, the Russian Federation, and Ukraine, asserted that the contracting parties to it would ''undertake to discharge the international obligations incumbent on them under treaties and agreements entered into by the former Union of Soviet Socialist Republics.''[38] In the realm of international tax, the principal issue raised by the breakup was whether the United States would extend the U.S.-U.S.S.R. tax treaty[39] to the former Soviet republics emerging as new sovereign states.

Treasury answered the question with an announcement issued on April 24, 1992.[40] Treasury stated that the U.S.-U.S.S.R. treaty would remain in effect for members of the CIS. It also announced negotiations on new treaties with Russia, Kazakhstan, and Ukraine. Finally, Treasury stated its intention to consult with the Baltic states of Estonia, Latvia, and Lithuania to ''determine whether those governments also want the U.S.-Soviet treaty to remain in effect for them until separate tax treaties are negotiated and put into force.''[41] This final note was of particular import given that the United States did not consider the Baltic states to be members of the Soviet Union,[42] meaning that Treasury was open to the idea of extending the treaty to states that it had theretofore not considered parties to it. This announcement, considered together with the CIS member states' announcement indicating their assumption of U.S.S.R. treaty obligations, was a clear indication that the desires of the new republics was a main determining factor in the U.S.'s decision whether to include them as parties to the U.S.-U.S.S.R. treaty.

The successor states' desires, however, were far from the only factor the United States considered. Compared to the question raised by Brexit, the United States had more history and international law to rely upon in making its decision. The 1978 Vienna Convention on Succession of States in Respect of Treaties (which the United States is not a signatory to and which has a relatively scant 15 parties) provides that newly independent states that were either former colonies or dependent upon a dominant state for the determination of their policy are granted a ''clean slate'' with respect to their treaty obligations, but that all other new states are bound by the treaties of their predecessors.[43] Meanwhile, the then-applicable 1978 Third Restatement of the Law on Foreign Relations provides for a ''clean slate'' approach to all new states, regardless of former colony status or dependence upon a dominant state.[44]

While the United States did not ignore these sources of international law, the State Department focused principally on state practice.[45] The past 200 years of history provides examples of both treaty succession and the ''clean slate'' approach following the

(USMCA) enters into force and replaces NAFTA, since NAFTA's extinction could spell the loss of equivalent beneficiary status granted to Mexican and Canadian residents in U.S. tax treaties. The analysis would not be analogous, however. A more comparable development would be if a party state were to withdraw from NAFTA and the agreement continued to remain in force between the other parties to it. See https://crsreports.congress.gov/product/pdf/R/R44981 for more on the USMCA.

[36] Joel P. Trachtman, *The Economic Structure of the Law of International Organizations,* 15 Chicago J. Int'l L. 162, 179 (2014); *see also Brexit Isn't All That Special. Here's Why Nations Leave International Organizations*https://www.washingtonpost.com/news/monkey-cage/wp/2016/07/01/brexit-isnt-all-that-special-heres-why-nations-leave-international-organizations/?utm_term=.cc90b3782d8c.

[37] http://www.consultant.ru/cons/cgi/online.cgi?base=ESU&n=40179&req=doc#0 (in original Russian).

[38] Ed. John Grenville, Bernard Wasserstein, *The Major International Treaties of the Twentieth Century: A History and Guide With Texts, Vol. 2.* Routledge, 2001, at p. 890.

[39] https://www.irs.gov/pub/irs-trty/ussr.pdf.

[40] *See* Treasury News NB-1763 (Apr. 24, 1992); *see also* 92 Tax Notes Int'l 19-13 (summarizing news release).

[41] *Id.*

[42] The United States considered the Baltic states to be occupied Soviet territory and refused to recognize them as Soviet governments. *See* "Statement by the Acting Secretary of State, the Honorable Sumner Welles" ("Welles Declaration") (July 23, 1940), https://digitalarchive.wilsoncenter.org/document/144967.pdf?v=965c0cce7fd4fdca8cdceebe85fe030c.

[43] Edwin D. Williamson and John E. Osborn, *A US Perspective on Treaty Succession and Related Issues in the Wake of the Breakup of the USSR and Yugoslavia,* 33 Va. J. Int'l L. 261, 262.

[44] *Id.* at 263.

