Interpreting Tax Treaties in Canada, the United States, and the United Kingdom

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ARTICLE

INTERPRETING TAX TREATIES IN CANADA, THE UNITED STATES, AND THE UNITED KINGDOM

Russell K. Osgood†

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† Professor of Law, Cornell University. The author thanks John J. Barceló, Steven M. Cherin, Alan L. Feld, Mark W. Janis, and William W. Park for comments on drafts of this article and Kevin M. Rowe for able research assistance. ©1984 by Russell K. Osgood. All rights reserved.
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I. Introduction

The interpretation and application of tax treaties raise unique and difficult issues of law. Tax treaties are generally-worded, bilateral


2. Although tax treaties are generally-worded, there is a clear tendency in recent agreements between developed nations to tie a treaty’s provisions closely to features of domestic tax law. A prime example of this is the 1975 United States-United Kingdom Convention, which attempts to fix the interrelationship among (1) the British system of partial corporate-shareholder taxation integration, (2) the operation of indirect foreign tax credits in connection with the deemed or actual payment of a dividend from a British corporation to a United States corporate shareholder, and (3) the proper level of taxation of the dividend from a British corporation to a United States shareholder. See Convention for the Avoidance of Double Taxation, Dec. 31, 1975, United States-United Kingdom, arts. 10, 23, 31 U.S.T. 5668, 5677-79, 5685-87, T.I.A.S. No. 9682, at 10-12, 18-20, amended by Additional Protocol, Aug. 26, 1976, art. III, 31 U.S.T. 5668, 5705-06, T.I.A.S. No. 9682, at 38-39 (amending art. 23), amended by Additional Protocol, Mar. 15, 1979, arts. III, V, 31 U.S.T. 5668, 5710-11, T.I.A.S. No. 9682, at 43-44 (amending arts. 10, 23) [hereinafter cited as 1975 United States-United Kingdom Convention].

Even though these treaty provisions are related specifically to the provisions of the underlying revenue laws, problems of interpretation still arise. For example, in Priv. Ltr. Rul. 8239019 (June 25, 1982) (available on LEXIS, Fedtax library, PR file), the IRS was asked to interpret Article 23(1) of the Convention, which provides that a U.S. corporation
instruments that rest on complex revenue legislation. The treaties modify, restrict, and elaborate the operation of the underlying revenue laws without radically altering them. The generality of treaty language presents special interpretation problems in view of the detail in the underlying statutes.

The bilaterality of tax treaties complicates their application in three ways. First, treaty language is designed to produce similar results in what may be two very different revenue systems. Second, the legal role of treaties may be different in the two signatory nations. Third, the same treaty language will be interpreted in two separate court systems without any guarantee of harmonious results.

Treaties also do not represent the sole or even the major form of dual-jurisdiction tax harmonization. Unilateral methods, such as the foreign tax credit, still provide a basis in the absence of, or within, a treaty for allocating jurisdiction over and revenue attributable to a person or entity with multination contacts.

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3. Sections 901 to 905 of the Internal Revenue Code provide unilateral double taxation relief for U.S. citizens and residents, including U.S. corporations. I.R.C. §§ 901-905 (West 1982 & Supp. 1985). In general, relief is provided only with respect to taxes on income sourced in another country or, in the case of I.R.C. § 902, on income earned by a foreign corporation and then distributed as a dividend to a U.S. corporate shareholder that owns 10% or more of the foreign corporation’s stock. Relief is limited in each year by I.R.C. § 904 to the amount of taxes that the United States would have imposed on the foreign income. Thus, taxes imposed by a foreign nation at a higher rate than U.S. taxation of the same income cannot be applied against U.S. liability on U.S. source income. By virtue of I.R.C. §§ 901 and 903, the only taxes that are creditable are income, war profits, and excess profits taxes, along with certain taxes imposed in lieu of such taxes.

Section 906 provides unilateral relief to nonresident alien individuals and foreign corporations that are not covered by a treaty. I.R.C. § 906 (West 1982 & Supp. 1985). This provision admits foreigners to the benefits provided for citizens and residents under I.R.C. § 901, but only in the case of income that is effectively connected with a trade or business within the United States. Thus, a foreigner paying the 30% tax on periodical income that is not effectively connected cannot get a U.S. credit but must look to his home country for relief. For a thorough discussion of many aspects of the operation of these various credit provisions, see Dale, The Reformed Foreign Tax Credit: A Path Through the Maze, 33 TAX L. REV. 175 (1978); Gann, The Concept of an Independent Treaty Foreign Tax Credit, 38 TAX L. REV. 1 (1982); Isenbergh, The Foreign Tax Credit: Royalties, Subsidies, and Creditable Taxes, 39 TAX L. REV. 227 (1984).

Canada and the United Kingdom maintain analogous, although not perfectly identical, foreign tax credit regimes. See 3 CAN. TAX REP. (CCH) ¶¶ 19,700-19,792 (1985); F. SIMON’S TAXES §§ F1.117-151 (rev. 3d ed. 1983) (United Kingdom).
The purpose of this Article is not to propose a departure either from the current structure or language of tax treaties or from their bilateral format. Nor does this Article address the desirability of using model treaties, such as the United Nations or OECD models. Instead, the purpose here is to look at the interpretation and application of treaties in Canada, the United States, and the United Kingdom in order to explore the range and substance of treaty application in those countries. The three leading developed common law jurisdictions are obviously not a random or representative sample of countries. The three countries were chosen because they conduct a large amount of trade with each other and have similar legal systems. In addition, these countries have the most highly developed set of cases and rulings interpreting and applying treaties. Finally, as will be seen below, the available decisional material frequently involves treaties with other countries, such as Sri Lanka, the Federal Republic of Germany, or Poland. Therefore, the findings of this Article are relevant to non-common law countries.

The investigation of the cases and materials in these three countries shows that courts and revenue authorities of the country in which income is sourced normally interpret tax treaties so as to apply their

4. Model treaties are forms developed by various organizations to guide treaty negotiators. For example, there is an OECD model income tax treaty, a U.N. model, and a United States Treasury Department model. However, the treaties that are actually negotiated frequently differ from all of these models. For example, both the Convention with Respect to Taxes on Income and on Capital, Sept. 26, 1980, United States-Canada, S. Exec. Doc. T, 96th Cong., 2d Sess. (1980), reprinted in 4 CAN. TAX REP. (CCH) ¶ 30,224 (1984) [hereinafter cited as 1980 United States-Canada Convention] and the 1975 United States-United Kingdom Convention, supra note 2, reflect the peculiarly strong economic ties and interests of the signatories. See infra note 7.


7. In 1983, the total value of U.S. exports was $200.5 billion. Exports to Canada were $38.2 billion and to the United Kingdom $10.6 billion. In the same year, the total value of Canadian exports was $76.7 billion. Exports to the U.S. were $53.8 billion and to the United Kingdom $2.0 billion. United Kingdom exports in 1983 totalled $91.6 billion. Exports to the U.S. were $12.7 billion and to Canada $1.4 billion. INT'L MONETARY FUND, DIRECTION OF TRADE STATISTICS, 1984 YEARBOOK 113, 382, 385 (1984) (all figures in U.S. dollars).

8. See infra notes 92-99, 113-26, 184-92 and accompanying text.

9. The “source country” is the country in which income is deemed to have arisen. For example, a sale of an interest in real estate, located in the United States, is deemed to be “income from sources within the United States” without regard to the location of the owner or other facts. I.R.C. § 861(a)(5) (1982).
INTERPRETING TAX TREATIES

The country's tax rules\(^{10}\) that would apply in the absence of a treaty. Treaties can alter source jurisdiction treatment, but this is not their main thrust. Nor do treaties reach for an international revenue accommodation. Rather, tax treaties are limited cessions of the fundamental notion of source jurisdiction sovereignty.

II
TAX TREATIES IN GENERAL

Any effort to describe the contents of a "typical" tax treaty confronts the fact that some treaties are quite old and differ substantially from recent treaties, including current model treaties. Even among more recent treaties, there are numerous variations of style and substance, reflecting history, ideology, and the particular treaty model that is followed. Nevertheless, there is general uniformity among most treaties regarding the major facets of design. First, tax treaties separate business from investment income. The source country may tax the business income of an individual or enterprise of the other signatory country only if that individual or enterprise has a permanent establishment within the source country.\(^{11}\) Thus, business income earned in the absence of a permanent establishment will not be taxed, even though it is earned within the source country.\(^{12}\)

Second, certain types of investment income are treated separately even if there is a permanent establishment, as long as they are not effectively connected with that permanent establishment.\(^{13}\) This income is usually taxed at lower rates than would apply to nonresident aliens of a nontreaty country. Third, the treaties resolve various jurisdictional issues. For example, a particular tax may be deemed to be creditable under a signatory's foreign tax credit regime,\(^{14}\) or real property income might be

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10. See infra note 178 for a discussion of the different tax rules that may apply.
11. See, e.g., 1975 United States-United Kingdom Convention, supra note 2, at art. 7(1) (referring to "business profits," a new term for the concept of "industrial and commercial profits" used in older treaties). Dividends and interest are also taxed as business profits if they are "effectively connected with a permanent establishment." See id. at arts. 10(5), 11(6).

A permanent establishment is usually defined by treaty as a permanent business presence in a non-domiciliary country. See, e.g., id. at art. 5. The concept has attracted considerable judicial and scholarly attention. For example, in Masri v. Minister of Nat'l Revenue, 73 D. Tax 5367 (Fed. Ct. Can. Tr. Div. 1973), the Trial Division of the Federal Court of Canada held that a U.S. resident who was an inactive partner in a partnership with substantial real estate investments in Canada but no other significant Canadian contacts was not involved in a permanent establishment there within the meaning of the 1942 United States-Canada Convention. See generally Williams, Permanent Establishments in the United States, 29 Tax Law. 277 (1976).
12. See, e.g., 1980 United States-Canada Convention, supra note 4, at art. VII(1).
13. See supra note 11 and accompanying text. Interest, dividends, royalties, capital gains, and rents are the most common types of such investment income.
14. See, e.g., 1975 United States-United Kingdom Convention, supra note 2, at art. 2(2)(b) (British petroleum tax eligible for a U.S. foreign tax credit). This provision negates
subjected to full taxation in the situs country, even in the absence of a permanent establishment.\textsuperscript{15} Fourth, certain persons and industries, such as visiting scholars,\textsuperscript{16} airline and shipping companies,\textsuperscript{17} and performing artists,\textsuperscript{18} are accorded special treatment. Fifth, the two nations establish mutual agreement and accommodation procedures for resolving conflicts concerning the application of the treaty.\textsuperscript{19} Sixth, the countries agree to exchange information.\textsuperscript{20} Seventh, each country reserves the right to tax its residents or nationals as though the treaty had not come into effect.\textsuperscript{21}

Tax treaties have been called "conventions for the avoidance of

\begin{footnotesize}
\begin{enumerate}
\item[15.] This does not mean that the situs country must tax real property income or that the residence country may not also tax real property income after providing a foreign tax credit. Rather, the situs country may tax the income even in the absence of a permanent establishment. See, e.g., 1975 United States-United Kingdom Convention, supra note 2, at art. 6; Convention for the Avoidance of Double Taxation, Sept. 8, 1978, Canada-United Kingdom, art. VI, 1980 Can. T.S. No. 25, \textit{reprinted in} 4 CAN. TAX. REP. (CCH) \textsuperscript{2}30,231 (1979) [hereinafter cited as 1978 Canada-United Kingdom Convention]. The Canadian Parliament adopted the 1978 Canada-United Kingdom Convention, together with certain precatory provisions, as the Canada-United Kingdom Income Tax Convention Act, 1980, ch. 44, pt. X, 1980-1983 Can. Stat. 899, 906.

\item[16.] See, e.g., 1975 United States-United Kingdom Convention, supra note 2, at arts. 20, 21.

\item[17.] See, e.g., id. at art. 8; 1978 Canada-United Kingdom Convention, supra note 15, at art. VIII.

\item[18.] See, e.g., 1975 United States-United Kingdom Convention, supra note 2, at art. 17; 1978 Canada-United Kingdom Convention, supra note 15, at art. XVI.

\item[19.] See, e.g., 1975 United States-United Kingdom Convention, supra note 2, at art. 25; 1978 Canada-United Kingdom Convention, supra note 15, at art. XXIII.

\item[20.] See, e.g., 1975 United States-United Kingdom Convention, supra note 2, at art. 26; 1978 Canada-United Kingdom Convention, supra note 15, at art. XXIV. For a brief discussion of the kinds of information that are exchanged pursuant to tax treaties, see Seemann, \textit{Exchange of Information under International Tax Conventions}, 17 INT’L LAW. 333 (1983).

\item[21.] See, e.g., 1975 United States-United Kingdom Convention, supra note 2, at art. 1(3). Thus, tax treaties are primarily relied upon by persons who are not citizens or residents of the forum jurisdiction. An exception arises when taxpayers use tax treaties to calculate the amount of their foreign tax credit. See infra notes 195-98 and accompanying text.

