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United States-Brazil Bilateral Income Tax Treaty Negotiations

By RICHARD MITCHELL*

I. Introduction

Today there is no bilateral income tax treaty (tax treaty) between the United States and Brazil. Despite promotion by politically powerful forces, nearly fifty years of intermittent negotiations have failed to produce an agreement acceptable to both nations.[1]

Negotiations have recently been renewed,[2] and the situation appears more hopeful now than ever before. The modernization of Brazil's tax code and the U.S. Treasury Department's eagerness to conclude tax treaties in emerging market nations bode well for a tax treaty in the near future.[3]

However, two difficult issues remain unresolved. Brazil still wants the United States to offer tax sparing, the traditional sticking point in U.S.-

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1. Among U.S. multinationals who want to see a U.S.-Brazil tax treaty in the near future are: Cargill, Coca Cola, CPC International, Goodyear, Quaker Oats, 3M, Whirlpool, Campion International, Colgate, Palmolive, Dow Chemical, IBM, Texaco, Westvaco, and Xerox. Letter from Joseph L. Andrus et al., Baker & McKenzie, to Phillip D. Morrison, International Tax Counsel, United States Treasury (Oct. 22, 1991), *available in* LEXIS, TAXRIA library, TNI file, 91 TNI 47-30 (1991). Senate Foreign Relations Committee Chairman Jesse Helms would also like to see such a treaty. Letter from Jesse Helms, Chairman, Senate Foreign Relations Committee, to The Honorable Robert E. Rubin, Secretary, United States Treasury (Sept. 18, 1995), *available in* LEXIS, TAXRIA library, TNI file, 95 TNI 198-9 (1995). So would the U.S. Chamber of Commerce. Letter from Benson Goldstein, U.S. Chamber of Commerce, to Phillip D. Morrison, International Tax Counsel, United States Treasury (Mar. 4, 1992), *available in* LEXIS, TAXRIA library, TNI file, 92 TNI 17-50 (1992).

2. Claudia McLachlan, *Trade Spike Spurs Tax Treaty Talks*, NAT' L. REV., Sept. 2, 1996, at A1, A17 (reporting that Treasury department international tax counsel says there have been negotiations with Brazil, but "problems persist").

3. For discussion of changes to Brazil's tax code *see* discussion *infra* Part III.A.1.

Brazil tax treaty negotiations.[4] In addition, the taxation of fees for technical services has recently emerged as a source of disagreement between the two countries.[5]

This Note will (1) argue that a U.S.-Brazil tax treaty is a desirable component of the U.S. tax treaty program; (2) examine the issues that have thwarted efforts toward that end; and (3) consider four approaches to overcoming the current impasse.

Arguments can be made that the U.S. tax treaty program should be dropped entirely in favor of a new program that can more efficiently pursue the same policies. In many ways, tax treaties are like dinosaurs in the modern world of international trade. They are bilateral in a world of multilateral trade agreements, and they take just short of forever to conclude. For example, the new U.S.-Thailand tax treaty is the product of fifteen years of negotiations.[6] Once the treaty is concluded, any change in tax policy by a treaty partner may require reopening negotiations separately with every treaty country for revisions. The United States has been in this position for a long time now as it has reopened treaty negotiations to add limitation of benefits provisions to existing treaties.[7]

While this criticism of the tax treaty program is valid, this Note proceeds from the premise that the U.S. tax treaty program will continue to expand. This Note will demonstrate that dropping the tax treaty program would put U.S. businesses at a disadvantage in the global marketplace.

II. A Primer of International Taxation

Much of what is commonly referred to as international taxation is a misnomer. In general, international taxation refers to a country's domestic laws on the taxation of transactions with other nationals or nations. Tax treaties are the only true international aspect of international taxation. However, there is enough similarity among international taxation systems of modern market-economy states to allow a general discussion of these

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4. McLachlan, *supra* note 2, at A17 ("U.S. multinationals 'would love' to see a treaty with Brazil, but the United States is not about to relent on its opposition to Brazil's negotiation demand for 'tax sparing.'").