[45] *Id.*

© 2020 The Bureau of National Affairs, Inc.
ISSN 0090-4600

breakup of states.[46] Due to the uncertainty of the law created by state practice (compared to the Vienna Convention on Succession of States and the Third Restatement's tilting toward the ''clean slate'' approach), the United States looked to its own interests in making its decision. The United States had a strong interest in fostering global respect for the rule of law, especially given the state of the world at the time, and many of the treaty obligations being considered concerned important national security interests including nuclear weapons and arms control issues.[47] Additionally, continuity of treaties was in many instances in the best interests of the members of the CIS given the destabilization caused by the fall of the Soviet Union. This was particularly true with respect to the U.S.-U.S.S.R. tax treaty, which is why the new states signaled their desire to remain parties to it.

These facts differ from the circumstances surrounding Brexit. A more apt comparison would be if there were a treaty that the United States had with a third-party state that included reference to the U.S.S.R.; there, Treasury would have had to decide whether the former Soviet states would be considered part of the Soviet Union for purposes of that treaty in the same manner as it must decide whether or not to consider the United Kingdom part of the EU for the purposes of the treaties in question here.

B. The Handover of Hong Kong (1997)

The transfer of Hong Kong's sovereignty from the United Kingdom to China on July 1, 1997, raised the question of whether the U.S.-China tax treaty would apply to Hong Kong. This was a different international law issue than the one resulting from the fall of the Soviet Union, because it concerned a transfer of sovereignty rather than newly independent or successor states. Whether a territory whose sovereignty has been transferred to a state inherits the treaty obligations of its new parent state is a difficult determination that turns on interacting principles of treaty interpretation and domestic law.[48]

The U.S.-China tax treaty provided Treasury solid grounds to determine that it would not apply to Hong Kong, which it announced in IRS Notice 97-40.[49] Article 2(1) of the U.S.-China tax treaty provides that the treaty applies to the taxes ''in the People's Republic of China,''[50] and Article 3(1)(a) provides that '' 'the People's Republic of China', when used in a geographical sense, means all the territory of the People's Republic of China, including its territorial sea, in which the laws relating to Chinese tax are in force[.] ''[51] Because Chinese tax laws would not apply in Hong Kong on or after the transfer of sovereignty, the only way to interpret the terms of the treaty was that they precluded its application to Hong Kong. Notice 97-40 also provided that the U.S.-Hong Kong agreement covering shipping income would remain in force (and that its extension would not apply to China), and that the IRS would ''continue to treat Hong Kong and China as separate countries. . .for purposes of the Code and regulations, including subpart F.''[52] In concert, these determinations made it clear that Hong Kong was not precluded from entering into a separate double tax treaty with the United States.

C. Conclusions From Case Studies

There are very important differences between the effects on tax treaties implicated by the fall of the Soviet Union, the transfer of Hong Kong's sovereignty, and the effects of Brexit. The principal issues in the two former cases were those of state succession and treaty succession, i.e., whether the U.S.-U.S.S.R. and U.S.-China treaties would remain in effect with respect to the former Soviet republics and China-controlled Hong Kong. This is a fundamentally different question than that facing Treasury concerning Brexit's effect on derivative benefits tests in U.S. treaties with third-party states.

The United States clearly paid attention to the newly independent post-Soviet republics' desires to be treated as parties to treaties, but a post-Brexit United Kingdom is not equivalent to a newly independent state (regardless of the claims of Brexiteers). Further, the decision whether to extend the U.S.-U.S.S.R. treaty to CIS states was made during a time when questions of state succession and its effect on treaties were of vital importance to the U.S. government.[53] The legislature and State Department devoted considerable resources to ensuring that U.S. decisions regarding state succession would protect U.S. national security interests.[54] In the tax realm, Treasury quickly commenced tax treaty negotiations with the former Soviet states with the Senate's blessing; The U.S.-Russian Federation double tax treaty was signed on June 17, 1992,[55] and ratified by the Senate on Novem-

[46] *Id.* at 263-264.

[47] *Id.* at 264.

[48] *See, e.g.*, John Shijian Mo, *Transfer of Sovereignty and Application of an International Convention: CISG in China in the Context of One Country, Two Systems*, 2 J. Int'l & Comp. L. 61 (2015).

[49] Notice 97-40

[50] U.S.-China Tax Treaty, art. 2 (1).

[51] U.S.-China Tax Treaty, art. 3(1)(a).

[52] Notice 97-40.

[53] The breakup of Yugoslavia also demanded the attention of legislators and the executive branch, but it did not have the same implications for Treasury because the United States did not have a tax treaty with Yugoslavia.

[54] *See, e.g.*, The START Treaty: Hearings Before the Committee on Foreign Relations, 102d Cong., 2d Sess. (1992) (source:). *See also* Louis Henkin, Madeleine Albright, et al. State Succession and Relations with Federal States, Proceedings of the Annual Meeting (American Society of International Law), Vol. 86 pp. 1-23 (Apr. 1-4, 1992), https://www.jstor.org/stable/25658612?seq=1.