\end{enumerate}

The language of saving clauses varies from treaty to treaty. For example, Article 1(3) of the 1975 United States-United Kingdom Convention, supra note 2, provides, "Notwithstanding any provision of this Convention except paragraph (4) of this Article, a Contracting State may tax its residents . . . and its nationals as if this Convention had not come into effect." Paragraph 4 contains several specific exceptions. \textit{Id.}

Rev. Rul. 79-28, 1979-1 C.B. 457 interpreted the saving clause in the Convention for the Avoidance of Double Taxation, Mar. 8, 1971, United States-Japan, art. 4, 23 U.S.T. 967, 973-75, T.I.A.S. No. 7365, at 7-9, to permit Japan to tax fully the income of a U.S. citizen flight crew member earned while serving on a Japanese airline, even with respect to service performed within the United States. Thus, the Convention was interpreted to cede source jurisdiction taxation over income earned by a national of the source country. This is perhaps the least common kind of cession of jurisdiction. There was, however, clear language in the Convention to support this interpretation. Article 5(1)(a) of the Convention incorporated a special source rule from Article 6 that covered this taxpayer's situation. This Article was explicitly excepted from the Convention’s saving clause by Article 4(4)(a).

\end{footnotesize}
double taxation." 22 Virtually all treaties have an article entitled "Elimination of Double Taxation." 23 This article frequently adapts the application of foreign tax credit regimes of the signatories. 24 In addition, most mutual agreement articles have as a residual basis for a mutual agreement "the elimination of double taxation in cases not provided for in the Convention." 25

Most treaties, in fact, eliminate very little double taxation. Because many countries have adopted elaborate foreign tax credit regimes, the primary purpose of modern treaties is not to prevent double taxation. Rather, these treaties provide for the source country's cession of taxing jurisdiction and revenue to the residence nation in the situations the treaty enumerates. 26 In addition, the treaties create a tailored interface between the two tax systems and otherwise resolve debatable issues under domestic nontreaty revenue law.

III

THE METHODS OF ADOPTING TAX TREATIES

Despite the great similarity among tax treaties, one might suppose that they would be construed differently in the various nations. One reason for differences in construction may be that tax treaties become authoritative legal instruments in Canada, the United States, and the United Kingdom by different methods. These different methods of adoption reflect constitutional differences among the three countries.

A. CANADA

Canada is a federal, parliamentary democracy operating under a newly repatriated constitution. 27 While the British monarch remains

23. See, e.g., 1980 United States-Canada Convention, supra note 4, at art. XXIV.
24. For example, Articles 10 and 23 of the 1975 United States-United Kingdom Convention, supra note 2, fit the United Kingdom's advance corporation tax (ACT) into the structure of the U.S. foreign tax credit provisions without otherwise altering the U.S. law. Without the Convention's accommodation of the ACT, it would be unclear whether shareholders or corporations could claim payment of the tax as a foreign tax credit because of the ACT's dual shareholder and corporate character. The ACT was first imposed by the Finance Act, 1972, ch. 41, §§ 84-111.
25. See, e.g., 1980 United States-Canada Convention, supra note 4, at art. XXVI(3).
26. The United States' views concerning the primary purposes of modern treaties are discussed in Rosenbloom, supra note 5, at § 31.04, at 31-54 to 31-57.
27. Prior to its recent patriation, the Canadian constitution existed as a United Kingdom statute, the British North America Act, 1867, 30 Vict., ch. 3, together with amendments, a few significant royal orders, and a few less significant British statutes. In December, 1981, the parliament of Canada adopted the Constitution Act, 1982, which contains the Canadian Charter of Rights and Freedoms, as well as a list of British statutes and royal orders deemed to survive the adoption of the Constitution Act. See 1980-1983
the head of state, the country is in all other respects fully sovereign. In Canada, as in the United States and the United Kingdom, the first step in the generation of a tax treaty is negotiation with a potential treaty partner.

Once a treaty is negotiated, the Canadian government submits it to the House of Commons and Senate for enactment. This is normally a pro forma matter in Canada’s parliamentary system. The Canadian parliament enacts a treaty by incorporating it into a statutory instrument that also includes a title, an effective date, and words of effectuation. Thus, Canadian courts treat tax treaties as statutes. In addition, these treaties have some quality of bindingness on Canada as

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29. Canada has signed tax treaties with over 40 nations. See 4 CAN. TAX REP. (CCH) 30,000, passim (1984).

30. For an example of words of effectuation, see infra text accompanying note 118.

31. There is substantial British and Canadian authority for the proposition that, except for peace treaties, a treaty does not become part of the municipal law of either nation without statutory action. See Francis v. The Queen, 3 D.L.R.2d 641 (Can. 1956). Chief Justice Kerwin, writing for three justices, stated, The Jay Treaty was not a treaty of peace and it is clear that in Canada such rights and privileges as are here advanced of subjects of a contracting party to a treaty are enforceable by the Courts only where the treaty has been implemented or sanctioned by legislation. This . . . is justified by a continuous line of authority in England. . . . It has been held that no rights under a treaty of cession can be enforced in the Courts except in so far as they have been incorporated in municipal law . . . .

Id. at 643 (citations omitted). Justice Rand, writing for two justices, explained, Except as to diplomatic status and certain immunities and to belligerent rights, treaty provisions affecting matters within the scope of municipal law, that is, which purport to change existing law or restrict the future action of the Legislature, including, under our Constitution, the participation of the Crown, and in the absence of a constitutional provision declaring the treaty itself to be law of the state, as in the United States, must be supplemented by statutory action.

Id. at 647.

Recent litigation concerning the Panama Canal Treaty, Sept. 7, 1977, United States-Panama, _ U.S.T._, T.I.A.S. No. 10030, has addressed the effect under international and domestic law of executive agreements that implement a treaty. See Coplin v. United States, 6 Cl. Ct. 115 (1984). In that case, a U.S. citizen argued that Article XV(2) of the Agreement in Implementation of Article III of the Panama Canal Treaty, Sept. 7, 1977, United States-Panama, _ U.S.T._, T.I.A.S. No. 10031, at 40, which provides that U.S. citizens who are employees of the Panama Canal Commission “shall be exempt from any taxes . . . as a result of their work for the Commission,” provided exemption from U.S. as well as Panamanian taxes. This Agreement was not submitted to the Senate for its advice and consent. 6 Cl. Ct. at 120. The United States argued, inter alia, that the Agreement lacked domestic effect because it was not ratified. Id. The Claims Court agreed with the taxpayer on the basis of several theories, including the theory that this executive agreement was a treaty within the meaning of I.R.C. § 894(a) (1982). See 6. Cl. Ct. at 124-25.
a nation subject to international law.\footnote{32}

\section*{B. The United States}

The United States generates a treaty by a process of negotiation similar to Canada's. However, unlike Canadian practice, once the treaty and an authoritative explanation of its terms are drafted, the President submits the treaty to the Senate for its advice and consent.\footnote{33} The Senate usually consents, and the treaty then goes into effect pursuant to an instrument of ratification signed by the President, the Secretary of State, or, more frequently, a lower-level diplomat.\footnote{34} Thus, in the United States, the treaty is an executive agreement that is reviewed by one legislative house but is not enacted as a statute. The final steps in implementation are an exchange of instruments of ratification followed by an official proclamation of the treaty by the President.\footnote{35}

Occasionally, as in the case of the 1975 United States-United Kingdom Convention,\footnote{36} the Senate consents to a proposed treaty with reservations or declines to consent unless certain provisions are stricken or renegotiated by way of an amendatory protocol.\footnote{37} Thus, even though the formal role of the Senate is less significant than the roles of the British and Canadian parliaments, the Senate has, in fact, been more active than the others in reviewing and considering the substance of proposed treaties.

Although U.S. treaties are not statutes, they have equal dignity with statutes under the Constitution.\footnote{38} Therefore, the Internal Revenue Code must make allowance for tax treaties. Section 7852(d) of the

\footnotetext{32}{The status of tax treaties under international law is murky at best. See infra notes 76-77 and accompanying text. No treaty provides that a dispute can or must be brought before an international tribunal, such as the International Court of Justice. In addition, except for some evidence that tax treaty disputes are occasionally submitted to consensual arbitration, there is no case law or other authority concerning what happens when parties to a tax treaty become embroiled in an intractable dispute. However, there is nothing in a tax treaty to suggest that it is not subject to the various international conventions and norms governing other treaties.}

\footnotetext{33}{U.S. Const. art. II, § 2, cl. 2.}

\footnotetext{34}{See, e.g., Protocol To Amend Tax Convention, Nov. 24, 1978, United States-France, 30 U.S.T. 5109, T.I.A.S. No. 9500 (signed by Acting Secretary of State); see Rosenbloom, supra note 5, at § 31.03[5] n.141.}

\footnotetext{35}{See Rosenbloom, supra note 5, at § 31.02[2].}

\footnotetext{36}{1975 United States-United Kingdom Convention, supra note 2.}

\footnotetext{37}{See Comment, America Waves the Rules While Britannia Rules the Waves, 1983 Brit. Tax Rev. 265, 265.}

\footnotetext{38}{The Supremacy Clause of the U.S. Constitution makes treaties and federal laws, along with the Constitution, the supreme law of the land. See U.S. Const. art. VI, cl. 2. This implies that treaties and statutes are equal, at least in regard to domestic effects. Thus, in the Head Money Cases, 112 U.S. 580 (1884), the Court held that a new federal statutory head tax on immigrants was enforceable despite existing treaty provisions that prohibited imposition of such taxes. See Rainey v. United States, 232 U.S. 310 (1914); 2 C. Hyde, International Law § 529 (2d ed. 1945).}
Code\textsuperscript{39} was enacted at the time of the recodification of the revenue laws in 1954 to ensure that the Internal Revenue Code of 1954 would not abrogate treaties that were in effect or nullify any of their provisions.\textsuperscript{40} This provision is now of limited and diminishing significance. Of greater importance are the rules contained in I.R.C. section 894.\textsuperscript{41} Section 894(a) establishes the supremacy of treaty exemption language: "Income of any kind, to the extent required by any treaty obligation of the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle."\textsuperscript{42} Section 894(b), by contrast, serves the limited function of negating the "force of attraction" principle,\textsuperscript{43} which was contained in most treaties negotiated prior to the adoption of the Foreign Investors Tax Act of 1966.\textsuperscript{44} That Act replaced the force of attraction feature of domestic law with the "effectively connected" concept.\textsuperscript{45} In most instances, this change reduced United States taxation of nonresident alien individuals and foreign corporations. However, in cases in which the change is not beneficial to a treaty national and is contrary to the treaty, the change does not apply.\textsuperscript{46}

C. THE UNITED KINGDOM

The British method of adopting a treaty differs from Canadian and U.S. methods. Under the Income and Corporation Taxes Act, 1970,\textsuperscript{47} a draft treaty negotiated by the government is laid before the

\textsuperscript{39} I.R.C. § 7852(d) (1982).
\textsuperscript{41} I.R.C. § 894 (1982).
\textsuperscript{42} I.R.C. § 894(a). See Langer, Override of Tax Treaties by Ordinary Legislation, 34 BULL. FOR INT'L FISCAL DOCUMENT’N 552, 553 (1980). The less basic and perhaps unintended consequences of this provision's narrowness will be explored later in this Article. For additional discussion of I.R.C. § 894(a), see infra notes 78-91 and accompanying text.
\textsuperscript{43} The force of attraction principle provided that when a nonresident alien individual or a foreign corporation was engaged in a U.S. trade or business, all of his or its U.S. source income was taxed as income attributable to that trade or business. This meant that unrelated passive investment income was lumped together with business income and taxed at graduated rates rather than pursuant to the fixed withholding tax rates of 30% or less. See P. McDaniel & H. Ault, supra note 40, at 54-55.
\textsuperscript{44} Pub. L. No. 89-809, tit. I, 80 Stat. 1539, 1541 (codified as amended in scattered sections of I.R.C. (1982)).
\textsuperscript{45} See sec. 104(b), § 882, 80 Stat. at 1555-57. Income is "effectively connected" if it is attributable to the U.S. trade or business. The effectively connected rules include a residual force of attraction rule. See infra notes 130-33 and accompanying text.
\textsuperscript{46} Section 110 of the Act provides,

No amendment made by this title shall apply in any case where its application would be contrary to any treaty obligation of the United States. For purposes of the preceding sentence, the extension of a benefit provided by any amendment made by this title shall not be deemed to be contrary to a treaty obligation of the United States.

Pub. L. No. 89-809, sec. 110, 80 Stat. at 1575.
\textsuperscript{47} Income and Corporation Taxes Act, 1970, ch. 10.
The House of Commons prays the Queen by Address to put the treaty in effect by Order in the Privy Council. The Queen may revoke a declaration in a subsequent Order of the Privy Council. Because of the formal quality of Parliamentary and royal consideration, a British treaty becomes law by virtue of its status as an executive agreement.