5. Letter from Joseph L. Andrus, to Phillip D. Morrison, *supra* note 1 (offering advice to getting over the "stumbling block" of fees for technical services).

6. Arthur J. Dichter, *U.S.-Thailand Treaty Explained*, 14 TAX NOTES INT'L 7, 7 (1997).

7. *See, e.g.*, Juliann Avakian Martin, *U.S. Tax Treaty Update*, Sept. 4, 1997, *available in* LEXIS, TAXRIA library, TNI file, 97 TNI 171-42 (1997).

laws. The following analysis of international taxation focuses on U.S. law as an unexceptional example, with discussion of how other states' laws may differ. This section touches only those aspects of international taxation which are fundamental to the rest of this Note.

A. *Jurisdiction*

1. *Source*

The modern U.S. tax code divides all types of income and deductions into two categories: foreign source and domestic source.[8] All taxpayers regardless of citizenship or residence are liable for domestic taxation on their domestic source income.[9] Domestic source income taxation of non-resident aliens is often enforced by requiring the domestic payor to withhold a fixed percentage of gross payments abroad.[10] Generally, the foreign taxpayer may not deduct expenses against domestic withholding taxes.[11]

Income source rules reflect an *in rem* theory of jurisdiction, known as territorial jurisdiction.[12] This jurisdiction rests on the theory that the transaction creates sufficient connection with a state to bring the transaction into the state's jurisdiction regardless of whether the taxpayer is personally subject to jurisdiction within that state.[13]

No state actually exercises all of its source based jurisdiction.[14] Respect for sovereign immunity inspires some restraint; however, practical economic and enforcement concerns are the primary source of jurisdic-

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8. *See id.* §§ 861, 865.

9. *See id.* §§ 1, 11, 62 (taxation of worldwide income generally), 871, 881, 882 (non-resident alien individuals and foreign corporations taxed only on U.S. source income).

10. *See id.* § 1441.

11. *See id.* § 871(a) (imposing a flat 30% tax on certain gross amounts received from U.S. resident taxpayers).

12. J. BISCHEL & R. FEINSCHEIBER, FUNDAMENTALS OF INTERNATIONAL TAXATION 4 (2d ed. 1985).

13. *Id.*

14. *See* I.R.C. §§ 892, 895 (1997) (exempting foreign governments, foreign central banks, and certain international organizations from income taxes on certain investments and deposits in the U.S. These exclusions are based on notions of sovereign immunity and treaty-based immunities of certain international organizations. *See* I.R.C. § 893 (1997) (exemption from tax of alien employees of foreign governments); CHARLES H. GUSTAFSON & RICHARD CRAWFORD PUGH, TAXATION OF INTERNATIONAL TRANSACTIONS ¶ 2133 (4th ed. 1995).

tional limitations.[15] The United States, for example foregoes much source based jurisdiction to tax capital gain and interest income.[16] U.S. attempts to tax these transactions could easily be circumvented by conducting such transactions overseas, thus resulting in a net loss to the U.S. economy [17]

Domestic source rules also define what constitutes foreign income for foreign tax credit purposes.[18] In this situation, foreign taxes paid on income characterized as foreign source under domestic tax laws may be credited against the taxpayer's domestic tax liability [19] Thus, when a state defines a type of income as foreign source, the state often foregoes taxation of the transaction either partially or entirely, even if one of the parties is a domestic citizen or resident.[20]

2. *Citizenship and Residence*

Taxpayers are generally classified as citizens, residents, or non-resident aliens.[21] Citizens and residents may be taxed on their worldwide income regardless of source.[22] Taxation jurisdiction of citizens and residents is similar to *in personam* jurisdiction.[23] Jurisdiction results from a taxpayer's connection to a state irrespective of income source determinations.[24]

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15. *Id.*

16. I.R.C. §§ 871(g)-(i), 881(c)-(d) (1997) (exempting non-resident alien individuals and foreign corporations from tax on certain U.S. source interest). Real estate capital gains of non-resident aliens and foreign corporations are taxed under I.R.C. § 897.