[55] Income Tax Convention With the Russian Federation.

© 2020 The Bureau of National Affairs, Inc.
ISSN 0090-4600

ber 20, 1993, along with five other tax treaties.[56] Today, the question of whether U.K. residents will enjoy beneficiary status post-Brexit is not one that has a grasp on the minds of those outside of Treasury and tax practice/academia. And, of course, the current outlook for treaty negotiation and amendments is bleak,[57] although potentially less bleak after July 2019 saw the passage of four tax treaty amendments.

The factors underlying Treasury's decision regarding the U.S.-China treaty's applicability to Hong Kong are different than those surrounding its determination regarding Brexit. The main determinant in deciding that the U.S.-China treaty would not apply to Hong Kong was that the treaty specifically stated that it would apply only to areas where Chinese tax laws applied, and Chinese domestic law stated that tax laws did not apply in Hong Kong.

In sum, these case studies are not particularly helpful in providing answers to the question this article raises. The fall of the Soviet Union and the transfer of Hong Kong to China both implicated questions of whether the states and territories would be considered parties to bilateral U.S. tax treaties. Those were much larger questions than the one facing Treasury regarding the U.K.'s post-Brexit classification in derivative benefits tests in third-party treaties. The U.S.S.R. was a party to a bilateral tax treaty with the United States, and so a determination that treaty rights and obligations would not extend upon its dissolution to the new states would spell the complete termination of the entire treaty. And the U.S. decision not to include Hong Kong as part of China with respect to its status as a party to the U.S.-China treaty meant that Hong Kong was no longer covered by any tax treaty with the United States. In the current case, only the extension of equivalent beneficiary status to U.K. residents is in question. The United States has a tax treaty with the United Kingdom, so Brexit does not risk the U.K.'s status as a party to its treaty with the United States. At risk for the United Kingdom are the benefits granted to its residents in U.S. tax treaties with third-party states. A better, though apparently non-existent, historical equivalent would be if, at the time of the events discussed in this section, U.S. bilateral treaties with third-party states granted benefits or imposed obligations by reference to the U.S.S.R. or China, and Treasury had to decide, without further treaty negotiation as an immediate option, whether it would treat the CIS states as part of the U.S.S.R. and Hong Kong as part of China for the purposes of interpreting those treaties. In conclusion, these case studies do not provide Treasury with close precedents that could justify a unilateral decision to extend equivalent beneficiary status to U.K. residents post-Brexit.[58]

VI. TREASURY'S OPTIONS

The most desirable course of action from both an international law and economic perspective would be to negotiate protocols to the treaties in question. Amending the treaties through the most procedurally stringent process guarantees that the desires of the contracting states will not go ignored and that both parties will be on the same page with respect to the definition of the treaty's terms. The downside to this, of course, is that protocols require Senate approval. Assuming that Senate action on tax treaties remains at a standstill, these are the primary actions that Treasury can take in making its determination and announcing it to the interested parties. While unilateral action would be the least complicated method, it is the one that is most likely to ignore the clear text of the treaties and to potentially violate the desires of our treaty partner states. On the other hand, while bilateral action takes into account the wishes of both treaty states, it can create separation of powers problems considering that the U.S. Constitution provides that entering into and amending treaties requires joint action on behalf of the executive branch and the Senate. The ideal option is one that Treasury has the legal authority to pursue, that provides for bilateral agreement with treaty partners, and that does not ignore the clear terms of the relevant treaty provisions. In this author's opinion, the most viable path is through competent authority relief (barring a federal statute that eliminates the obstructionist procedural tool that Senator Paul has wielded so effectively).

A. Issue a Notice

The most unilateral option for Treasury is to simply issue a notice stating that for purposes of the 13 existing treaties that define equivalent beneficiary status by reference to the EU, the United Kingdom will be treated as an equivalent beneficiary after its withdrawal. This method is easy and simple for both Treasury and the companies applying for treaty benefits. No change needs to be made to Form W-8BEN-E, *Certificate of Status of Beneficial Owner for United States Tax Withholding and Reporting (Entities)*,[59] the form that taxpayers use in applying for benefits under a tax treaty. Residents who were equivalent beneficiaries prior to Brexit can continue as if nothing has changed.

However, there are many detriments to this approach. First, it ignores the plain meaning of the terms in the definitions of equivalent beneficiaries in the treaties in question. Arguably, this would be a violation of U.S. law by Treasury, given the importance of the ordinary meaning of treaty terms in U.S. jurisprudence concerning treaty interpretation. Second, unless Treasury receives approval from all thirteen states that define equivalent beneficiaries by reference to EU membership, the notice could alienate our treaty partners as a sign of further U.S. international tax excep-

[56] *Senate Ratifies Six Tax Treaties*, Tax Notes (Nov. 20, 1993).