IV

TREATY INTERPRETATION

A. INTERPRETATION BY TAXPAYERS

The most frequent occasion for tax treaty interpretation is private interpretation by taxpayers and their advisors. Generally, a taxpayer who is a citizen or resident of one contracting state employs a treaty in order to determine the proper treatment of income he derived in the other contracting state. Such a person may also use the treaty indirectly to determine liability to his home state when calculating the amount of his foreign tax credit.

B. INTERPRETATION IN MUTUAL AGREEMENT PROCEEDINGS

Treaty interpretation also occurs pursuant to a "mutual agreement" or "competent authority" procedure. Treaties typically pro-

48. Id. at § 497(8).
51. This is clearly so in Canada and the United States. Because the United Kingdom does not operate on a self-assessment system, official scrutiny of treaty questions is more likely to occur in that country.
52. See infra notes 195-98 and accompanying text.
53. See Rev. Proc. 82-29, 1982-1 C.B. 481 (competent authority procedure with respect to "allocation of income and deductions"); Rev. Proc. 77-16, 1977-1 C.B. 573 (competent authority procedure for matters other than "allocation of income and deductions," such as "the availability to a United States taxpayer of credits against foreign tax, exemptions from foreign tax, reduced rates of foreign tax, and other benefits and safeguards").

In a brief, thoughtful comment on other papers, David Rosenbloom has taken the position that competent authority interpretation of treaty language should perhaps be more aggressive than, or at least as aggressive as, judicial interpretation.

I feel strongly . . . that the competent authority is more than simply exercising a mechanical function sitting there with, in one hand, the treaty and, in the other hand, the Internal Revenue Code, maybe a dictionary, and spinning forth answers to what words mean . . .

. . . [O]ne view which I share is that the competent authority has the right and duty to take account of all my primary materials, and that, yes, present policies, present models, any available evidence that will help, can be relied upon legitimately by the competent authority in resolving particular double taxation problems that come up under a treaty.

Rosenbloom, supra note 1, at 545. Not surprisingly, Rosenbloom, then a Treasury official, argued that the notes of the negotiators are more reliable materials to interpret a treaty than Senate ratification reports. Id. at 544.
vide that, under certain circumstances, the revenue authorities of the two signatories may agree on the application of the treaty to a particular case or on a general matter of treaty interpretation. The requisite circumstances vary from treaty to treaty but generally include double taxation or other inconsistent treatment. Some older treaties suggest that the home state must receive a "claim," but modern treaties provide only that there may be a mutual agreement.

At least one group of commentators has suggested that mutual agreements may operate in some instances to amend the provisions of a treaty, but this is highly debatable in the United States, the United Kingdom, and Canada. It is widely thought that the Department of the Treasury, which is the competent authority in the United States, may not act in a legislative manner. However, a former Treasury official, Mr. David Rosenbloom, has argued that the Treasury should be given very broad latitude in mutual agreement proceedings.

The competent authorities must have leeway to resolve cases of double taxation in a practical way. Since it is not imaginable that treaty partners will invariably accept U.S. positions on all issues, the U.S. competent authority must have room to negotiate, both in regard to facts and, to some extent, in regard to principle. . . . Although there are doubtless cases where a proposed resolution would exceed any reasonable mandate, a strict interpretation of the competent authority function could deprive tax treaties of a considerable part of their utility.

54. But see Rev. Rul. 54-53, 1954-1 C.B. 156 (the mutual agreement procedure of the United States-Sweden treaty cannot be employed to ameliorate a harsh inconsistency in the treatment of alimony by the two nations). The Ruling holds that there is no relief for a Swedish resident receiving alimony from a U.S. alimony trust when each nation takes the position that it is taxable income. The Ruling concludes, "However, [the mutual agreement] article does not refer to a case where the reason for the double taxation of income is due to the differences in the systems of taxation in the two countries." 

55. See Rev. Rul. 56-251, 1956-1 C.B. 846 (interpreting the Estate Tax Convention, Oct. 18, 1946, United States-France, 64 Stat. 133, T.I.A.S. No. 1982). I am unaware of any developments that shed light on the meaning of the word "claim." It might mean a mere request for a mutual agreement proceeding. But perhaps it requires that the taxpayer have a ripe claim for a grievance, as opposed to a possible grievance.

56. See Avery Jones I, supra note 56, passim.

57. See Avery Jones I, supra note 56, passim.

58. See Rosenbloom, supra note 5, at § 31.03[2].

59. Id.
This formulation of the power of mutual agreement authorities would be easier to accept if one could confidently define "leeway," "practical," and the concept of negotiating principle "to some extent." Mr. Rosenbloom makes clear that he believes that as a general matter a treaty should not be treated as an inflexible statute, as he thinks the Internal Revenue Service does. However, he never articulates a basis in the language of United States treaties for giving the competent authorities greater interpretative license than is permitted to a court.

Prior to the adoption of the Freedom of Information Act, it was difficult to obtain the text of agreements arising from mutual agreement proceedings. In addition, it has been hard to ascertain the frequency of these proceedings. There is even less evidence about what happens if the two signatories cannot agree. It appears that the European nations sometimes submit these disputes to ad hoc arbitration. A few older tax treaties provide for binding arbitration of disputes that cannot be resolved through mutual agreement proceedings.

As a result of the Freedom of Information Act, the texts of U.S. agreements generated by mutual agreement proceedings should now become available. In fact, an agreement dated January 26, 1984, between Canada and the United States concerning the amount of depreciation allowable for oil drilling rigs that a U.S. resident operates off the coast of Canada has been released. This agreement provides that a taxpayer may elect to take accelerated depreciation deductions for any rig that is a permanent establishment in Canada. Straight-line depreciation is provided if the rig is not a permanent establishment. The agreement does not state whether a rig by itself normally

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60. Rosenbloom states that "[t]reaties are not 'super-Codes' joining two systems with specific and comprehensive rules." Id. at § 31.03[2], at 31-39.

61. The OECD model appears to give quasi-legislative power to competent authorities. See Avery Jones I, supra note 56, at 334-36. For articles discussing mutual agreement proceedings, see Avery Jones, Mutual Agreement Procedure, 34 BULL. FOR INT'L FISCAL DOCUM'N 556 (1980); Avery Jones I, supra note 56; Avery Jones, Berg, Depret, Ellis, Fontaneau, Lenz, Migatake, Roberts, Sandels, Strobl & Ward, The Legal Nature of the Mutual Agreement Procedure Under the OECD Model Convention—I, 1980 BRIT. TAX REV. 13 [hereinafter cited as Avery Jones II].


63. One group of commentators has compiled data for the 1970s that indicates that mutual agreement proceedings are not very common. See Avery Jones II, supra note 61, at 21.


65. Id. at 23.


67. Id. at paras. 2, 4.

68. Id. at para. 4. The agreement may also cover the situation in which the U.S. resident has a permanent establishment in Canada in addition to the rig, and the rig's income is
would constitute a permanent establishment under the 1942\textsuperscript{69} or the 1980 United States-Canada Conventions.\textsuperscript{70} Nor does the agreement make clear against what income the depreciation can be deducted, that is, what income is taxable in Canada, if the rig is not a permanent establishment and if the U.S. resident has no other permanent establishment.

This oil rig depreciation agreement does more than resolve a dispute between a taxpayer and one nation's revenue authorities. However, it does not appear to be legislative in character. Rather, it interprets the Conventions' provisions for deductions from business profits by establishing the amount of, and procedure for obtaining, deductions for oil rig depreciation. It is, therefore, consistent with a limited view of the role of mutual agreement proceedings.

C. INTERPRETATION BY COURTS

Interpretation of tax treaties also occurs in courts. A taxpayer may litigate the meaning of a treaty instead of seeking a mutual agreement proceeding or after such a proceeding ends in disagreement or failure.\textsuperscript{71} A taxpayer usually asserts his interpretation of a treaty first with the revenue bureaucracy and, if necessary, in the courts of the contracting state that is not his home state. Therefore, most of the cases discussed in this Article involve people or entities "foreign" to the forum jurisdiction.\textsuperscript{72}

This Article assumes that taxpayers, competent authorities, and courts in all three countries should interpret treaties in the same fashion. However, only the naive would fail to see that role differentiation might produce results favorable to taxpayers in the hands of taxpayers and their advisors and results favorable to the government or governments in mutual agreement proceedings. At least judicial interpretation should proceed along similar lines in Canada, the United States, and the United Kingdom. It is true that results may not always be identical because of the open-textured nature of many treaty provisions. It is also true that the courts of Canada and the United Kingdom do not consider preparatory legislative materials when attributable to that establishment. In this situation, Canada has the right to tax the rig's income.


70. 1980 United States-Canada Convention, supra note 4.


72. The few cases involving taxpayers domiciled in the forum nation concern liability for withholding taxes or determinations of the foreign tax credit. See infra notes 113-26, 195-98 and accompanying text.
interpreting a treaty,73 whereas courts in the United States rely on such materials. This difference in approach may lead to some differing results. Nevertheless, treaties, particularly the joint treaties of the three nations, should be interpreted commonly in the absence of treaty language that contemplates different results in accordance with the nontreaty law of the source jurisdiction.74

V

THE RELATIONSHIP BETWEEN A TAX TREATY AND A SIGNATORY'S REVENUE LAWS WHEN THE UNDERLYING REVENUE LAWS CHANGE

In all three nations, a tax treaty is "law" on which the residents and corporations of one signatory nation may rely against the other signatory nation, but generally not against their domiciliary nation.75 The underlying revenue law is also "law," however, and frequently the two come into conflict because of a change in domestic revenue legislation after the effective date of a treaty.

A. LEGISLATIVE POWER TO NULLIFY A TREATY

The jurisprudence of each of the three nations accords to its legislature a degree of lawmaking power that permits the abrogation of part or all of a treaty, without regard to the treaty's provisions for termination or to the effectiveness of such an abrogation under inter-

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73. Ward II, supra note 1, at 549.
74. Another method of interpreting tax treaties is to issue interpretive regulations. A leading case on the permissible scope of interpretive regulations is Samann v. Commissioner, 313 F.2d 461 (4th Cir. 1963), in which the court upheld a Treasury Regulation arising under the Convention for the Avoidance of Double Taxation, May 24, 1951, United States-Switzerland, 2 U.S.T. 1751, T.I.A.S. No. 2361 [hereinafter cited as 1951 United States-Switzerland Convention]. The regulation provided that the maintenance of a permanent establishment at any time within a taxable year would constitute the maintenance of a permanent establishment for the entire taxable year. The Convention merely provided that a person "not having a permanent establishment in the former State shall be exempt from taxation in such former State." Id. at art. VIII. The Convention also provided that "the two contracting States may prescribe regulations necessary to carry into effect the present Convention within the respective States." Id. at art. XIX. The court held that although "the Treasury cannot contract or expand an international compact," it may interpret a treaty. 313 F.2d at 463. The court also found that the failure of Swiss and other European authorities to object to this interpretation of the permanent establishment concept indicated their approval. Id. at 463-64.
75. Thus, the 1975 United States-United Kingdom Convention, supra note 2, provides that each signatory may tax its residents "as if this Convention had not come into effect." Id. at art. 1(3). In the situations in which a corporation has dual residence, only a few of the Convention's provisions can give rise to a claim for "relief or exemption." Id. at art. 1(2), amended by Additional Protocol, Aug. 26, 1976, art. 1, 31 U.S.T. 5668, 5704, T.I.A.S. No. 9682, at 37. One such situation is the creditability of the Petroleum Revenue Tax under Article 1 of the Convention, which is made applicable to U.S. citizens and residents by I.R.C. § 894 (1982).
national law. Unilateral termination may give rise to a legal claim in a competent international tribunal, such as the International Court of Justice. However, because that tribunal has jurisdiction only with the consent of the parties, international law provides no effective remedy for unilateral termination.\(^76\)

I. United States: FIRPTA and Stapled Entities

A recent, hotly disputed, unilateral legislative nullification of treaty language occurred when the United States passed the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA).\(^78\) This Act added I.R.C. section 897\(^79\) and other statutory provisions\(^80\) that represent a substantial break with past tax treatment of foreign investments in U.S. real estate. Section 897 treats gains or losses on sales and certain other dispositions of U.S. real property interests as gains or losses that are effectively connected with the conduct of a trade or business within the United States.\(^81\) This ensures that such gains or losses will be treated as U.S. business income, rather than being taxed as periodical income or not being taxed at all if the taxpayer fails to meet certain presence requirements in the United States.\(^82\)

76. Article 36(1) of the Statute of the International Court of Justice provides, The jurisdiction of the Court comprises all cases which the parties refer to it and all matters specially provided for in the Charter of the United Nations or in treaties and conventions in force.

A signatory to a tax treaty could argue that the signing of the treaty constitutes "deemed" consent to the Court's jurisdiction. The United States made a similar argument in connection with its litigation against Iran following Iran's seizure of the U.S. hostages. See In re United States Diplomatic and Consular Staff in Tehran (U.S. v. Iran), 1980 I.C.J. 1, 24-27 (Judgment of May 24). No tax treaty that I am aware of provides that disputes may or shall be heard by the International Court of Justice.