17. Taxing these transactions would either substantially end them (as is the case with interest on deposits in foreign branches of U.S. banks), or be impossible to enforce (such as the sale of stock of U.S. corporations in public markets).

18. *See* I.R.C. §§ 901(a), 904(a) (1997) (limiting foreign tax credit to proportion of U.S. tax attributable to foreign source income).

19. *Id.*

20. *Id.*

21. No one section of the Internal Revenue Code does this, but I.R.C. §§ 871, 881, & 882 establish special tax rules for non-resident aliens and foreign corporations.

22. I.R.C. §§ 1, 11 (1997). The Code is structured so that these sections purport to tax everyone on worldwide income, but non-resident aliens and foreign corporations are exempted from taxation on most foreign source income elsewhere in the Code. *See id.* §§ 871, 881, 882.

23. BISCHEL & FEINSCHREIBER, *supra* note 12, at 6.

24. *Id.*

Unlike the United States, most countries do not use citizenship as the sole basis for jurisdiction.[25] In this Note, "resident" will refer to U.S. citizens as well as residents.

Residency for taxation purposes need not reflect residency for other legal purposes. U.S. tax law, for example, defines residency more broadly than U.S. immigration law.[26] U.S. tax codes also define residency for entities that are not encompassed within noncommercial law, such as corporations and partnerships.[27]

B. Double Taxation

International double taxation arises when two or more states exercise taxation jurisdiction over the same income. Much like tariffs, double taxation makes certain international transactions artificially more expensive than similar domestic transactions.[28] According to free market economic theorists, this inhibits international division of labor and slows international economic growth.[29] Thus, double taxation undermines the policies of trade treaties such as General Agreement on Tariffs and Trade (GATT), North American Free Trade Agreement (NAFTA), and the Common Market of the Southern Cone (MERCOSUR).[30] The avoidance of double taxation is the primary argument in favor of a U.S.-Brazil tax treaty, because double taxation is most effectively and equitably relieved by tax treaties.

Between the United States and Brazil, double taxation currently affects many common activities, although each country has laws designed to relieve residents of some double taxation burdens.[31] These activities in-

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25. *Id.* at 5; IRC §§ 1, 11 (1997). Non-resident citizens are not exempted from worldwide taxation. *See* Cook v. Tait, 265 U.S. 47, 54 (1924) (holding that U.S. citizenship in and of itself gives the U.S. jurisdiction to tax an individual).

26. I.R.C. § 7701(b) (1997).

27. *Id.* § 7701(a)(4)-(5).

28. *Id.*

29. PAUL A. SAMUELSON & WILLIAM D. NORDHAUS, ECONOMICS 836 (12th ed. 1985).

30. AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT, INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION II, 17 (1991) (referring to economic benefits of relief from double taxation provided in tax treaties); General Agreement on Tariffs and Trade, Oct. 30, 1947, 55 UNTS 194 (1950); North American Free Trade Agreement, Dec. 17, 1992, 32 ILM 289 (1992); Treaty of Asuncion Creating a Common Market among Argentina, Brazil, Paraguay, and Uruguay, Mar. 26 1991, 30 ILM 1941 (1991).

31. *See* discussion *infra* Part II.B.2.

clude, but are not limited to, overseas employment, overseas business through branches and subsidiaries, and overseas lending.[32]

1. *How Double Taxation Arises*

Double taxation can arise in three situations: (1) when more than one state exercises residence jurisdiction to tax the same income; (2) when one state exercises residence jurisdiction and another exercises source jurisdiction to tax the same income; and (3) when more than one state exercises source jurisdiction to tax the same income.[33]

a. *Residence/Residence Double Taxation*

Double taxation can arise when a taxpayer is deemed a resident of more than one state. This occurs when one taxpayer qualifies as a resident in two different states, or when a taxpayer is liable for taxation as a citizen in one state and a resident in another.