[57] *See* https://www.state.gov/s/l/treaty/pending/ (Sept. 29, 2019).

[58] That said, Treasury's attitude toward the Baltic states reveals that strict treaty interpretation — which would weigh against extending equivalent beneficiary status to U.K. residents — is the obvious path.

[59] Rev. July 2017.

© 2020 The Bureau of National Affairs, Inc.
ISSN 0090-4600

tionalism. The timing — shortly after the OECD BEPS project and a period of international cooperation with respect to, e.g., information sharing — would be particularly bad. Third, there is no historical precedent for this type of notice. As explained in Section V, the decision to apply the U.S.-U.S.S.R. tax treaty to the former Soviet republics was just one of many regarding U.S.S.R. state and treaty succession, and it was consistent with international law and state practice. The decision not to apply the U.S.-China treaty to Hong Kong was based off of a plain language reading of the treaty and its interaction with Chinese domestic law. Never before has Treasury unilaterally announced its intention to purposefully misinterpret a tax treaty. Now is probably not the best time to start.

B. Selective Nonenforcement

Rather than announce its decision to the world, Treasury and the IRS can choose not to enforce the failure of a U.S. withholding agent to withhold at a rate above the treaty rate when treaty benefits are denied by virtue of U.K. residents' post-Brexit loss of equivalent beneficiary status. This would be an approach similar to the ''don't ask, don't tell'' approach taken by the Service with respect to domestic taxation of employee frequent-flier miles.[60] This approach is attractive by virtue of its quietness, as opposed to a Treasury notice's announcement to the world that the U.S. is willfully misinterpreting tax treaty provisions; however, large enterprises that need to account for tax costs years in advance may not find sufficient assurance in an unannounced policy on which they cannot explicitly rely.

However, there are administrability concerns. First, this approach could likely work effectively only if the U.S. withholding agent is a subsidiary of the company claiming treaty benefits. If the company claiming benefits and the withholding agent are unrelated, then the agent might not know to withhold the smaller amount. Also, there would probably need to be a change made to the Form W-8BEN-E, given that it currently requires the taxpayer to certify under penalty of perjury that the company claiming treaty benefits ''meets the derivative benefits test.''[61] While any IRS nonenforcement policy impliedly includes nonenforcement of perjury, it is difficult to expect sophisticated executives and tax practitioners to rely on a clear misinterpretation of a tax treaty in filling out a Form W-8BEN-E without the assurance of nonenforcement provided by something like a Treasury notice. Perhaps the preparer could check a box pointing to an attached document explaining that the company would meet the derivative benefits test but for its U.K. ownership, resulting in a ''tell, don't tax'' kind of arrangement. But this arrangement would make it impossible for the IRS to look the other way, destroying the plausible deniability upon which selective nonenforcement policies rest.

Finally, as Professor Lawrence Zelenak has written in the realm of domestic ''customary deviations'' from tax statutes, this kind of blanket nonenforcement policy may contribute to a loss of respect for the rules of treaty interpretation among Treasury and IRS officials.[62] Once they start to ignore one treaty provision — without having to announce their reasoning — then it might be easier to ignore another. Such a pattern could result in a loss of trust among treaty partners and doubts about which treaty provisions are being enforced and which are being ignored at a given time.

C. Competent Authority Relief

There is one approach that would grant equivalent beneficiary status to U.K. residents while avoiding the pitfalls of the previous two — competent authority relief. By granting benefits under the competent authority relief provision in the LOB provisions in the treaties in question, Treasury can unilaterally grant U.K. residents equivalent beneficiary status while acting completely within its legal authority and faithfully interpreting the treaties' provisions.

The competent authority relief provisions are found in either paragraph 6 or paragraph 7 of every treaty that defines equivalent beneficiary status by reference to EU membership.[63] The provision grants the authority to the competent authority of the contracting state in which the taxpayer claiming benefits does not reside to grant treaty benefits to the taxpayer.[64] Ten of the 13 treaties require the competent authority to first determine that obtaining treaty benefits was not one of the principal purposes of the taxpayer's conduct before granting benefits. The ''principal purpose'' test[65] is a somewhat complicated and confounding concept in international tax law,[66] but it should not be an obstacle in the situations in which we would be applying the competent authority relief provisions. The purposes of the LOB and the principal purpose test are both to curb treaty shopping, and U.K. shareholders are likely not treaty shopping given that they would be able to get the same treaty benefits under the U.K. treaty with the United States had they invested directly from the United Kingdom to the United States. If Treasury determines that a company should pass the LOB, then the company is very unlikely to fail the principal purpose test.

