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HEADLINE: 92 TNI 3-9 DIPLOMATIC SILENCE: THE SECRECY SHROUDING TAX TREATY MAKING SHOULD BE LIFTED. (Tax Treaties)

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Tax Analysts has a long and distinguished history of combatting the secretive predispositions of government concerning tax matters. If it has not yet succeeded in uncovering the mysteries of the DIF formula for selecting returns for audit, it has secured for us publication of private letter rulings, general counsel memoranda, technical advice memoranda, actions on decisions, /1/ and unpublished district court tax opinions and orders. /2/

I believe that a similar effort is now warranted to demystify the process by which the United States negotiates and approves tax treaties.

Tax treaties, like tax legislation, are the supreme law of the land, subject only to the requirements of the United States Constitution /3/ and, if we believe certain emanations of Justice Clarence Thomas, natural law. However, treaties do not attain this status by the same route as domestic tax legislation. Tax legislation must be introduced as a bill, considered in public hearings, voted upon by the Committee on Ways and Means of the House of Representatives and the Finance Committee of the Senate, followed by votes by both full houses, followed, if necessary by a House-Senate conference, followed by further votes of both houses and, ultimately, by the President's signature.

This process is relatively open. The bill is published at the outset of the process. The hearings are public and interested parties usually have plenty of opportunity to voice their concerns. It is true that the process of marking up the bill can lead to last-minute changes with virtually no public debate. In the field in which I practice, for example, the enact-

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ment of the passive foreign investment company legislation, /4/ the earnings-stripping rules, /5/ and the restrictions on the availability of the estate and gift tax marital deductions where the surviving spouse is not a U.S. citizen /6/ are prime examples of last-minute, ill-considered changes. (And, indeed, all three pieces of legislation have proved extraordinarily unsuccessful and difficult to implement, requiring extensive technical corrections and/or long-winded regulations.)

Under Wraps

Contrast the tax legislative process with the shroud of secrecy surrounding every step of the U.S. treaty-making process. First, treaty negotiations and negotiations for protocols to amend treaties are initiated either by the United States Treasury Department, through the Office of the International Tax Counsel, or by Treasury's foreign counterpart. Treasury will announce that negotiations are under way and invite interested parties to submit comments. /7/ Apart from the fact that little publicity is given to this invitation, it is hard for its readers to determine whether or not they are interested parties until the nature of the changes to the existing arrangements is known.

Imagine an invitation to "interested partiesng to make submissions on "the Internal Revenue Code." The invitees might be a little unclear as to exactly what about the Internal Revenue Code is of interest to the invitors, but at least they would have a tax code to work with as a starting point. No such joy befalls the respondent to a request for comments on treaty negotiations. The United States published a model treaty in 1977 and updated it in 1981. It further proposed a revised limitation on benefits provision in December 1981, but never formally adopted that proposal. In the meantime, wholesale renegotiation of our older treaties has virtually been mandated by the fundamental shifts in domestic legislation brought about by the Tax Reform Act of 1986, the numerous technical corrections, and the torrent of further changes that followed.

Treasury has publicly admitted that the 1981 model is no longer its first draft. /8/ There is a virtually moribund project within the International Tax Counsel's Office to draft a new model treaty, but the priority for this appears to be buried so low that if you dug a few more feet you would reach China. My first call, therefore, would be for Treasury to publish the internal draft that it uses as its starting point, while we await publication of the new model.

One might argue that this would give away some U.S. negotiating position. I hardly think so. At some point, Treasury always does produce a first draft, which it gives to the other country. This first draft presumably does not vary excessively from country to country. (One certainly hopes not, given the fact that the United States should be striving for uniformity and the same basic policy goals in all of its treaties.) Nevertheless, Treasury justifies its secretive approach to treaty negotiations and the treaty-making process by referring to the need for confidentiality in sensitive, quasi-diplomatic negotiations. It says it does not want to give away its position for fear that this knowledge will enable its negotiating partner to strike a better deal. Treasury also is sensitive to the concerns of the negotiating partner about maintaining confidentiality. I am not entirely unsympathetic to these concerns; but they have been drastically overplayed.