77. To remedy this situation, Lindencrona and Mattsson have proposed a binding arbitral procedure to resolve treaty conflicts. See G. LINDECRONA & N. MATTSSON, supra note 64, at 59-65.


82. The old method for taxing such gains in the absence of a treaty is set forth at I.R.C. § 871(a)(2) (1982). This method is still applicable to non-real estate capital gains earned by nonresident alien individuals. The individual pays a 30% tax on such gains if he was "present in the United States for a period or periods aggregating 183 days or more" in a taxable year. Id. There was no analogue to I.R.C. § 871(a)(2) for a foreign corporation. Therefore, such gains were taxable only if they were "effectively connected with the conduct of a trade or business within the United States." I.R.C. § 882(a)(1) (1982).
Section 897 took effect immediately as a matter of domestic law and for nonresident aliens not subject to any treaty. Many treaties in effect at the time of the passage of the Act tracked or bettered the pre-FIRPTA treatment of non-trade or business real property gains and losses. Thus, the enactment of section 897 threatened to make treatment under those treaties extraordinarily favorable. As a consequence, Congress decided to nullify unilaterally all contrary treaty provisions as of January 1, 1985, unless the parties renegotiated the treaty in light of the FIRPTA change.

An even more aggressive U.S. nullification of contrary treaty provisions occurred in 1984. The Deficit Reduction Act of 1984 created I.R.C. section 269B, which provides that a foreign corporation that is a “stapled entity” with respect to a domestic corporation “shall be treated as a domestic corporation.” Thus, the United States will tax the foreign corporation’s income without regard to its source, even if the foreign corporation has no connection to the United States except the stapling.

Because section 269B nullifies, although in a limited number of cases, a fundamental characteristic of international taxation, that is, the separate foreign identity of a nonresident foreign corporation, one would suppose that the change would be phased in, as the FIRPTA changes were. Section 269B(d) provides, however, that “[n]othing in

83. This abrogation of contrary treaty provisions had the potential of conflicting with I.R.C. § 894(a) (1982), which establishes the supremacy of treaty exemption language. As a matter of statutory interpretation, the later provision, I.R.C. § 897, might be deemed to control the earlier provision, I.R.C. § 894. Nonetheless, Congress explicitly amended I.R.C. §§ 894(a) and 7852(d) in enacting I.R.C. § 897. See Pub. L. No. 96-499, § 1125(c)(1), 94 Stat. at 2690.

84. If the parties negotiate a new provision that is signed before January 1, 1985, then I.R.C. § 897, or the new supervening treaty provision, will apply to treaty nationals on the effective date of the new provision, but in no event may this date be after December 31, 1986. If the parties attempt to negotiate a new treaty and fail to sign it before January 1, 1985, then January 1, 1985 will be the effective date of I.R.C. § 897. See Pub. L. No. 96-499, § 1255(c)(2), 94 Stat. at 2690-91.


87. Entities are considered stapled if more than 50% in value of the beneficial ownership of each are “stapled interests,” meaning that “by reason of form of ownership, restrictions on transfer, or other terms or conditions, in connection with the transfer of 1 of such interests the other such interests are also transferred or required to be transferred.” I.R.C. § 269B(c) (West Supp. 1985). Stapling is a technique for avoiding controlled foreign corporation status and obtaining other unrelated domestic advantages. For example, in Priv. Ltr. Rul. 7839012 (June 27, 1978) (available on LEXIS, Fedtax library, PR file), which preceded the adoption of I.R.C. § 269B, the taxpayer contended that the stapling was not prompted by tax avoidance motives, but was necessary to make its foreign sales affiliate acceptable to European customers. The Ruling recognized that the stapled foreign corporation was separate from its domestic counterpart. See id. at paras. 10-11. This would no longer be the result under I.R.C. § 269B.

section 894 or 7852(d) or in any other provision of law shall be construed as permitting an exemption, by reason of any treaty obligation of the United States heretofore or hereafter entered into, from the provisions of this section." The Act also provides that section 269B(d) shall not apply to any entity that was stapled as of June 30, 1983.90

Thus, treaties are nullified except with respect to those taxpayers audacious enough to have engaged in the stapling stratagem before Congress moved to eliminate it. Section 269B can be explained as an effort by Congress to close a perceived loophole that treaty partners probably did not anticipate, much less negotiate, in the process of treaty drafting. At the same time, section 269B is very broad and gives the Treasury the power to issue regulations that treaty partners might argue strike at important features of treaties and, therefore, constitutes another display of congressional high-handedness.91 The stapled stock provision illustrates, as does FIRPTA, that subsequent legislation may overrule contrary treaty provisions.

2. United Kingdom and Canada: WOODEND

The unlimited power of the British Parliament is so universally understood that it is difficult to imagine that anyone would challenge, or that the courts would need to determine, Parliament’s power to abrogate a treaty for domestic purposes. However, the Privy Council addressed this issue and recognized broad parliamentary power in

89. Id. at § 269B(d).

90. Pub. L. No. 98-369, sec. 136(c)(5), 98 Stat. at 671. The Act also provided a new, seemingly mechanical definition of a nonresident alien. Pub. L. No. 98-369, sec. 138(a), § 7701(b), 98 Stat. at 672–76 (codified at I.R.C. § 7701(b) (West Supp. 1985)). This provision appears to be generally applicable and might be thought to override certain treaty provisions. The Conference Report, however, indicates the opposite intent.

The conferees do not intend that the conference agreement override treaty obligations of the United States. For example, an alien who is a resident of the United States under the new statutory definition but who is a resident of a treaty partner of the United States (and not a resident of the United States) under a United States income tax treaty will be eligible for the benefits that the treaty extends to residents of the treaty partner. However, notwithstanding the treatment of the alien as a resident of the other country for treaty purposes, the conference agreement will treat the alien as a U.S. resident for purposes of the internal tax laws of the United States. For example, if the alien owns more than 50 percent of the voting power of a foreign corporation, the foreign corporation will be a controlled foreign corporation (sec. 957).

H.R. REP. No. 861, 98th Cong., 2d Sess. 967. This subtle approach to treaty benefit preservation is consistent with the approach discerned below. See infra notes 127–41 and accompanying text.

91. Most significantly, I.R.C. § 269B and, presumably, any regulations issued under it disregard the foreign status of the stapled entity. Even if the stapled entity is not engaged in the conduct of a U.S. trade or business, it is treated as a domestic corporation. I.R.C. § 269B(a)(1). This rule contradicts the rule of most treaties that an entity of one contracting state may not be taxed on its business profits derived in the other contracting state unless it has a permanent establishment in that other contracting state. See, e.g., 1980 United States-Canada Convention, supra note 4, at art. VII(1).
Woodend (K.V. Ceylon) Rubber & Tea Co. v. Commissioner of Inland Revenue, 92 a case involving a treaty-statute conflict in a Commonwealth country.

In 1950, the United Kingdom and Ceylon, now Sri Lanka, signed an Agreement for the Avoidance of Double Taxation, 93 which Ceylon proceeded to enact as positive law. The Agreement provided:

The residents of one of the territories shall not be subjected in the other territory to any taxation or any requirement connected therewith which is other, higher or more burdensome than the taxation and connected requirements to which the residents of the latter territory are or may be subjected. 94

In 1959, Ceylon substantially increased its tax rates and changed its method of taxing businesses.

The Rubber and Tea Company, which was managed in Britain, was engaged in various agricultural pursuits in Ceylon but was considered a nonresident enterprise under the new tax. The Privy Council, following the decision of the Supreme Court of Ceylon, held that the new taxes to which the Rubber Company was subjected were not “higher or more burdensome” than those imposed on residents. 95 The Privy Council found, however, that one of the new taxes was “other” than a tax imposed on a resident enterprise. 96 Because this tax was “other” taxation, the 1959 Act was pro tanto in conflict with the 1950 Agreement. 97 The Council applied the maxim that specific language in a later statute is deemed to repeal general language in a prior statute. Because the Act and the Agreement were irreconcilable, the Council held that the Act repealed the Agreement. The Council reasoned, “It is unlikely that in the course of preparing [the Act,] agreements such as the 1950 agreement would have been completely overlooked . . . .” 98

Woodend involved subtler facts than the FIRPTA and stapling episodes. It follows, however, that if the Parliament of Ceylon can nullify a tax treaty by implication, then it can do so directly. It must also follow that the Parliament at Westminster can do the same. Although Woodend is only persuasive authority in Canada, the Supreme Court of Canada has approved the Privy Council’s conclusion in dictum. 99

94. Id. at art. XVIII(1).
95. [1971] 1 A.C. at 332.
96. The offending tax was imposed on any “remittances” that a nonresident company made abroad. Id.
97. Id.
98. Id. at 334-35.
B. General Statutory Change in Relation to Arguably Contrary Treaty Language

In the cases of FIRPTA and stapled entities, Congress explicitly nullified existing treaty provisions. In *Woodend*, the Privy Council held that a major statutory change in the scheme of taxation that is directly repugnant to treaty language will overrule the treaty. In most instances the clash between a treaty and a statute is less obvious. The treaty speaks in broad terms, and the legislature has made a general and relatively insignificant change in the revenue laws. This change is made without giving much, if any, thought to foreign taxpayers and their particular problems, let alone the language of particular treaties. Further complications result from the fact that the language of the treaty may be so general that it is not even clear that there is a conflict.

It should be apparent that treaties cannot be read to require the halting of underlying changes in the revenue laws on which the treaty rests. On the other hand, to the extent that the treaty is designed to secure special treatment or exemption for a nonresident, a change in domestic law that threatens the exemption gives rise to an issue of the relationship of domestic law to the treaty. For example, virtually all treaties provide that the business profits of an enterprise of one contracting state may be taxed by the other state only as explicitly provided in the treaty. Thus, a domestic law that imposes new taxation on the business profits of an enterprise of the other signatory state conflicts with a tax treaty unless the new law expressly overrides the treaty or unless the treaty's language has some elasticity.

The rest of this section considers cases in which a change in the underlying revenue laws conflicted with treaty language or threatened to make a treaty provision useless. In these cases, the courts employed various theories to explain why a treaty should be interpreted one way or another. The resulting theories are inconsistent among themselves and frequently are internally incoherent.

In *Estate of Burghardt v. Commissioner*, the Tax Court of the United States considered whether a general legislative change should be read into a provision of the 1955 Estate Tax Convention between

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100. See, e.g., 1975 United States-United Kingdom Convention, supra note 2, at art. 7.
the United States and Italy. That Convention provides that an Italian resident, not a U.S. citizen but subject to U.S. estate taxation, is entitled to a prorated specific exemption from estate taxes. At the time the treaty was adopted, U.S. law provided that up to $60,000 of a U.S. resident’s estate was sheltered from taxation by a specific exemption. Estates that fell within the provisions of the treaty qualified for a proportion of this exemption based on the proportion of U.S. property in the estate. After the treaty entered into force and before the death of Charlotte Burghardt, a non-U.S. citizen residing in Italy who owned United States property, the United States replaced the specific exemption with a unified credit. The unified credit in 1978, the year of Mrs. Burghardt’s death, was $34,000 for a U.S. citizen or resident.

The Internal Revenue Service argued that Mrs. Burghardt’s United States ancillary administrator could only avail himself of the very limited unified credit of $3600 accorded to the estates of deceased nonresident aliens not covered by more advantageous treaty provisions. The administrator countered that the 1955 treaty was intended to provide a proportion of the then-existing full specific exemption. Furthermore, the 1976 unified credit changes should be read into the words “specific exemption,” as used in the Italian treaty, thereby enabling the estate to take advantage of the full unified credit for citizens and residents.

The Tax Court agreed with the administrator:

The basic aim of treaty interpretation is to ascertain the intent of the parties. Courts must “give the specific words of a treaty a meaning consistent with the genuine shared expectations of the contracting parties.”


103. 1955 United States-Italy Estate Tax Convention, supra note 102, at art. IV(a).
105. 1955 United States-Italy Estate Tax Convention, supra note 102, at art. IV(a).
109. 80 T.C. at 706-07.
110. Id. at 707. “Petitioner argues that the phrase ‘specific exemption’ is a general term that describes the level at which estate taxation begins.” Id. In fact, the concept of a specific exemption came from old I.R.C. § 2052. See Rev. Rul. 81-303, 1981-2 C.B. 255, 255, which had previously construed the phrase “specific exemption” not to refer to the new unified credit in the context of seven estate tax treaties, including the Italian treaty.
When treaties are ambiguous, they are to be construed “in a broad and liberal spirit, one which prefers the favoring of rights granted under it over a restrictive view of those rights.”

The Tax Court, perhaps inconsistently, sees two major rules in tax treaty interpretation. First, the court views a treaty as a contract more than a statute and focuses attention on the parties' intentions. Presumably, the court believes that contracts can be interpreted more liberally than statutes, at least when the intentions of the parties are discernible. Second, the court seeks to preserve the rights the treaty secures. Thus, it might be expected that the Tax Court will stretch treaty language to favor the taxpayer over the Treasury.