Residence/residence double taxation commonly affects individuals who work overseas.[34] U.S. citizens working overseas are most likely to face this kind of double taxation because the United States taxes the worldwide income of citizens regardless of residence.[35] Persons domiciled in the United Kingdom and working overseas are another group susceptible to this kind of double taxation because domicile in the United Kingdom makes a person a resident under domestic law.[36]

Corporations are also subject to residence double taxation. A state's tax laws may define a resident corporation as: (1) a domestically incorporated corporation; (2) a corporation whose place of central management is located domestically or; (3) more rarely, a corporation whose greatest eco-

32. Both the U.S. and Brazil impose source based taxation on these activities. *See* I.R.C. §§ 871(a)(1)(a) (interest), 872(a), 862(a)(3) (compensation for personal services), 7701(a)(4) (domestic subsidiaries of foreign corporations taxed as domestic corporations), 881(b)(1) (U.S. income tax on U.S. trade or business of foreign corporation), 884 (branch profits tax) (1997); Tax Management Portfolios, Brazil, 954 T. M. VII, IX, XI [hereinafter "Brazil"]; *see* discussion *infra* Part II.B.1.

33. AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT, INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION II 6 (1992).

34. *Id.* at 6-7.

35. *Id.*

36. Tax Management Portfolios, Business Operations in the United Kingdom, 68 T.M. VII.

nomic activity is conducted locally.[37] Because U.S. law defines corporate residence according to state of incorporation, U.S. corporations are often faced with double taxation stemming from operations in countries, such as Brazil, that define corporate residency as according to place of central management.[38]

In addition to increasing the costs of international transactions, corporate residence double taxation also limits the freedom of multinational companies to structure their international operations. Some multinationals find it economically impossible to establish foreign subsidiaries for the purpose of conducting overseas business, because corporations are sometimes considered residents in the country of legal organization and at other times in the country of central management location.

b. Residence/Source Double Taxation

Residence/source taxation occurs when a state exercises its residence jurisdiction over income and another country exercises its source jurisdiction over the same income. It is considered the most common kind of double taxation.[39] It affects many international capital investments, and sometimes the international trade of goods and services.[40]

Between the United States and Brazil, residence/source double taxation would affect these common transactions: (1) most dividend payments; (2) interest on sales; (3) remittances of income by branches; (4) interest paid to overseas banks; and (5) royalties.[41] This list is neither exhaustive nor unusual.

c. Source/Source Double Taxation

Source/source double taxation arises when the same income qualifies as domestic source income in two different states. Between the United States and Brazil, transactions involving intellectual property and know-how are often subject to source double taxation due to their respective laws

37. JOSEPH ISENBERG, INTERNATIONAL DOUBLE TAXATION: U.S. TAXATION OF FOREIGN PERSONS AND FOREIGN INCOME ¶ 4.1, at 3 (1996).

38. I.R.C. § 7701(a)(4) (1997); Brazil, *supra* note 32, at VIII.

39. J.D.R. ADAMS & J. WHALEY, THE INTERNATIONAL TAXATION OF MULTINATIONAL ENTERPRISES IN DEVELOPED COUNTRIES 42 (1977).

40. *See* I.R.C. §§ 861(a)(3) & (6), 865(b) (1997). These sections source certain income from the sales of personal property and services domestically.

41. *Id.* §§ 861, 884; Brazil, *supra* note 32, at VIII, IX, XI.

defining domestic source fees and royalties.[42] In many of these cases, elimination of the source/source basis for double taxation would not relieve the taxpayer of any tax burden since the income is also subject to residence/source double taxation.[43] However, residence/source double taxation is preferable to source double taxation because neither U.S. nor Brazilian foreign tax credit laws alleviate source/source double taxation.[44]

2. *The Foreign Tax Credit*

Because double taxation undermines free market economic theories, modern tax codes have provisions to relieve residents from double taxation.[45] The three most common ways this is done are: (1) a tax credit for foreign taxes paid by a domestic taxpayer (foreign tax credit); (2) an exclusion of foreign source income from a resident's domestic tax base; and/or (3) a deduction for foreign taxes paid by a domestic taxpayer.[46] Because the United States and Brazil rely primarily on the foreign tax credit to unilaterally alleviate double taxation, exclusions and deductions are not discussed in this Note.