---

[60] Lawrence Zelenak, *Custom and the Rule of Law in the Administration of the Income Tax*, 62 Duke L.J. 829, 830-31 (2012).

[61] Form W-8BEN-E, Part XXX.

[62] Lawrence Zelenak, *Custom and the Rule of Law in the Administration of the Income Tax*, 62 Duke L.J. 829, 853-854 (2012).

[63] *See* Table Two.

[64] The U.S. Competent Authority for all U.S. tax treaties is the IRS Director, International. *See* IRM 4.60.3.1.5, ″U.S. Competent Authority,″.

[65] For a summary explanation of the test, see Mindy Herzfeld, *News Analysis: Treaty Abuse — The Principal Purpose Test*, Tax Notes Int'l, Tax Analysis Doc 2016-1763.

[66] For a particularly animated criticism of the principal purpose test in the context of the BEPS Multilateral Instrument, see NYU School of Law, ″22nd Annual David R. Tillinghast Lecture on International Taxation: Robert B. Stack″ (Sept. 22, 2017), beginning at 24:53.

© 2020 The Bureau of National Affairs, Inc.
ISSN 0090-4600

Table Two: Competent Authority Relief Provisions in U.S. Treaties that Use EU/EEA Membership as Criteria for Equivalent Beneficiary Status		
U.S. Treaty	Treaty Provision [Article (Paragraph)]	PPT?
Belgium	21(7)	Yes
Denmark	22(7)	Yes
Finland	16(6)	Yes
France	30(6)	Yes
Germany	28(7)	Yes
Iceland	21(7)	Yes
Ireland	23(6)	Yes
Luxembourg	24(7)	No
Malta	22(6)	No
Netherlands	26(7)	Yes
Sweden	17(6)	Yes
Switzerland	22(6)*	No
United Kingdom	23(6)	Yes

* U.S. competent authority must consult with Swiss competent authority before granting benefits.

Thus, it appears that this problem is exactly the type of situation to which the provision was meant to apply. Competent authority relief provides redress to companies that should not be caught up in the LOB because they are not treaty shopping but nevertheless do not pass the derivative benefits test. An important question is whether Treasury has the authority to issue a blanket notice concerning competent authority relief, because there are administrative hurdles to applying competent authority relief on a case-by-case basis. The procedural requirements for requests for U.S. competent authority assistance are laid out in Section 3 of Rev. Proc. 2015-40.[67] They can be made either before or after actual double taxation has occurred. The taxpayer must submit a pre-filing memorandum if the request concerns a taxpayer-initiated position, which might lead to a pre-filing conference at the election of the U.S. competent authority. The revenue procedure also recommends an optional pre-filing conference for a number of situations. The Appendix lays out the information that must be included in a competent authority request. Finally, a taxpayer requesting discretionary LOB relief must pay a user fee of $32,500.

There is a different procedure for requests for advance rulings regarding the interpretation of a U.S. tax treaty, which must be submitted to the Associate Chief Counsel (International) in accordance with different revenue procedures.[68] Given Treasury's obligation to give weight to the ordinary meaning of the treaty's terms when interpreting them, these requests would almost certainly fail.

Granting discretionary LOB relief upon request is the only method for granting equivalent beneficiary status to U.K. residents post-Brexit that is both fully within Treasury's authority and entirely faithful to the terms of the derivative benefits tests in question. But this approach is costly. A boom in requests for competent authority relief would entail ballooning costs to both taxpayers and Treasury (which would have to reply to each request individually). Further, it could be construed as discriminatory to smaller companies that do not have the revenue or personnel to make it worthwhile to jump through the procedural hoops in requesting competent authority relief. The question is whether the competent authority relief regime provides a mechanism for issuing a blanket determination, which would eliminate the need for individual taxpayers to request relief. The answer is, mostly, yes: via a Competent Authority Arrangement.

In the IRS's words, ''[a] Competent Authority Arrangement'' is a bilateral agreement between the United States and the treaty partner to clarify or interpret treaty provisions.''[69] The reference to treaty *interpretation* — which seems to set textual boundaries — is a potential obstacle, as is the fact that the other state must agree to the arrangement. However, there is precedent suggesting that agreements could be made with treaty partners ''clarifying'' that post-Brexit U.K. residents should be treated as equivalent beneficiaries. The October 15, 2009, Competent Authority Agreement between the United States and Belgium provides that under the LOB provision in the U.S.-Belgium treaty, the determination of whether a person is an equivalent beneficiary is to be made taking into account new language ''deem[ing]'' a shareholder in the company claiming treaty benefits to hold the same voting power in the company paying the dividend as the company claiming the benefits holds in such company.[70] Could a Competent Authority Arrangement ''deem'' U.K. residents to be equivalent beneficiaries for purposes of a U.S. tax treaty, and could the treaty partner state agree to this without it amounting to a violation of the treaty?