The Tax Court's eclecticism and willingness to look at a treaty primarily as a contractual agreement contrasts sharply with the 1982 decision of the Supreme Court of Canada in The Queen v. Melford Developments, Inc. Melford borrowed money from the Bank of Nova Scotia. A German bank that was not a Canadian enterprise or resident guaranteed the loan. Melford paid the German bank a one-percent loan guaranty fee. Revenue Canada asserted that the fee constituted a payment of interest from which Melford was required to withhold tax pursuant to the Income Tax Act and the 1956 Canada-West Germany Convention. At the time the Convention was signed, guaranty fees were not treated as interest under Canadian tax law. However, a 1975 amendment to the Income Tax Act provided that guaranty fees were thereafter deemed to be interest.

Melford claimed that "interest," as used in the Convention, did not include guaranty fees, because they were not interest under Canadian law in 1956. If the income was not interest, it could only have

112. Courts that suggest that a tax convention should be interpreted as a contract rather than a statute generally do not explain the consequences of such a distinction. It would appear that such a distinction is employed to justify a free-wheeling interpretation. The probable logic for this approach is that a contract is presumed to represent a meeting of the minds. Therefore, a court is empowered to interpret contractual language more loosely to effectuate that meaning. By contrast, a statute is the work of one or more hands. While courts attempt to discern and employ legislative intent, at least in the United States, see supra text accompanying note 73, they are more constrained by the language actually selected.
113. 139 D.L.R.3d 577 (Can. 1982).
114. Id. at 578.
been subject to Canadian taxation if it constituted business profits of the German bank earned through a permanent establishment. By agreement of the parties, the German bank did not have a permanent establishment in Canada.

Melford relied upon the language of effectuation in the statute that enacted the 1956 Convention as support for its argument. Section 3 of the statute provided, "In the event of any inconsistency between the provisions of this Act, or the Agreement, and the operation of any other law, the provisions of this Act and the Agreement prevail to the extent of the inconsistency."\textsuperscript{118} In addition, the Convention provided that undefined terms, such as interest, shall have the same meaning that they have under the nontreaty laws of the contracting countries.\textsuperscript{119}

In his opinion for the Supreme Court, Justice Estey stated forthrightly that Parliament could amend or repeal the 1956 Act if it so chose.\textsuperscript{120} However, no such intention was evidenced at the time of the amendment of the Income Tax Act in 1975 with respect to guaranty fees. Justice Estey limited the scope of the Court’s decision by holding that the effectuation language and the Convention did not freeze Canadian \textit{procedural} tax law.\textsuperscript{121} With respect to \textit{substantive} tax law, any domestic legislation that increases the tax burden on a taxpayer who is protected by a treaty is without effect unless Parliament expressly states such an intention. The Court held:

\begin{quote}
[T]he effect of [section] 3 is to make the operation of any other law of Parliament, including the \textit{Income Tax Act}, subject to the terms of the 1956 Act and the incorporated agreement. . . . Thus any legislative action taken for whatever reason which results in a change or expansion of a definition of a term such as "interest" does not prevail over the terms of the 1956 statute because of the necessary meaning of [section] 3 thereof.\textsuperscript{122}
\end{quote}

Justice Estey did not expound a particular theory of tax treaty interpretation. He rejected any analogy to \textit{Woodend}, because in \textit{Woodend} there was actual or constructive intent to repeal or to replace inconsistent portions of the United Kingdom-Ceylon agreement.\textsuperscript{123}

\begin{itemize}
\item \textsuperscript{119} 139 D.L.R. 3d at 579. Article II(2) of the 1956 Canada-West Germany Convention, \textit{supra} note 116, stated,
\begin{quote}
In the application of the provisions of this Convention by one of the contracting States any term not otherwise defined in this Convention shall, unless the context otherwise requires, have the meaning which it has under the laws in force in the territory of that State relating to the taxes which are the subject of this Convention.
\end{quote}
\item \textsuperscript{120} 139 D.L.R.3d at 584.
\item \textsuperscript{121} \textit{Id.} at 583. One cannot be exactly sure of the dividing line between procedural and substantive tax law. Presumably Justice Estey meant that things like the date for filing a return were not frozen by the treaty.
\item \textsuperscript{122} \textit{Id.} at 584-85.
\item \textsuperscript{123} \textit{Id.} at 586-87.
\end{itemize}
There was no evidence of such intention in Canada’s 1975 amendment of its Income Tax Act.\textsuperscript{124}

\textit{Melford} renders the operation of bilateral tax treaties extremely difficult. The Court assumed that the maximum content of an undefined term, such as “interest,” with respect to treaty nationals, is frozen at its meaning on the date of the treaty’s enactment. However, no nation that negotiates a treaty assumes that such generally used terms are immutable. Indeed, most negotiators probably believe that general terms such as “interest” will breathe along with the underlying law. The absence of definitions of these terms while other terms are specifically defined implies that the general terms were intended to be elastic.\textsuperscript{125}

Although not articulated as such, Justice Estey seems to view a tax treaty primarily as a statute that freezes the maximum content of the law as of the moment of effectuation, except when the treaty explicitly eschews such a freezing. This approach contrasts with the contract and rights notions of the U.S. Tax Court in \textit{Burghardt} and would entail significant administrative problems.\textsuperscript{126}

The decisions in \textit{Burghardt} and \textit{Melford} were favorable to the taxpayer. It should not be surprising that in administrative rulings the revenue officials who must interpret treaty language in light of statutory changes will arrive at different conclusions, using some or all of the same interpretative techniques. A leading example is United

\textsuperscript{124} Id.

\textsuperscript{125} In a case that superficially resembles \textit{Melford}, The Queen v. Armos, 36 D. Tax 6165 (Fed. Ct. App. Can. 1982), the Federal Court of Appeal of Canada concluded that the 1942 United States-Canada Convention, \textit{supra} note 69, as amended by the Supplemental Convention, June 12, 1950, United States-Canada, art. 1(j), 2 U.S.T. 2235, 2239, T.I.A.S. No. 2347, at 6, prevented the recapture of previously deducted capital allowances. The deductions were taken to reduce rental income from property previously owned by a resident trustee and then distributed to nonresident trustees who actually effected the sale of the property. The major difference between this case and \textit{Melford} is that Article XIII A(2) of the amended Convention provided,

\begin{quote}
Rentals from real property derived from sources within Canada by an individual or corporation resident in the United States of America shall receive tax treatment by Canada not less favorable than that accorded under Section 99, The Income Tax Act, as in effect on the date on which this Article goes into effect.
\end{quote}

Thus, the immunity from capital allowance recapture that the taxpayer in \textit{Armos} sought is supported by the specific language of the treaty and is substantially clearer than the immunity approved in \textit{Melford}.


\textsuperscript{126} For example, with approximately 40 treaties, Revenue Canada would have to accommodate the variations likely to exist in the use of the words “interest” or “deduction” based on different treaty effective dates and dates of legislative changes.
States General Counsel Memorandum 35472 (GCM 35472).\(^{127}\) The main focus of this Memorandum was to apply a major change in the tax rules resulting from the passage of the Foreign Investors Tax Act of 1966\(^{128}\) to the language of the 1951 United States-Switzerland Convention.\(^{129}\)

Prior to the adoption of the 1966 Act, the Internal Revenue Code, in the absence of a treaty, provided that when a nonresident alien individual or foreign corporation became engaged in a trade or business within the United States, all of his or its U.S. source income, whether it was business income or separate investment income, would be gathered together by "force of attraction" and taxed as regular income.\(^{130}\) The 1966 Act, in response to complaints by foreign investors and major U.S. trading partners, dropped the force of attraction rule. The Act provided instead that fixed or determinable annual or periodical gains and income that were not related to a foreign taxpayer’s U.S. trade or business would be taxed at a flat thirty percent rate.\(^{131}\) However, the Code retained the force of attraction rule for all business income that was derived from U.S. sources after a taxpayer became engaged, to any extent, in a trade or business within the United States.\(^{132}\) This new set of statutory rules is known as the "effectively connected" regime.\(^{133}\)

Many treaties that were negotiated during the era of the force of attraction rule, including the Swiss treaty, recognized the rule. Thus, under this treaty any U.S. source income could be attributed to a permanent establishment,\(^{134}\) if one existed. When Congress repealed the force of attraction rule with the 1966 Act, it added section 894(b) to the Code.\(^{135}\) Section 894(b) provides that any prior treaty that incorporated the force of attraction rule would be unilaterally altered to sever income that was effectively connected with a trade or business

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127. General Counsel Memorandum 35472 (undated) (available on LEXIS, Fedtax Library, GCM file).
129. 1951 United States-Switzerland Convention, supra note 74.
131. See Pub. L. No. 89-809, secs. 103(a), 104(a), 80 Stat. at 1547-50, 1555 (codified as amended at I.R.C. §§ 871(a) (individuals), 881 (corporations) (West 1982 & Supp. 1985)).
134. A "permanent establishment" is the treaty analogue to the domestic law concept of being engaged in a trade or business within the United States. See P. McDaniel & H. Ault, supra note 40, at 170-71.
from periodical income. This was done in the belief that the change would be beneficial to most treaty nationals.

General Counsel Memorandum 35472 described a Swiss taxpayer who sought to benefit from the force of attraction provision in the United States-Switzerland Convention. The taxpayer asserted that it should not be forced to sever its effectively connected income from its periodical income, as required by section 894(b), even though severing the income would result in lower taxation for most treaty nationals. Apparently, the taxpayer had effectively connected losses or such a small amount of income that it was advantageous to tax the periodical gains at regular business rates.

The 1966 Act included an uncodified provision, section 110,136 which provided that the extension of a benefit by operation of section 894(b) would not be deemed contrary to any treaty provision. The taxpayer argued that section 894(b) would deny him the benefit of the force of attraction rule. GCM 35472 rejected this position on the theory that the separate taxation of periodical income at a rate of thirty percent, which was provided by the treaty as amended by section 894(b), was the “benefit” covered by section 110 and that the taxpayer was still guaranteed this benefit:

We do not think that preventing the taxpayer from grouping his noneffectively connected dividend income with the income effectively connected with his trade or business, deprives him of any benefit granted by the Income Tax Convention with Switzerland. . . . This so-called “benefit” [of lower dividend taxation in this case], however, was provided by Code § 871 before that section was revised by the [1966] Act and not by the Tax Convention with Switzerland which nowhere refers to a graduated rate of tax for dividends.137

General Counsel Memorandum 35472 conflicts with the words of the Swiss Convention, which recognized the force of attraction principle independently of former I.R.C. section 871.138 Thus, the taxpayer’s argument that he had been deprived of a benefit and that I.R.C. section 894(b) should not be applied to him is quite convincing. The Service’s rejection of this argument would reduce the impact of section 110 and permit the effectively connected concept to be applied even in the face of contrary treaty language.

Section 110 of the 1966 Act makes GCM 35472 different from normal treaty interpretation, but this difference strengthens the taxpayer’s argument, because section 110 explicitly shelters treaties from the Act’s provisions. The rejection of the taxpayer’s argument may indicate the lengths to which revenue authorities will go in twisting treaty language. Or one might infer from GCM 35472 that tax treaties

137. General Counsel Memorandum 35472, supra note 127.
138. See 1951 United States-Switzerland Convention, supra note 74, at art. III(1)(a).
are loosely worded guidelines that are accommodated and interpreted in light of underlying developments in the revenue laws of the signatories.

Evaluation of the results in GCM 35472 must take into account the fact that the Memorandum considered a second, related issue and came to a conclusion favorable to the taxpayer. The 1966 Act, in addition to severing periodical income from effectively connected business income, provided that in some cases income from sources without the United States would be treated as “effectively connected” and therefore taxable in the United States. Prior to 1966, the United States did not reach foreign source income of nonresident aliens and foreign corporations. In GCM 35472, the taxpayer sought a determination that the treaty prevented the taxation of any foreign source income, even though the treaty contained no explicit prohibition. GCM 35472 held for the taxpayer on this issue:

We realize that in our consideration of the first issue of this case we reject the taxpayer's argument, based on the old force of attraction rule... while in our analysis of the second issue we rely on the force of attraction rule for our conclusion that all foreign-source income is exempt under the Convention. The explanation for this apparent discrepancy is found in Code § 894(a) which states that income, to the extent provided by a treaty, shall not be included in gross income and shall be exempt from taxation. Since there is nothing in the Convention requiring that dividend income be taxed at graduated rates, the present statutory treatment of taxing non-effectively connected dividend income at a 30 percent rate does not affect any exemption provided by a treaty ... . Therefore, the taxpayer cannot rely on Code § 894(a) to continue the tax on his dividends at graduated rates. On the other hand, we believe Article III(1)(a) of the Convention exempts from taxation foreign-source income of Swiss nonresident aliens so that Code § 894(a) does come into play in deciding the second issue in favor of the taxpayer.