The primary tool employed by most countries, including the United States and Brazil, is the foreign tax credit.[47] Foreign tax credit laws allow a domestic taxpayer to credit foreign taxes paid on foreign source income against the taxpayer's domestic tax on the same income.[48] Thus, the foreign tax credit alleviates double taxation by deferring to the taxing jurisdiction of the income source state.

The foreign tax credit works by allowing resident taxpayers to credit their foreign taxes paid against their domestic tax liability. The credit is generally capped at the taxpayers' domestic tax liability before accounting for the foreign tax credit. The practical result of this is that taxpayers will pay taxes on foreign source income at the higher of either the foreign or

42. I.R.C. § 861(a)(3),(4) (1997); Brazil, *supra* note 32, at VIII, IX, XI. Royalties and fees for services may be subject to source based taxation in both countries.

43. *Id.*

44. Foreign tax credit laws limit credits for foreign taxes paid to the pro rata share of domestic tax paid on foreign source income. IRC § 904(a) (1997).

45. ISENBERG, *supra* note 37, ¶ 1.2.

46. I.R.C. § 164(a) (1997); BISCHEL & FEINSCHREIBER, *supra* note 12, at 8.

47. *See* I.R.C. §§ 901-908 (1997); ISENBERG, *supra* note 41, at ¶ 5.2.1; INT'L TAX SUMMARIES B-56 (George J. Yost, ed., 1996).

48. *See* I.R.C. §§ 901-908 (1997).

the domestic rate. Note that this alleviates double taxation at the expense of the domestic treasury

While the foreign tax credit goes a long way toward alleviating double taxation, it suffers from several imperfections. First, it does not eliminate source double taxation.[49] Because a country defines "foreign source" and "domestic source" income according to its domestic law, two countries may both tax income as domestic source. The foreign tax credit is only available for foreign taxes on foreign source income, thus neither country will allow a credit.[50]

Second, source country taxation generally taxes gross investment income, and allows only a limited set of deductions against trade or business income.[51] Therefore, taxpayers with net losses may still pay significant taxes in the country of income source that cannot be credited against any U.S. taxes.

The third problem, unique to U.S. taxpayers, is the basketing system. Under the basketing system, U.S. resident taxpayers claiming a foreign tax credit must allocate their foreign source income to one or more statutory categories, or "baskets," of income. Each basket is defined by the type of income appropriate to that basket. For example, a U.S. resident's foreign source interest income must be allocated to the "high withholding tax interest" basket if it is subject to foreign withholding taxes at rates of five percent of gross or higher.[52] Income which does not fall within any of the eight defined baskets falls into a residual, or "general limitation" basket.[53]

U.S. resident taxpayers must calculate their foreign tax credit separately for each basket. Assume a scenario where a U.S. resident received one hundred dollars of income allocable to her high withholding tax interest basket and one hundred dollars of income allocable to her general limitation basket. The interest income is subject to twenty dollars of foreign withholding tax and the general limitation income is subject to ten dollars of foreign withholding tax.

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49. *See* IRC §§ 901(a), 904(a) (limiting foreign tax credit to proportion of U.S. tax attributable to U.S. defined foreign source income.

50. *Id.*

51. I.R.C. §§ 871(a), 881(a) (1997) (tax on 30% of gross on most investment income); Brazil, *supra* note 32, at VIII.B (15% withholding of gross amounts of remittances abroad from Brazil).

52. *See* I.R.C. § 904(d)(2)(B) (1997).

53. *See id.* § 904(d)(1)(I).

In order to claim a foreign tax credit, the taxpayer must first determine her U.S. pre-credit tax liability on the income in each basket. Assume for this example that her U.S. tax liability on the two types of income is ten and twenty dollars respectively

The tax payer may then credit her foreign taxes paid in each basket to the extent of her U.S. tax liability for that same basket income. Thus, in this example, the taxpayer will be able to credit her first ten dollars of foreign tax liability on her high withholding tax interest income, and the full ten dollars of her foreign tax liability on her general limitation income.