Treasury and the competent authority of the relevant treaty partner state could certainly try, although the substance of the clarification in the U.S.-Belgium agreement is less problematic from a treaty interpretation perspective. Whether a shareholder of a company should be deemed to be a shareholder in a company paying that company a dividend is not explicitly considered in the U.S.-Belgium treaty; whether current or

[67] *See also* https://www.irs.gov/individuals/international-taxpayers/competent-authority-assistance.

[68] Rev. Proc. 2015-40, §13; *see* Rev. Proc. 2015-1, Rev. Proc. 2015-7.

[69] https://www.irs.gov/individuals/international-taxpayers/competent-authority-arrangements.

[70] https://www.irs.gov/pub/irs-utl/usbelgium_limitationonbenefits_equipvalentbeneficiary101509.pdf.

© 2020 The Bureau of National Affairs, Inc.
ISSN 0090-4600

former EU members are to be considered equivalent beneficiaries is.

Although its costs are many,[71] case-by-case competent authority relief appears to be Treasury's most effective option that is clearly within its authority and that does not require irrational treaty interpretation. The best option — the one that achieves the correct result and integrates the desires of our treaty partners — is entering into Competent Authority Arrangements that grant equivalent beneficiary status to U.K. residents in a way that does not veer so far from reasonable treaty interpretation as to constitute treaty renegotiation. If that boundary is crossed, there is a real possibility that certain U.S. lawmakers might consider this a usurpation of the Senate's power to approve treaties and treaty protocols. In the next section, I describe the potential challenges, including legal challenges originating in the Senate, to each of the options listed above.

VII. POTENTIAL CHALLENGES

A. Treaty States

If Treasury uses one of the methods listed above in granting U.K. residents equivalent beneficiary status with respect to a treaty, it is conceivable that the contracting state may be displeased — either by the granting of benefits itself, the method by which Treasury grants the benefits, or both. If that is the case, then how might the state challenge the decision? The most direct challenge would be one that springs from the tax treaty itself. According to the U.S.-Belgium treaty, ''[t]he competent authorities of the Contracting States shall endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention.''[72] If no agreement can be reached, then the case may be resolved through arbitration (although arbitration is generally used for particular taxpayer cases rather than general interpretive questions). Placing the decision making power with arbitration panels is problematic because arbitration board decisions implemented under MAP have no precedential authority and in many (if not all) cases will state no rationale.[73] Thus, it might be unclear whether the board's decision was reached based on the facts of an individual case, on what it considers to be a faulty treaty interpretation on the part of the United States, or on the blanket policy of granting equivalent beneficiary status to U.K. residents via competent authority relief. Not only would arbitration leave the broader dispute between the two treaty states unresolved, but it could create even more unwanted confusion among taxpayers.

Perhaps the contracting state could deny benefits to the resident company by assessing the tax it believes should have been withheld in the United States. If it were to do this, then the competent authority relief provision in most of the treaties in question require it to consult with the U.S. competent authority before such denial.

A state might also dispute the decision based on international law. When a contracting state violates a treaty, the other state has a limited amount of options. While tensions may flare, it is unlikely that a treaty state would withdraw from or terminate the treaty entirely. Withdrawal would place a massive burden on its own citizens and have potentially catastrophic effects on business activity within its borders. Additionally, it would be unwise to terminate the treaty to put pressure on the United States for a quick renegotiation because the current tax treaty barrier in the Senate has all but foreclosed that possibility. Such a bargaining position would be too reckless for an established state.

B. U.S. Residents

U.S. residents might sue to enjoin Treasury from granting U.K. residents benefits on the basis that by wrongly interpreting the treaty, the United States is declining to collect tax revenue it is lawfully owed and that the difference will be made up by the tax dollars of U.S. residents. Or, they might sue because they don't think the U.S. government should be bailing out U.K. residents when the majority of them voted for Brexit and should have to deal with the consequences. Whatever the reason, a U.S. resident suing in order to have a court stop Treasury from granting benefits is unlikely to have standing to make such a claim.