The problem with this reasoning is that the treaty explicitly recognizes the force of attraction concept but never considers whether the United States can tax foreign source income. In addition, GCM 35472 seems to ignore the effect of section 110 of the 1966 Act. A literal approach to treaty interpretation would have suggested the

140. General Counsel Memorandum 35472, supra note 127.
141. The first sentence of Article III(1)(a), on which the Memorandum relies, merely states, “A Swiss enterprise shall not be subject to taxation by the United States in respect of its industrial and commercial profits unless it is engaged in trade or business in the United States through a permanent establishment situated therein.” 1951 United States-Switzerland Convention, supra note 74, at art. III(1)(a). Thus, it does not recognize explicitly that foreign source income can never be taxed by the United States. By contrast, the second sentence explicitly recognizes the force of attraction principle. “If it is so engaged the United States may impose its tax upon the entire income of such enterprise from sources within the United States.” Id.
opposite result on each issue. \textit{GCM 35472} offers no theory, purpose, or policy concerning treaty interpretation to justify its results.

In sum, \textit{Burghardt}, \textit{Melford}, and \textit{GCM 35472} show that treaty language is treated as a guidepost but is not applied literally. In \textit{Burghardt}, the Tax Court of the United States attempted to fathom the signatories' purposes as if the agreement were a contract and sought to protect the "rights" of affected taxpayers. In \textit{Melford}, the Supreme Court of Canada froze the word "interest," as used in the 1956 Canada-West Germany Convention, at its meaning on the effective date of the treaty, even though the treaty and the enabling legislation contained no explicit freezing provision. Finally, \textit{GCM 35472} suggests that explicit treaty language may be swept aside by a general legislative change, even when the later statute contains a saving clause. \textit{GCM 35472} also suggests, inconsistently, that treaty language may not be disregarded without express language of nullification, by virtue of the saving clause in I.R.C. section 894(a).

Unfortunately, the best that can be gleaned from these cases is inconsistency of result and incoherence of theory. This is not to say that they are wrong or that no theory can explain the results. The peculiarity of these cases may illustrate the truism that hard cases make bad law. These are cases in which a legislature has passed legislation that unintentionally nullifies a treaty provision. In the context of such strains, the courts labor hard to produce results that they see as "just" but for which the justifications seem weak. As will be seen shortly, an approach that draws these cases together can best be seen in a context in which the interpretation of ambiguous treaty language is not accompanied by an alteration of the underlying revenue laws.

VI TREATY INTERPRETATION NOT IN THE CONTEXT OF A CHANGE IN THE UNDERLYING REVENUE LAWS

Were it not for the fact that revenue laws change frequently, \textit{Burghardt}, \textit{Melford}, and \textit{GCM 35472} would be extraordinary cases. Even with rapid statutory change, the more common case of treaty interpretation involves determining how to apply a treaty provision in light of unchanged revenue laws. \textit{Inland Revenue Commissioners v. Exxon Corp.} is a good example of such a case. \textit{Exxon} concerned Exxon's operations in the United Kingdom, which were conducted through a holding company, Esso Holding Co. U.K. Inc. (Holdings).

\begin{itemize}
\item \textit{See infra} notes 143-99 and accompanying text.
\item \textit{1982} 1 W.L.R. 999 (Ch).
\end{itemize}
Holdings was a Delaware corporation, but it conducted all of its activities in the United Kingdom. Thus, for U.K. tax purposes it was a U.K. resident and subject to U.K. taxation. At the same time, because Holdings was a Delaware corporation, it was a “citizen” of the United States and thus fully subject to U.S. taxation. On March 29, 1973, Holdings paid a dividend to its parent, Exxon.\textsuperscript{144} Article XV of the 1945 United States-United Kingdom Convention\textsuperscript{145} provides,

Dividends and interest paid by a corporation of one Contracting Party shall be exempt from tax by the other Contracting Party except where the recipient is a citizen, resident, or corporation of that other Contracting Party. This exemption shall not apply if the corporation paying such dividend or interest is a resident of the other Contracting Party.\textsuperscript{146}

Holdings argued that the dividend should be exempt from U.K. taxation under the first sentence of Article XV because Holdings and Exxon were both U.S. corporations. In addition, Holdings noted that it was not taken out of the first sentence by the second sentence of Article XV, because Article II(1)(g) defined the term “resident of the United Kingdom” to exclude a U.S. corporation.\textsuperscript{147}

Holdings’ argument was difficult to refute. The Crown noted that the term defined in Article II(1)(g), “resident of the United Kingdom,” is not the exact term employed in the second sentence of Article XV, “resident of the other Contracting Party.”\textsuperscript{148} The Crown argued that the two terms should not be treated as synonymous. According to the Crown, if the residence definitions of Article II were imported into the second sentence of Article XV, that sentence would deprive the United Kingdom of taxation on dividends in all similar situations.\textsuperscript{149} If the facts were reversed, however, this result would not follow, because the term “resident of the United States,” as set forth in Article II(1)(h), did not exclude U.K. corporations. The reason for this non-parallelism in Article II was that the United Kingdom, because of its residence-based tax system, did not attach significance to the place of incorporation.

Thus, if the non-parallel definitions of Article II were applied in Article XV, the exemption would not apply if a similarly situated

\textsuperscript{144} Id. at 1000.

\textsuperscript{145} Convention for the Avoidance of Double Taxation, Apr. 16, 1945, United States-United Kingdom, 60 Stat. 1377, T.I.A.S. No. 1546, superseded by 1975 United States-United Kingdom Convention, supra note 2 [hereinafter cited as 1945 United States-United Kingdom Convention].


\textsuperscript{147} See [1982] 1 W.L.R. at 1002.

\textsuperscript{148} Id. at 1001.

\textsuperscript{149} Id.
U.K. corporation were the payor. The Crown found this result unacceptable, as did Judge Goulding of the Chancery Division:

Although it seems to me that upon the plain meaning of the words used, the expression "resident of the other contracting party" in [the second] sentence does import the residence definitions of Article II . . . I must nevertheless give it a different construction, so that it does not fail of effect. . . . The words of the Convention are not those of a regular parliamentary draftsman but a text agreed upon by negotiation between the two contracting governments. Although I am thus constrained to do violence to the language of the Convention, I see no reason to inflict a deeper wound than necessary. In other words, I prefer to depart from the plain meaning of language only in the second sentence of article XV, and I accept the consequence, strange though it is, that similar words mean different things in the two sentences.150

Judge Goulding's evaluation of his decision seems harsh albeit refreshing. The decision makes Article XV fully operative for both nations. The United Kingdom, with its residence system of taxation, would want to tax the dividend from Holdings to Exxon as a matter of domestic law. Furthermore, the United Kingdom received no explicit, reciprocal concession from the United States in Article II or XV that would have led it to alter this feature of domestic taxation.

The Chancery Division's decision in Exxon seems to be based on a notion that tax treaties provide for item-by-item reciprocity between the parties. While the presence or absence of reciprocity may guide interpretation, it cannot be the primary touchstone of interpretation. One nation might accept a lack of reciprocity on one item in a treaty in return for an advantage elsewhere. Moreover, concern for real reciprocity implies that there is a similarity between the revenue laws that may not actually exist.

The decision of the United States Court of Claims in Brown & Williamson, Ltd. v. United States151 illustrates the problems of attempting to base treaty interpretation upon a notion of reciprocity. Brown & Williamson, a British company, operated in the United States through various subsidiaries. The subsidiaries periodically repatriated their net earnings to the U.K. parent by paying dividends. Under the 1945 United States-United Kingdom Convention,152 a subsidiary was required to withhold tax at a rate of fifteen percent on dividends that were paid to its parent.153 The new United States-

150. Id. at 1004.
152. 1945 United States-United Kingdom Convention, supra note 145.
United Kingdom Convention, which became effective in 1980, reduced this tax retroactively to five percent for dividends that were paid on or after January 1, 1975.

Brown & Williamson petitioned for a refund of the excess dividend taxes that its subsidiaries had paid after January 1, 1975 and made a claim for interest. The new treaty does not require or prevent the payment of interest on refunds. The United States pays interest in the event of an overpayment of tax, but the United Kingdom does not. The United States argued that no overpayment obligation arose until the new treaty came into effect on April 25, 1980, and, therefore, interest did not begin to accrue until that date.

The problem with the United States' argument was that in similar contexts in which there has been a retroactive reduction of taxes it has conceded that interest was due on the amount refunded. Thus, the United States had to argue that the treaty's failure to require the payment of interest on refunds, together with certain general, precatory provisions in the treaty, established that interest was due only from April 25, 1980.

The Court of Claims rejected the government's position. The court noted that other treaties have specifically denied interest on the refunds they generate and that such a provision was missing in this case. Senior Judge Skelton dissented for a variety of reasons including the absence of reciprocity in the obligation to pay interest:

On the basis of reciprocity . . . a citizen of the United Kingdom, such as the plaintiff in the instant case, who gets a tax refund from the United States should not be able to collect interest on the refunded taxes. To hold otherwise places an economic burden on citizens of the United States as compared to citizens of the United Kingdom similarly situated. Obviously, the framers of the Treaty and the governments which ratified it did not intend to discriminate between the citizens of the two countries, nor to create a windfall for citizens of the United Kingdom . . . .

154. 1975 United States-United Kingdom Convention, supra note 2.
155. See id. at arts. 10(2)(b)(i), 28(2)(b).
157. See 688 F.2d at 748.
158. Id. at 749.
159. The United States argued that "the provision that the treaty 'shall enter into force [on April 25, 1980]' indicates that interest is not payable before that date." Id. at 751 (quoting 1975 United States-United Kingdom Convention, supra note 2, at art. 28(2)).
160. 688 F.2d at 751.
161. Id. at 765 (Skelton, J., dissenting). Judge Skelton relied on American Trust Co. v. Smyth, 247 F.2d 149 (9th Cir. 1957). In Smyth, the Ninth Circuit held that capital gains derived by a U.S.-based trust with British beneficiaries were exempt from United States taxation by the applicable Convention to ensure "reciprocity," even though they were not currently distributable. Id. at 152. "We conceive the purpose of the Treaty to have been full reciprocity and equality of tax treatment between nationals of the United States and the United Kingdom." Id. But see infra notes 171-76 and accompanying text.
As with many things labelled "obvious," there is nothing obvious about what Judge Skelton said. Tax treaties are not designed primarily to achieve equality or reciprocity. They are used primarily to harmonize what may be two very different tax systems. To that end, they frequently operate in a reciprocal fashion. However, they rarely alter the underlying tax laws. In the absence of specific language, one would not suppose that the tax treaty between the United States and the United Kingdom would alter the practice of one nation in paying interest on refunds and of the other not to pay such interest. Therefore, while reciprocity occurs often, it is not a fundamental principle, and its logic sometimes must give way to underlying domestic revenue laws.

*Exxon* suggests that reciprocity is an aid in interpreting a tax treaty, but *Brown & Williamson* shows that it cannot be the primary guide for interpretation. *Exxon* looks at a tax treaty as a contract. Accordingly, the role of a court in interpreting the treaty is to discern the intention of the parties. The holding in *Brown & Williamson* and the court's choice not to articulate the contract analogy suggest that in its view the analogy fails to provide answers to difficult interpretative questions. *Brown & Williamson*, however, does not indicate whether a U.S. court would discard or interpret a treaty provision quite as forcefully as the Chancery Division did in *Exxon*.

The decision of the Court of Claims in *Great-West Life Assurance Co. v. United States*¹⁶² indicates that at least that court will do so. Great-West Life Assurance Company, a large Canadian insurer, did a significant amount of business in the United States. Under the insurance laws of various states, Great-West was obliged to maintain within each state certain reserves in the form of trustee accounts. A significant portion of Great-West's reserves constituted debts owed to Great-West by other Canadian entities, including the Government of Canada. In its tax returns, Great-West initially conceded that the interest received from these Canadian obligors on their debts was income effectively connected with its United States business and therefore subject to U.S. taxation. However, Great-West petitioned for a refund after reviewing Article XII of the 1942 United States-Canada Convention,¹⁶³ which prohibited taxation of interest or dividends paid by one Canadian entity to another.¹⁶⁴

Great-West claimed that Article XII was literally applicable, and the United States apparently conceded this point. The United States

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¹⁶². 678 F.2d 180 (Ct. Cl. 1982).
¹⁶³. 1942 United States-Canada Convention, supra note 69.
¹⁶⁴. 678 F.2d at 181-82. Article XII(1) provides,

> Dividends and interest paid by a corporation organized under the laws of Canada to a recipient, other than a citizen or resident of the United States of America or a
argued, however, that the treaty should not be applied literally in this case. The United States contended that the purpose of Article XII was to waive U.S. source rules and the right to tax only if interest or dividends are paid to Canadians who lacked significant contacts with the United States.\footnote{165} The United States asserted that Article XII did not apply to Great-West, because it was "present" in the United States and because the income was earned in the United States. Great-West did not deny that Article XII operated to alter United States source rules, but it contended that the expansive language of Article XII should be applied to its situation.\footnote{166}

The Court of Claims rejected the taxpayer's argument, even though a narrow interpretation of Article XII would mean that the Article was not perfectly reciprocal.\footnote{167} The court ruled that Great-West's income on reserves held in the United States was taxable in the United States.\footnote{168}

Great-West is the most conventional treaty interpretation case yet encountered in this Article. Article XII seems to speak in broad terms, but the context and contemporaneous documents\footnote{169} indicate a more limited meaning. The decision in Great-West employs both loose, intention-focused contractual interpretation and rigid statutory interpretation.\footnote{170}

The issue that Great-West leaves open is how a treaty's provisions are to be interpreted in the absence of guidance from contemporaneous sources, particularly when non-reciprocity may result from a par-

corporation organized under the laws of the United States of America, shall be exempt from all income taxes imposed by the United States of America.