Note that in this example, ten dollars of the taxpayer's foreign taxes cannot be credited against her U.S. taxes. As a result, part of her income will be subject to double taxation. Thus, her effective tax rate is twenty percent—one third greater than her effective tax rate in both the country of income source, and the country of the taxpayer's residence. In the United States, this extra burden is partially offset by allowing excess tax credits to be carried over into subsequent years in which the taxpayer does not hit the foreign tax credit ceiling.[54]

Congress designed the basketing system to stop domestic taxpayer abuse of the foreign tax credit by generating foreign source income subject to little or no foreign tax in order to raise their foreign tax credit limit.[55] Taxpayers could fully credit foreign taxes on income subject to foreign effective tax rates higher than their domestic effective tax rate. According to Congress, abuse existed because the foreign tax credit is designed to limit domestic taxpayers tax liability to the higher of either their domestic or foreign tax liability, not the lower of the two.[56]

However, as the above example demonstrates, basketing results in excess tax credits in some baskets with little or no tax credits in other baskets, even though all of the taxpayer's transactions may have had a legitimate business purpose and may have been conducted all in one country. Because foreign tax credit carryovers expire after five years, many taxpayers never utilize all of their excess tax credits and are therefore subject to double taxation on their income regardless of the foreign tax credit.[57]

In addition to allowing double taxation to sometimes go unremedied, the basketing system also increases the difficulty and expense of tax com-

54. *Id.* § 904(c).

55. GUSTAFSON & PUGH, *supra* note 14, ¶ 8067.

56. S. REP. NO. 99-313, at 295-298 (1986).

57. *See* I.R.C. § 904(c) (1997). This section also provides for a two year carryback.

pliance. There are nine baskets of income[58] and transactions of unrelated parties may determine which basket certain sources of income will fall in at the end of the taxable year.[59] Because of these and other complexities, compliance with the foreign tax credit law can be extremely expensive.

C. *Tax Treaties*

The primary purpose of tax treaties is to eliminate double taxation more effectively than unilateral legislation such as foreign tax credit laws.[60] Tax treaties generally accomplish this by shifting taxing jurisdiction away from the country of income source.[61] As a result, tax treaties shift the cost of alleviating double taxation from the country of taxpayer residence to the country of income source.

From a taxpayer's perspective, there are many reasons to prefer residence taxation to source taxation.[62] In general, tax treaties alleviate double taxation more completely than foreign tax credits. If not for source taxation, taxpayers would not be concerned about complicated foreign tax credit laws. Under residence taxation, a taxpayer also benefits from the ability to net foreign income against domestic expenses and losses.

Tax treaties eliminate double taxation primarily by (1) assigning each taxpayer a single country of residency; (2) establishing minimum thresholds on the source country's taxation of trade or business income; and (3) lowering source country withholding rates on interest and income from

58. *See id.* § 904(d)(1).

59. *See id.* § 904(d)(1)(E). Non-controlled section 902 corporations are foreign corporations in which the U.S. shareholder holds 10% or more of the voting stock and in which all U.S. shareholders owning 10% or more of the stock do not own more than 50% of the combined voting power or value of all the outstanding shares. *See id.* §§ 902(a), 904(d)(2), 957(a).

60. ISENBERG, *supra* note 37, ¶ 55.2, at 3.

61. United Nations Model Double Taxation Convention Between Developing and Developed Countries, Introduction, *available in* LEXIS, TAXRIA library, TNI file, 85 TNI 41-66 [hereinafter "U.N. Model"].

62. *See Tax Conventions with the Russian Federation; Treaty doc. 102-39; the Mexican States; Treaty doc. 103-7; the Czech Republic; Treaty doc. 103-17; the Slovak Republic; Treaty doc. 103-18; the Netherlands; Treaty doc. 103-6; Protocols amending tax conventions with Israel, Treaty doc. 103-16, the Netherlands, Treaty doc. 103-19, and Barbados, Treaty doc. 102-41. Hearing before the Committee on Foreign Relations, United States Senate*, 103d Cong., 1st Sess. 16, 17 (1993) (Statement of Leslie B. Samuels, Assistant Secretary for Tax Policy, United States Treasury) [hereinafter "Samuels"].

property.[63] Tax treaties also have articles which do not pertain to double taxation, such as limitation of benefits provisions, and exchange of information provisions.[64] However, detailed discussion of these provisions is beyond the scope of this Note.