The problem is not that tax treaties are judicially unenforceable. In fact, in *Columbia Marine Services v. Reffet, Ltd.*,[74] the Second Circuit has considered a taxpayer's appeal from the determination resulting from his request for competent authority relief under the 1975 U.S.-U.K. double taxation treaty. The general rule is that ''treaties do not create rights that are privately enforceable in the federal courts.''[75] However, a private action may arise under a treaty if the treaty is self-executing (meaning that it becomes domestic law as soon as it enters into force, requiring no implementing legislation) and ''it expressly or by im-

[71] Keep in mind that Treasury has the power to refund competent authority application fees and process relief requests using an expedited procedure.

[72] U.S.-Belgium Treaty, art. 24 ¶3.

[73] Article 22 paragraph (j) of the June 1, 2006 Protocol amending the U.S.-Germany Treaty states: ''The determination of the board will not state a rationale. It will have no precedential value.'' The U.S.-Belgium and U.S.-Ireland treaties, for example, use the following language: ''[U]nless any concerned person does not accept the determination of an arbitration board, the determination shall constitute a resolution by mutual agreement under this Article and shall be binding on both Contracting States with respect to that case.'' U.S.-Belgium Treaty art. 24 ¶8(e); U.S.-Ireland Treaty, art. 26 ¶5.

[74] 861 F.2d 18 (2d Cir. 1988).

[75] *United States v. Li*, 206 F.3d 56, 60-61 (1st Cir. 2000) (*en banc*) (''[T]reaties do not generally create rights that are privately enforceable in the federal courts'') (citing *Edye v. Robertson*, 112 U.S. 580, 598, 5 S. Ct. 247, 28 L. Ed. 798, Treas. Dec. 6714 (1884).

© 2020 The Bureau of National Affairs, Inc.
ISSN 0090-4600

plication provides for a private right of action.''[76] Income tax treaties and protocols are generally self-executing.[77] So, the Second Circuit seemed to infer the creation of a private right of action from competent authority relief provisions that are very similar to those in the treaties at hand.[78]

The problem for U.S. taxpayers challenging the granting of benefits to U.K. residents is that in order for a litigant to have standing, he must suffer an actual injury himself.[79] Taxpayers can challenge the taxes that have been assessed against them (either in the Tax Court or in the district courts after full payment).[80] But in the hypothetical case in front of us, taxpayers would be challenging Treasury for ***not*** assessing taxes upon ***someone else***. This is an example of third-party standing, also known as ''taxpayer standing.'' There are two general lines of argument plaintiffs make in cases of taxpayer standing: (1) they may argue that they have suffered financial harm because their tax bill would be lower if the United States interpreted the treaty correctly and withheld at the statutory rate, or (2) they may argue that they have suffered a ''psychic injury'' arising out of a violation of their constitutional rights.[81] While the latter argument has succeeded with respect to the Establishment Clause, albeit rarely,[82] the former has been repeatedly rejected by the Supreme Court.[83]

Just as the absence of taxpayer standing has given the Service room for selective nonenforcement,[84] it would also insulate Treasury from challenges made by U.S. taxpayers to a policy granting equivalent beneficiary status to U.K. residents. Ultimately, any challenge to the policy made by U.S. taxpayers would almost certainly have to be made in the political arena.

C. Members of the U.S. Senate

If Treasury enters into agreements with treaty partner states (e.g., Competent Authority Arrangements) agreeing to grant U.K. residents equivalent beneficiary status post-Brexit, U.S. Senators may argue that such an agreement constitutes treaty renegotiation that infringes upon the Senate's treaty power granted in Article II, Section 2, Clause 2 of the U.S. Constitution. Recently, Senator Paul challenged a similar kind of international tax agreement on similar grounds. In 2015, he and several individual plaintiffs sued Treasury to strike down the Foreign Account Tax Compliance Act (FATCA) and certain intergovernmental agreements (IGAs). Paul alleged that he had been ''denied the opportunity to exercise his constitutional right as a member of the U.S. Senate to vote against the FATCA IGAs.''[85]

The Sixth Circuit ruled that Sen. Paul did not have standing to challenge the IGAs because ''any incursion upon [his] political power is not a concrete injury like the loss of a private right, and any diminution in the Senate's lawmaking power is not particularized but is rather a generalized grievance.''[86] The court distinguished the facts from those of *Coleman v. Miller*,[87] in which the Supreme Court found that a group of 21 Senators had standing to challenge a resolution that twenty of them had voted against, stating that ''Paul has not pleaded that his vote on its own would have been sufficient to forestall the IGAs.''[88] This suggests that if a large enough bloc of Senators is willing to challenge a Competent Authority Arrangement in court, they may possibly be determined to have standing.