Treasury could at least publish the first draft once it has been sent to the foreign country. This would not need to be kept secret on the grounds of national security since the other country now has the document and, presumably, could publish it if it wished. Certainly, all of us who practice in the field have had the experience of obtaining details of treaty negotiations from countries more forthcoming than the United States on these matters.

When Treasury announces the initiation of negotiations, it also should publish with some specificity the list of issues with which it is concerned. This is particularly true in the case of protocols. What use is it for Treasury to tell us that it is seeking a protocol with, for example, Belgium? What aspects of the Belgian treaty are of concern? Did the U.S. not recently have a protocol with Belgium?

The negotiation process is also held in comparative secrecy. We hear more about the progress of negotiations on treaties to limit strategic weapons than we hear about the progress of tax treaty negotiations. "Talks were held in Timbuctu on October 2nd and 3rd and it is expected that a return visit will be paid to Washington on March 15th and 16th." How informative!

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Eventually, a treaty reaches the point where it can be signed. One might think that at last the public would be able to examine the newly born product of official thinking. Unfortunately, one would be wrong. Months can go by between signature or initialing of the treaty by officials of the respective governments and its actual publication.

Once the treaty is published, it is virtually nonnegotiable. As Co-Chair of the Subcommittee on Tax Treaties of the ABA Tax Section's Committee on U.S. Activities of Foreigners and Tax Treaties, I am charged with organizing comments on individual treaties before they are presented to the Senate Foreign Relations Committee for approval, which is the next step in the process. However, unlike my brethren who comment on tax legislation armed with reports and descriptions from the Joint Committee on Taxation, the Senate Finance Committee, and/or the House Ways and Means Committee, no such materials are available to me or my committee members. Treasury always publishes a technical explanation of a signed treaty but, as a practical matter, it does not like to issue the technical explanation until the staff of the Senate Foreign Relations Committee has had an opportunity to review it in conjunction with the issuance of the staff's own report. Traditionally, the staff issues that report only a day or so before the hearings are scheduled. The staff are busy people and operate on the just-in-time principle.

By the time that meaningful information becomes available, therefore, it is far too late for the public to make any effective comment on the treaty. For one thing, once the treaty is initialed, it is virtually impossible to change it, since this would involve going back to the other country and renegotiating. If treaty negotiations could be held swiftly and perhaps with less formality, this might not be a problem. But, as matters stand and given Treasury's limited resources to deal with dozens of countries, negotiations have to be scheduled months in advance. Unless there is some major aspect of the treaty that causes the Senate Foreign Relations Committee to bridle, /9/ the treaty will either be approved in the form it is negotiated, with the occasional reservation or understanding, /10/ or it will simply die of indifference, as has happened to some of the treaties the U.S. has negotiated over the years.

What's It Going To Cost Us?

Another well-concealed feature of treaty negotiations concerns estimates of revenue impact. Generally, the objective of both parties in the treaty negotiation is for the revenue impact of the treaty to be neutral between the countries. /11/ That is, the United States and the treaty partner should each give up its right to collect taxes in an amount approximately equal to the amount being foregone by the other country. The problem is that although the revenue impact is intended to be neutral overall, the impact of particular provisions may not be.

Treasury intimates that it undertakes revenue estimates of each of the key provisions, particularly those relating to withholding taxes and foreign tax credits. A bland statement occurs at the end of all Senate Foreign Relations Committee Reports stating that the treaty is not expected to have any direct impact on the budget. Routinely, we are assured that the treaties are carefully negotiated to secure the desired balance, but we are given no information about the impact of particular provisions or what the effect of changing those provisions might be. Treasury does not publish revenue estimates concerning our treaties and we therefore cannot tell which provisions are revenue raisers, which are losers, and how the various rules interplay. We also have no way of evaluating or commenting on such estimates. The lack of such information makes it more difficult for commentators to make appropriate suggestions for change.

A good example would be the impact of a change in withholding tax rates. What does the United States give up when it agrees to a reduction in withholding rates, and what does it gain for its taxpayers from the other country? What other concessions did the U.S. either make or receive to achieve balance and, indeed, which provisions are linked to each other? Without revenue estimates, providing public input in these circumstances is not practical.