1942 United States-Canada Convention, \textit{supra} note 69, amended by Supplemental Convention, June 12, 1950, art. 1(g), 2 U.S.T. 2235, 2238, T.I.A.S. No. 2347, at 5.\footnote{165} See \textit{678 F.2d} at 185. The United States cited the Senate Committee on Foreign Relations Report on the original treaty. \textit{See id.}\footnote{166}

\footnote{166. \textit{Id.}}

\footnote{167. Article XII is divided into two parts. Part I refers to dividends and interest paid by a Canadian corporation to a "recipient, other than a citizen or resident of the United States . . . or a [United States] corporation." 1942 United States-Canada Convention, \textit{supra} note 69, amended by Supplemental Convention, June 12, 1950, art. 1(g), 2 U.S.T. 2235, 2338, T.I.A.S. No. 2347, at 5. Part II refers to similar payments by a United States corporation "whose business is not managed and controlled in Canada" to comparable non-Canadian recipients. \textit{Id.} at 2 U.S.T. 2238-39, T.I.A.S. No. 2347, at 6. The two halves of Article XII, by their own terms, were not perfectly reciprocal. But the interpretation of the United States, accepted by the court, further compounded this non-reciprocity by defining the similar terms "a corporation organized under the laws of Canada" and "a corporation organized under the laws of the United States" to mean different things. \textit{Id.} at 2 U.S.T. 2238-39, T.I.A.S. No. 2347, at 5-6.\footnote{168}

\footnote{168. The court relied on the transmittal letter signed by the Secretary of State at the time of treaty negotiation, subsequent related legal developments, and the interpretation placed on Article XII by the Treasury since the implementation of the treaty. \textit{678 F.2d} at 186-89.}\footnote{169. See \textit{supra} note 168.}\footnote{170. See \textit{678 F.2d} at 183, 188-89.}
ticular interpretation. The United States Supreme Court had faced this situation previously.\textsuperscript{171} Article XIV of the 1945 United States-United Kingdom Convention\textsuperscript{172} provided that a U.K. resident who was not engaged in a trade or business in the United States would not be subject to U.S. tax on capital gains. This article was included in the treaty because at that time the United Kingdom did not tax capital gains. In \textit{Maximov v. United States},\textsuperscript{173} the trustee of a United States trust with British beneficiaries contested the imposition of capital gains tax on undistributed income of the trust.

The treaty did not specifically accord or deny the exemption of Article XIV to a United States trust with British beneficiaries. The treaty did not even explicitly make reference to trusts. The trustee argued that Article XIV should be extended to his case because the trust's beneficiaries were as deserving of the treaty's exemption as were the direct recipients of capital gains. The Supreme Court rejected the notion that treaties secure "invariable or inflexible equality."\textsuperscript{174}

It appears from the relevant materials instructive as to the intent of the parties to the Convention that the general purpose of the treaty was not to assure complete and strict equality of tax treatment—a virtually impossible task in light of the different tax structures of the two nations—but rather, as appears from the preamble to the Convention itself, to facilitate commercial exchange through elimination of double taxation resulting from both countries levying on the same transaction or profit; an additional purpose was the prevention of fiscal evasion.\textsuperscript{175}

The Supreme Court concluded that Article XIV did not exempt the trust's capital gains from U.S. taxation. However, the Court implied that if the gains had been distributed or if the trust were a grantor trust, the exemption would have applied.\textsuperscript{176} These two implications are significant because they indicate that in rejecting rigid reciprocity the Supreme Court was not interpreting Article XIV mechanically. Rather, the Court indicated that if dividends, technically received by a trust, are distributed currently to a British beneficiary or if that beneficiary is deemed to be the owner of the trust property under the grantor trust rules, then the Court would apply the Article XIV exemption.

In three of the four cases discussed, \textit{Maximov}, \textit{Great-West}, and \textit{Brown & Williamson}, the courts proceeded from the notion that tax treaties are not necessarily premised on reciprocity or equality. In \textit{Exxon}, however, the Chancery relied on the notion of reciprocity in formulating an interpretation that "[did] violence to the language of

\begin{itemize}
\item \textsuperscript{171} See \textit{Maximov v. United States}, 373 U.S. 49 (1963).
\item \textsuperscript{172} 1945 United States-United Kingdom Convention, \textit{supra} note 145, at art. XIV.
\item \textsuperscript{173} 373 U.S. 49 (1963). For a more comprehensive discussion of the facts of this case, see \textit{Maximov v. United States}, 299 F.2d 565 (2d Cir. 1962) \textit{aff'd}, 373 U.S. 49 (1963).
\item \textsuperscript{174} 373 U.S. at 55.
\item \textsuperscript{175} \textit{Id.} at 54 (footnote omitted).
\item \textsuperscript{176} See \textit{id.} at 55 n.3.
\end{itemize}
the Convention." The four cases can be explained more simply and consistently. In each case, the court's result follows closely the result that would be reached under the non-treaty tax law of the source country. The United Kingdom normally would expect to tax dividends paid by a resident company, Holdings, to a nonresident company, Exxon. Brown & Williamson is given the same interest on its refund that would be payable to a United States citizen or resident if a retroactive tax reduction occurred. Capital gains earned and retained by Maximov, the United States trustee, are fully taxed to the trust without regard to the identity or domicile of its beneficiaries. Finally, Great-West was engaged in a trade or business in the United States, and the income from the assets used in that trade or business was derived in the United States. The United States collected tax on Great-West's income. The pattern in these cases is to interpret treaties, in the absence of other direction, by importing into the treaty the applicable rule of the source jurisdiction. This explanation is supported by the result in two recent United States rulings.

*Revenue Ruling 84-21* involved the following corporate structure:

\[ X \]

\[ \text{FX} \]

\[ \text{FY} \]

\[ \text{FZ} \]

\[ \text{FX} \]

\[ \text{FY} \]

\[ \text{FZ} \]

\[ \text{FZ} \]

For the year in question, X distributed dividends to its three shareholders, FX, FY, and FZ. Under the 1967 United States-France

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177. Inland Revenue Comm'rs v. Exxon Corp., [1982] 1 W.L.R. 999, 1004 (Ch.).
178. There are three possible applicable source country rules. The first is the source country rule that is applicable to similarly situated nontreaty aliens. The second is the rule that is applicable to residents (or citizens in the case of the United States) engaging in the same transaction. The third is a special treaty rule that gives treatment more favorable than that received by nontreaty aliens but not as favorable as, or at least different from, treatment received by domiciliary taxpayers.

The first rule is never sought in the case of a treaty national, because the taxpayer can obtain that result even in the absence of a treaty. The second rule is the normal goal and the normal result in most cases. An argument could be constructed for the third possibility, but such a specific divergence from the second rule would seem to require specific treaty authorization. Most treaties do not provide such authorization. The *Great-West* case is one of the few examples in which an argument for the third type of applicable source rule could be made.

Income Tax Convention,\(^{180}\) tax must be withheld from dividends at a rate of fifteen percent unless the recipient is a corporation that owns at least ten percent of the distributing corporation, in which case only five percent is to be withheld.\(^{181}\) The question presented in the ruling was whether X only had to withhold five percent from the dividends to FX and FY on the theory that FZ "owned" directly and indirectly at least ten percent of X. The treaty used the unadorned verb "owns" without the adverbs "directly or indirectly." The Ruling concluded that, because the word "own" in the Internal Revenue Code connotes direct ownership unless it is explicitly modified by an attribution provision, the word would have the same connotation in a treaty.\(^{182}\) Therefore, X would have to withhold at the fifteen percent rate on dividends to FX and FY.\(^{183}\)

Revenue Ruling 84-17\(^{184}\) interprets the 1974 United States-Poland Convention.\(^{185}\) This Ruling supports the general notion that the interpretation of a treaty reflects underlying domestic revenue law. The Ruling shows, however, that there are certain limits to this principle. As was discussed above,\(^{186}\) the 1966 Act replaced the "force of attraction" concept with the "effectively connected" principle. However, the force of attraction concept was partially retained. If a non-resident alien or foreign corporation has effectively connected business income, then all business income, whether actually attributable to the business giving rise to the effectively connected status or not, is deemed to be effectively connected.\(^{187}\) Some tax treaties, including the Polish Convention, reject this limited force of attraction rule.\(^{188}\) Instead, they provide that the existence of a permanent establishment only results in regular taxation of the income attributable to that permanent establishment.\(^{189}\) Business income from other lines of business of the same foreign entity, unrelated to the permanent establishment,
are not taxable in the source country.\textsuperscript{190}

In \textit{Revenue Ruling 84-17}, the Polish entity conducted three different business activities in the United States. Business activity “a” was a permanent establishment. The taxpayer also derived U.S. source income from business activity “b,” which had no permanent establishment. In addition, the taxpayer had a U.S. source loss from business activity “c,” also not conducted through a permanent establishment. The taxpayer wished to rely on the treaty for the non-taxation of the income of activity “b,” but it also wished to offset the gain from activity “a” with the loss from activity “c.”

In the absence of a treaty, I.R.C. sections 864 and 882\textsuperscript{191} would require that the income and losses of all three activities be added together. Article 5(2)(a) of the treaty\textsuperscript{192} permits a taxpayer in this situation to elect full aggregation as provided under the Code. Neither the Code nor the treaty permitted election of I.R.C. section 882 aggregation without the inclusion of the income of activity “b.” Therefore, the Ruling rejected the taxpayer’s proposal. The taxpayer had to choose between fully disaggregated treatment, as provided by the treaty, and full aggregation, as provided by the Code.

\textit{Revenue Ruling 84-17} is reconcilable with the notion that the regular laws of the source country will usually control treaty interpretation in situations in which the treaty is indeterminate. Thus, the Ruling rejected the taxpayer’s claim, which was inconsistent with the laws of the source country. The taxpayer wanted partial treaty treatment and partial non-treaty domestic law treatment without any basis in the treaty or the domestic law for this mixing of results. This Ruling shows that there are limits to the extent to which domestic law may be read into a treaty. Here, the taxpayer was prohibited from selecting, on the basis of which result favors him, partial treatment under domestic law and residual treatment under the treaty.

Although a conclusion that ambiguous treaty language is normally resolved in favor of the application of the source country’s income tax laws is hardly startling,\textsuperscript{193} it is interesting that this princi-

\textsuperscript{190} See id.
\textsuperscript{192} See 1974 United States-Poland Convention, supra note 185, at art. 5(2)(a).
\textsuperscript{193} An occasional exception occurs in administrative proceedings in which the revenue authorities interpret treaties contrary to the domestic law of the source country in situations in which an interpretation that is consistent with domestic law would reduce revenue. Thus, in Priv. Ltr. Rul. 8239019, supra note 2, the Service refused to read into the indirect credit of Article 23(1) of the 1975 United States-United Kingdom Convention, supra note 2, the sixty-day throwback rule of I.R.C. § 902(c)(1) (1982). In addition, in Brown & Williamson Ltd. v. United States, 688 F.2d 747 (Ct. Cl. 1982), discussed supra notes 151-61 and accompanying text, the revenue authorities of the United States resisted an interpretation that would require interest on refunds even though such an interpretation was consistent with U.S. domestic law.
ple is not usually articulated. Instead, judicial and administrative opinions speak in terms of reciprocity, equality, contractual versus statutory interpretation, and liberal\textsuperscript{194} versus narrow construction. As is true of any principle of interpretation, however, source rule dominance is not applied in every situation.

The decision of the Trial Division of the Federal Court of Canada in \textit{Bank of Nova Scotia v. The Queen}\textsuperscript{195} demonstrates this. The Bank of Nova Scotia owed income tax to the United Kingdom for the year ending October 31, 1972. The tax was not paid until it became due on January 1, 1974. The Bank was an accrual method taxpayer. Under United Kingdom law, it was required to set aside prior to the tax payment due date an amount equal to the taxes owed. The Bank set the money aside in pounds sterling. At the time the money was set aside in October, 1972, it was worth Canadian $452,794. However, because of a change in the exchange rate, the same amount of pounds sterling was worth only Canadian $412,514 on the date on which payment was actually made. Not surprisingly, the Bank wished to claim the higher amount as a foreign tax credit paid under Canadian law and the 1966 Canada-United Kingdom Agreement.\textsuperscript{196}

The Income Tax Act of Canada stated that a foreign tax credit is determined by reference to the tax "paid" by a taxpayer to a foreign country.\textsuperscript{197} This provision seems to indicate the date of payment, in this case the lower amount, as the proper date for selecting an

\textsuperscript{194} Although "liberal construction" is a recurring "standard" for treaty interpretation, it is rarely made clear who or what is to be the object of a "liberal" interpretation. In Saunders v. Minister of Nat'l Revenue, 11 Can. Tax App. Bd. 399 (Can. T.A.B. 1954), an often-cited case, the Canadian Tax Appeal Board provided one answer:

The accepted principle appears to be that a taxing Act must be construed against either the Crown or the person sought to be charged, with perfect strictness—so far as the intention of Parliament is discoverable. Where a tax convention is involved, however, the situation is different and a liberal interpretation is usual, in the interests of the comity of nations. Tax conventions are negotiated primarily to remedy a subject's tax position by the avoidance of double taxation rather than to make it more burdensome.