If the challengers were to have standing, then the question would rest upon whether Treasury's entry into the CAAs constitutes an impermissible intrusion into the Senate's treaty making powers. If a CAA agrees to an interpretation that is so contrary to the ordinary meaning of the terms in the treaty that it amounts to the renegotiation of the treaty's substantive provisions, then that could potentially be an unconstitutional overstep in violation of the separation of powers doctrine. On the other hand, legislators

---

[76] *Columbia Marine Servs.*, 861 F.2d at 21.

[77] *See* Senate Executive Report 114-5 (concerning the Protocol Amending the Tax Convention with Japan) at V. ''Implementing Legislation'' (''As is the case generally with income tax treaties, the Protocol is self-executing and does not require implementing legislation for the United States.''). *See also SenateExecutive Report 111-3 concerning the Tax Convention with Malta*, and Senate Executive Reports 114-1 through 114-4, all of which include the same paragraph.

[78] Note, however, that the Second Circuit seemed to set the ''[q]uests of jurisdiction aside'' before undertaking its interpretation of the treaty, so it might go too far to say that the court held that the competent authority relief provision did affirmatively create a private right of action. *Columbia Marine Servs.*, 861 F.2d at 21.

[79] *Lujan v. Defenders of Wildlife*, 504 U.S. 555, 560-61, 112 S. Ct. 2130, 2136 (1992) (''First, the plaintiff must have suffered an 'injury in fact' — an invasion of a legally protected interest which is (a) concrete and particularized, and (b) 'actual or imminent,' not 'conjectural' or 'hypothetical[.]' '' Second, there must be a causal connection between the injury and the conduct complained of — the injury has to be 'fairly. . .trace[able] to the challenged action of the defendant, and not. . .the result [of] the independent action of some third party not before the court.' Third, it must be 'likely,' as opposed to merely 'speculative,' that the injury will be 'redressed by a favorable decision' '' (citations omitted).

[80] *Flora v. United States*, 357 U.S. 63 (1958).

[81] James R. Parks, *A New Theory of Taxpayer Standing*, 6 Colum. J. Tax L. 118, 128.

[82] *See Flast v. Cohen*, 392 U.S. 83, 88 S. Ct. 1942 (1968); *but see Ariz. Christian Sch. Tuition Org. v. Winn*, 564 U.S. 125, 131 S. Ct. 1436 (2011).

[83] *See Massachusetts v. Mellon* (commonly referred to as *Frothingham v. Mellon*), 262 U.S. 447, 43 S. Ct. 597 (1923). *See also Simon v. E. Ky. Welfare Rights Org.*, 426 U.S. 26, 46 (1976) (Stewart, J., concurring).

[84] Lawrence Zelenak, *Custom and the Rule of Law in the Administration of the Income Tax,* 62 Duke L.J. 829, 850 (2012)..

[85] *Crawford v. U.S. Dep't of the Treasury*, 868 F.3d 438, 444 (6th Cir. 2017).

[86] *Id*. at 460.

[87] 307 U.S. 433.

[88] *Crawford* at 460.

© 2020 The Bureau of National Affairs, Inc.
ISSN 0090-4600

probably do not have standing to challenge a policy of discretionary nonenforcement, because the Service has enforcement authority with respect to tax assessment and collection, and enforcement authority includes the authority to prioritize certain enforcement goals over others.

VIII. FINAL RECOMMENDATION/ CONCLUSION

Short of the passage of a federal law tackling this issue, Treasury's best option appears to be to initially issue a notice and change the Form W8-BEN-E to let taxpayers know they can pass the test, on the condition that the United States will try to negotiate IGAs/ CAAs granting equivalent beneficiary status to U.K. residents as soon as possible. This works for numerous reasons: It aligns with the purpose of the derivative benefits test. It does not violate customary rules of treaty interpretation because it relies on a straightforward reading of the competent authority relief treaty provisions, rather than on a tortured interpretation of the definition of equivalent beneficiary. If treaty partners have problems with it, then that would hopefully spur negotiations, which would hopefully lead more quickly to bilateral understanding. If treaty partners do not have problems with it, then there would not be a pressing need to enter into an IGA/ CAA, Treasury can go on with its business (like issuing Tax Cuts and Jobs Act[89] regulations), and companies with U.K. residents would not have to change their business operations or ownership structure. The policy arguments for granting benefits are so strong, and our relationship with the United Kingdom (not to mention with other treaty states) is so important, that Treasury will find a way to grant equivalent beneficiary status to U.K. residents. It just might need to get a little creative.

[89] Pub. L. No. 115-97 (2017).

© 2020 The Bureau of National Affairs, Inc.
ISSN 0090-4600