Suggestions for Change

About a year ago, Peter Barnes, then Treasury's Deputy International Tax Counsel, audaciously complained about the quality of the input Treasury was receiving on tax treaties. We rarely hear from you, he mused in public, and the quality of what we get is not high. /12/

I can understand his complaint. The problem is that it really reflects how commentators are shackled by Treasury's policy of withholding basic information, the tardiness with which Treasury and the Senate Foreign Relations Committee

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staff dispense their meager rations, the relative futility of making comments at all when by the time they can be made the treaty is effectively immutable, and the unavailability of meaningful revenue estimates.

I therefore propose the following:

o Treasury must publish a new draft model U.S. income tax convention, with variations for conventions with "developingng or "new industrializedng countries. Alternatively, it should publish its working draft.

o Prior to the initiation of negotiations, Treasury should announce to the public what issues are of particular concern to it in negotiating or renegotiating the treaty or protocol in question.

o Treasury should provide revenue estimates of both matters as they stand before the treaty is negotiated or renegotiated and as they are anticipated to stand if the treaty is brought into effect. These estimates need to be broken down in a meaningful way.

o Treasury should publish its technical explanation of any proposed treaty well in advance of any hearings before the Senate Foreign Relations Committee and the Senate Foreign Relations Committee staff should similarly publish its report in good time. The hearings should not take place until at least six weeks after the reports have been made public.

Across my desk every day flow dozens of memoranda and correspondence from third parties marked "confidentialng or "to be opened by addressee only." The number of these items truly deserving of confidential treatment is a small fraction of those for which such treatment is claimed. Similarly, the U.S. government's obsession with secrecy is barely justified in most of the cases for which claims are made that national security is involved. In the case of tax treaty negotiations, it is hardly justified at all.

I have not, I admit, spent a great deal of effort trying to establish whether information of this sort could be prized out of the government through the Freedom of Information Act. Frankly, I don't think that it should have to be. Treasury should amend its ways voluntarily. It has every opportunity to do so. All of the recent incumbents in the position of International Tax Counsel have been distinguished members of the private bar before they came into government. Surely these people have experienced and will continue to experience the same frustrations that I have with the process. As insiders, they should do something about it when they have the chance.

Members of our subcommittee currently are working on an issues paper relating to the tax treaty-making process. We hope that our paper will stimulate some government rethinking about the level of public involvement in the process. If any reader would like to contribute to the paper, please get in touch.

/1/ United States Department of Justice v. Tax Analysts, 109 S. Ct. 2841, 1989-1 USTC 9386 (1989)

/2/ Tax Analysts and Advocates v. Internal Revenue Service, 505 F.2d, 350 (D.C. Cir. 1974); Taxation with Representation Fund v. Internal Revenue Service, 646 F.2d 666 (D.C. Cir. 1981); see also section 6110.

/3/ U.S. Constitution, Article VI, section 2.

/4/ Sections 1291 et seq.

/5/ Section 163(j).

/6/ Sections 2056(d) and 2523(i).

/7/ See, e.g., Treasury Department News Release NB-1016 (Nov. 11, 1990), reprinted in 3 CCH Tax Treaties 25,560 (negotiations with Brazil).

/8/ Treasury officials like to point to the new treaties with Germany and India as examples reflecting current U.S. treaty objectives. However, those treaties were heavily negotiated and each contains quite a few provisions that are specific to the countries in question. See, e.g., United States-Germany Income Tax Treaty of 1991, arts. 10(3) (certain dividends)

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and 23(2) (relief from double taxation of German residents); United States-India Income Tax Treaty of 1990, art. 12 (special treatment of technical services).

/9/ E.g., Senator Metzenbaum's concerns about the limitation on benefits article in the treaty with the People's Republic of China; or the treaty with Denmark signed in 1980, which was to replace the 1948 treaty but which stalled over oil taxation.

/10/ E.g., United States-United Kingdom Income Tax Treaty of 1980, art. 9(4) (unitary tax treaty eventually ratified with Senate reservation).

/11/ Externally revenue-neutral treaties usually are also revenue- neutral internally, since tax foregone by the other country generally decreases U.S. foreign tax credits, thereby offsetting taxes foregone by the United States. But see Morrison, "Talking Past Each Other on Tax Treaty Policy and Subpart F," 69 Taxes 1001 (1991).

/12/ Remarks at American Tax Institute in Europe conference, November 15, 1990, reported in BNA Daily Tax Report 222 at G-3.

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