1. Residency

Tax treaties all have independent rules for determining residency.[65] These rules supersede domestic statutory definitions and are designed to assign all taxpayers residency in one country, or the other, or neither.[66] Residency rules eliminate the possibility of residence double taxation.[67] If application of the rules fails to determine a single state of residence for a taxpayer, treaties provide for either negotiation (through "competent authorities") or arbitration to determine the appropriate state of residence.[68]

2. Permanent Establishment

Taxpayers are often subject to source taxation for conducting a foreign trade or business.[69] Although no statutory definition of trade or busi-

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63. *See* United States Model Income Tax Convention of Sept. 20, 1996, XL INTERNATIONAL TAX TREATIES OF ALL NATIONS 481 (Diamond and Diamond eds., 1996), arts. 4, 5, 10-20 [hereinafter "1996 Model"].

64. *See id.* art. 22. Limitation of benefits provisions are a particular pet peeve of the U.S. *See id.* art. 26; U.N. Model, *supra* note 61, art. 26; Model Double Taxation Convention on Income and Capital, *adopted by the Organization of Economic Cooperation and Development Council on* April 11, 1977, IVB INTERNATIONAL TAX TREATIES OF ALL NATIONS 481(Diamond and Diamond eds., 1996), art. 26 [hereinafter "OECD Model"].

65. *See* 1996 Model, *supra* note 63, art. 4; OECD Model, *supra* note 64, art. 4, U.N. Model, *supra* note 61, art. 4.

66. Treaties and statutes have equal status, and later in time takes precedence. *See* Whitey v. Robertson, 124 U.S. 190, 194 (1888); *See, e.g.*, 1996 Model, *supra* note 63, art. 4, ¶¶ 2-4; OECD Model, *supra* note 64, art. 4, ¶¶ 2-3; U.N. Model, *supra* note 61, art. 4, ¶¶ 2-3.

67. *See* 1996 Model, *supra* note 63, art. 4, ¶¶ 2(d)-(4); OECD Model, *supra* note 64, art. 4, ¶¶ 2(d)-4; U.N. Model, *supra* note 61, art. 4, ¶¶ 2(d)-3. These paragraphs are catch-all provisions for taxpayers not given definite resident status under the other paragraphs of the article.

68. *See* 1996 Model, *supra* note 63, art. 25; OECD Model, *supra* note 64, art. 25. Arbitration is sometimes agreed to as an alternative to negotiation. *See, e.g.*, Convention between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes, Aug. 29, 1989, U.S.-F.R.G., art. 5, ¶ 5, 2 TAX TREATIES (CCH) ¶¶ 3249 *et seq.*

69. *See* I.R.C. §§ 871(b)(1), 882(a)(1) (1997).

ness exists, it may be defined for U.S. tax purposes as "the process of producing or seeking to produce income from actively doing something as distinguished from merely owning income-producing property."[70] A trade or business may be an enterprise as large as an overseas branch of a large corporation, or as small as an artist's or athlete's foreign tour.[71]

Tax treaties limit source based trade or business taxation to taxpayers conducting that trade or business through a permanent establishment in the source country. The permanent establishment rule establishes a relatively high threshold for source based taxation of trade or business income.[72] This shields discrete, incidental, or *de minimis* international trade or business activities from double taxation. International business actors are also better able to predict the tax treatment of their income.