\textit{Id.} at 402. The Board concluded that the "retired pay" of a retired U.S. Naval Officer living in Canada was not a pension, but was akin to regular pay and, therefore, was taxable only in the United States. The Board's formulation of the purpose of a tax treaty is similar to that employed by the Tax Court in \textit{Burghardt}. \textit{See supra} notes 111-12 and accompanying text.


exchange rate. On the other hand, Article 21 of the Agreement guarantees a Canadian credit for any United Kingdom tax “payable.” Article 21 suggests that the credit should be computed using the date on which the obligation to pay the tax accrued, which would lead to the larger credit.

The Trial Division judge postulated that the “purpose of foreign tax agreements generally is to avoid double taxation.” He could find no risk of double taxation upon either theory of when the credit should be calculated. On the other hand, because the taxpayer was using the accrual method, in part as a result of requirements of Canadian banking law, it seemed appropriate to permit it to value its credit in Canadian dollars as of the time of the accrual of the obligation.

Ultimately, these two conclusions led the court to find for the taxpayer without appearing to rest its decision on the treaty’s use of the word “payable” or the Canadian Income Tax Act’s use of the word “paid.” Moreover, the court’s conclusion appears to be contrary to the use of the word “paid” in the Income Tax Act. Thus, it would seem to be an unusual case in which ambiguity in a treaty was resolved in a manner that was contrary to the source country rule.

In sum, the cases indicate that Canadian, British, and U.S. judges find in treaty ambiguity a basis for applying the rules that are applicable to nontreaty nationals. In most cases, these are also the rules applicable to domestic taxpayers, because business income is taxed in the hands of nonresident aliens and foreign corporations as though it were domestic income of a domestic taxpayer. The conclusion of this Article explains that this theory, which is obvious in the case of treaty ambiguity, can also explain the results in cases of arguable inconsistency with a treaty.

VII
SUMMARY AND CONCLUSION

The reader of this article has traversed difficult terrain. The cases are complex, and the language of the statutes and treaties is frequently vague, occasionally subtle, and usually not easy to interpret. The temptation is to say that the cases show only the hopeless indeterminacy of language and the willingness of taxpayers and revenue-maximizing bureaucrats to contest murky questions.

At least one proposition is clear. The legislature is supreme; it may nullify treaties at any time. The United States took such a step with FIRPTA and again with stapled entities. However, occasional

199. See supra note 178.
exercises of supremacy do not establish a norm of desirable behavior. Because treaties are primarily agreements, it is hard to imagine why they should be abrogable without renegotiation or compliance with their termination provisions, which usually include notice and one year's wait.\textsuperscript{200}

The cases discussed above were separated into those that arose after a change in the underlying revenue law and those that involved attempts to apply the underlying revenue law to ambiguous treaty language. The former cases address the question of whether a treaty provision has been knowingly curtailed. In \textit{Melford}, the Supreme Court of Canada found no evidence of an intention to curtail the "special" treatment of interest in the 1956 Canada-West Germany Convention.\textsuperscript{201} This lack of intention, coupled with the language of the enabling statute, led the Court to freeze the meaning of the word "interest" in the treaty at its 1956 meaning. By contrast, in \textit{Burghardt}, the Tax Court of the United States read the words "specific exemption" in the 1955 United States-Italy Estate Tax Convention\textsuperscript{202} to mean "unified credit." This interpretation of the treaty reflected the change in domestic tax law that substituted the unified credit for the earlier specific exemption.

The reasoning of both decisions seems wrong. \textit{Burghardt} relies on the notion that treaties are designed to help taxpayers and should be interpreted remedially and for their benefit. However, treaties are developed by countries primarily to sort out the interfacing aspects of their tax systems and to cede jurisdiction from the source nation to the taxpayer's residence nation when the taxpayer's contacts with the source nation are minimal. When the law has changed, it seems far-fetched to twist language to save taxpayer benefits that are based on inference from treaty language. On the other hand, the result in \textit{Burghardt} may be justifiable because the 1955 United States-Italy Estate Tax Convention\textsuperscript{203} intended to confer an estate tax exemption that was accorded to U.S. citizens and residents but was not available to

\textsuperscript{200} Governments are sometimes careful to ensure that a change in domestic law does not overrule treaty provisions. For example, in 1975, Canada instituted a tax on the branch operations of foreign enterprises. Act of Mar. 13, 1975, ch. 26, § 123, 1974-1976 Can. Stat. 389, 660. The purpose of the tax is to tax the unincorporated branch of a foreign enterprise in the same fashion as a separately incorporated Canadian subsidiary that annually repatriates its net income to its foreign owner. See 3A CAN. TAX. REP. (CCH) ¶ 26,901 (1981). The Department of National Revenue, Taxation, issued Interpretation Bulletin No. IT-277 (Jan. 5, 1976), reprinted in 5 CAN. TAX. REP. (CCH) ¶ 52,281 (1976), which admitted that the change potentially violated the income tax treaty signed with France. The Bulletin stated that in the event of a conflict between the new law and any treaty, the treaty would prevail.

\textsuperscript{201} 1956 Canada-West Germany Convention, supra note 116.

\textsuperscript{202} 1955 United States-Italy Estate Tax Convention, supra note 102.

\textsuperscript{203} Id.
nonresident aliens not subject to the treaty. The same is not true of *Melford*. At the time of the conclusion of the 1956 Canada-West Germany Convention,²⁰⁴ there was no intention to confer a particular benefit upon treaty nationals. By the time of the disputed transaction, even Canadian residents could not have guaranty fees exempted from treatment as interest. In sum, where no particular benefit was intended, as in *Melford*, it seems unjustifiable to prevent expansions and contractions of the meaning of a treaty term, as long as the changes are not made discriminatorily. In both cases, the judicial focus should have been on what the signatories were seeking to accomplish and not on whether ambiguous language creates unintended benefits that are to be preserved.

*GCM 35472* is the key to explaining these treaty cases. The Memorandum seems wrong in that it disregards, to the taxpayer’s detriment, treaty language that recognizes the force of attraction rule. The Memorandum also, in puzzling fashion, reads into the treaty an implicit guaranty of a feature of domestic law, namely the nontaxation of foreign source income to a nonresident alien or foreign corporation, even if engaged in a trade or business within the United States. The results of *GCM 35472* show a tendency to read current domestic law into ambiguous treaty language.

*Exxon* and the other cases that try to relate treaty and statutory language outside of the stressful environment of legislative change do not appear to be any more successful at identifying coherent bases for treaty interpretation. *Exxon* rejects a plausible reading of the treaty because it would create a nonreciprocal dividend tax article. *Brown & Williamson* rejects reciprocity as the touchstone for treaty interpretation and, together with *Great-West*, *Maximov*, and *Revenue Ruling 84-21*, shows that ambiguity is normally resolved not in terms of reciprocity or equality but by applying the source jurisdiction rules that are applicable to a domestic taxpayer. *Bank of Nova Scotia* may contradict this approach, but it probably demonstrates that the courts of the residence nation, when it is the forum state, will read into ambiguous treaty language the nontreaty law of the forum.²⁰⁵

The two major bases for interpretation that the courts have suggested, reciprocity and contractualism, are unhelpful. In *Exxon*, the problem was not that the clause in the treaty lacks reciprocity, which is not invariably present, but that it was worded reciprocally and the taxpayer’s interpretation would have rendered it nonreciprocal. The

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²⁰⁴. 1956 Canada-West Germany Convention, *supra* note 116.

²⁰⁵. Thus, a fundamental rule of the taxpayer’s residence nation, such as the requirement that banks report their gains using the accrual method, may overwhelm a contrary rule of the source country, even though the latter rule is arguably covered by a treaty.
parties to tax treaties know how to word provisions nonreciprocally. Thus, the taxpayer's interpretation is suspect.

Another approach to interpretation is to regard treaties as contracts rather than statutes. Some courts seem to think that the contract approach permits them to take greater liberties with treaty language. This approach is also flawed. It seems unlikely that the signatories, who use expert drafting skills in writing domestic revenue legislation, would fail to use these skills in writing treaties. Furthermore, the impact of this interpretative device is not clear. Statutes as well as treaties can be ambiguous, and they may be ambiguous for the same reasons. For example, the signatories might not have contemplated the situation that makes the treaty appear to be ambiguous, or they might have intentionally fuzzed over some specific problem in order to produce an agreement. Both phenomena characterize the legislative process as well. Finally, even if one conceives that there is a categorical distinction between interpreting a treaty as a contract and interpreting it as a statute, the distinction is not particularly useful. If a transaction is squarely within or outside precise words in a treaty, as in Exxon, it is not clear why the courts should have any more license to revise a treaty than they have to revise a statute.

Whether a tax treaty is viewed as a contract or a statute, the primary technique of treaty interpretation should be to apply general language to specific facts in light of the drafters' intentions. Occasionally, there is evidence of specific intention. Usually there is no such evidence, and ascertaining intention entails recourse to the general intentions of countries in concluding treaties. These intentions are to achieve bilateral revenue accommodation with the least possible derogation of the source jurisdiction's regular rules and to exchange limited waivers of source jurisdiction taxation. Occasionally, the


207. One possible justification for treating a treaty as a statute rather than as a contract is that exemptions accorded to nonsignatories, such as taxpayers, might be accorded a higher degree of protection under the former approach as opposed to the latter, under which a third party beneficiary claim has to be constructed. This idea obviously affected the court in Melford. See supra notes 120-26 and accompanying text. However, because courts usually state that a treaty is to be viewed as a contract and not as a statute, this justification does not explain the preference for the contract approach.

208. In the well-known case of Johansson v. United States, 336 F.2d 809 (5th Cir. 1964), Judge Rives carried the source rule preference to an interesting conclusion. He held that Ingemar Johansson was not a resident of Switzerland for purposes of applying the 1951 United States-Switzerland Convention, supra note 74, because under U.S. law he would not have been a Swiss resident. The court disregarded the acceptance of Johansson's Swiss residence by a competent Swiss official because this acceptance was based on Johansson's assertion of Swiss residence. 336 F.2d at 812. The income in question was U.S. source boxing income. The court also held that a recently-formed Swiss corporation, used solely
parties agree to alter a generally applicable domestic rule. But more often, the courts apply, in the absence of explicit contrary treaty language, the non-treaty rule that is applicable within the source jurisdiction to similarly situated taxpayers.

The proposition that in the absence of a contrary showing of the drafters’ intent courts tend to decide ambiguous cases in favor of the rules of the source jurisdiction explains situations that vague notions, such as liberal versus strict construction or contractual versus statutory interpretation, fail to explain. This rule is also less misleading than the theory that treaties should be reciprocal.

The courts’ tendency to apply the rules of the source jurisdiction may indicate that courts favor the rules of the forum jurisdiction and would prefer to disregard tax treaties. There is, however, a more principled reason to resort to the rules of the source jurisdiction. Tax treaties contain limited cessions of taxing jurisdiction and revenue by source countries in favor of the taxpayer’s nation of residence. These treaties are consistent with the notion of source country dominance that is present in foreign tax credit regimes. Insofar as these treaties contain waivers of source jurisdiction taxation, they are still consistent with the general notion of source country hegemony, because the waivers are limited to situations in which contact with the source country is minimal. Thus, because the basic message of tax treaties is to permit source country taxation, treaties should be interpreted in cases of ambiguity to favor the source country rule.

There appears to be only one major exception to the foregoing theory of treaty interpretation. If a treaty knowingly departs from one source country rule, a court may attempt to preserve the particular “benefit” thus granted even in the face of considerable statutory change. This situation arose in Burghardt, in which the 1955 United States-Italy Estate Tax Convention replaced the low estate tax exemption of domestic law for non-treaty aliens in favor of the larger exemption accorded to citizens and residents. However, even Burghardt is reconcilable with the larger theory advanced in this Article because, in preserving the particular benefit secured by the treaty, the Tax Court did nothing more than apply the source rule applicable to citizens and residents. Thus, it would appear that such rules are, and should be, read into ambiguous treaty language even when it disadvantages the treasury of the source nation to do so.

to take advantage of the Convention’s exclusion of U.S. source earned income of a Swiss resident, could be similarly disregarded. Id. at 813.

209. 1955 United States-Italy Estate Tax Convention, supra note 102.