In addition to permanent establishment rules, tax treaties often have special rules for artists, athletes, and students. These rules set higher thresholds for trade or business taxation based on performance of personal services.[73]

3. *Withholding Limitations*

Source based taxation of income from property, such as interest, dividends, rents, royalties, and annuities, is generally imposed by requiring domestic payors to withhold a percentage of gross payments to foreign payees.[74] Additionally, tax treaties establish upper limits for withholding of income from property[75]

The United States imposes source taxation on "fixed or determinable, annual or periodic" income, which encompasses interest and income from

70. GUSTAFSON & PUGH, *supra* note 14, ¶ 4007.

71. Performance of personal services in the United States is a trade or business if taxpayer is present in the United States for more than ninety days or compensation greater than $3,000. I.R.C. § 874(b)(1) (1997).

72. *See id.* art. 5; *cf.* I.R.C. §§ 871(b), 864(c), 861(a)(3) (1997). These code provisions would subject a non-resident alien to source based trade or business taxation without a permanent establishment.

73. 1996 Model, *supra* note 63, arts. 17, 20; OECD Model, *supra* note 64, arts. 17, 20; U.N. Model, *supra* note 61, arts. 17, 20.

74. *See* I.R.C. §§ 1441(a), 1442(a) (1997).

75. 1996 Model, *supra* note 63, arts. 10-13; OECD Model, *supra* note 64, arts. 10-13; U.N. Model, *supra* note 61, arts. 10-13.

income-producing property.[76] Alternatively, Brazil requires withholding on these transactions at ten percent to fifteen percent.[77]

The 1996 Model Treaty would eliminate all withholding for interest and royalties, and set a fifteen percent maximum withholding rate for dividends.[78] Brazil's existing tax treaties (except the Brazil-Japan treaty) tax dividends at fifteen or twenty-five percent, and interest and royalties at ten, fifteen, or twenty-five percent.[79] Brazil's existing tax treaties reflect the recent past when Brazil required withholding at higher rates.[80] The difference between United States and Brazilian policy on withholding results from their different positions in the world economy.[81] The significance of this difference is discussed below.[82]

III. United States-Brazil Income Tax Treaty Issues

A. *Historical Background*

The United States entered into its first tax treaty with France in 1932.[83] It was a fairly simple document by today's standards, but it incorporated the basic idea of shifting taxing authority away from the country of income.[84]

The United States and Brazil first began tax treaty negotiations as early as 1949.[85] In 1967, U.S. and Brazilian negotiators sent their respec-

76. I.R.C. §§ 871(a)(1)(A), 881(a)(1) (1997); 1996 Model, *supra* note 62, arts. 10-13.

77. Brazil, *supra* note 32, at XI.

78. 1996 Model, *supra* note 63, arts. 10-12.

79. Haroldo Maggi, *Brazil, available in* LEXIS, TAXRIA library, TNI file 94 TNI 212-24, § 7.2 (1994).

80. Currently at 15%, Brazil's statutory withholding rates are lower than the maximum rate permitted by some of its treaties. Brazil, *supra* note 36, at VIII.B.

81. U.N. Model, *supra* note 61.

82. *See* discussion *infra* Part III.B.

83. Convention Between the United States and France Concerning Double Taxation, Aug 27, 1932, U.S.-Fr., 7 TIAS 977.

84. The treaty had 10 articles and the treaty and protocols together are six pages on a LEXIS printout, compared to the 29 articles and 24 pages (without any protocol) of the 1996 Model. *Id.*, *See generally* 1996 Model Treaty, *supra* note 63. The treaty has several restrictions on source based taxation including the permanent establishment concept and elimination of withholding on royalties, annuities, and private pensions. Convention between the United States and France Concerning Double Taxation, *supra* note 103, arts. I, X.

85. ALBERT A EHRENZWEIG & F.E. KOCH, INCOME TAX TREATIES 13 (1949).

tive governments a completed tax treaty for ratification.[86] It would have been Brazil's third tax treaty,[87] and the United States's first tax treaty with a Latin American country[88]

Between the time the treaty was negotiated and the time it went to the U.S. Senate Foreign Relations Committee the Kennedy administration entered the White House. That administration vehemently opposed tax sparing,[89] a tax treaty provision that allows foreign tax credit for source taxes deemed paid, *i.e.*, a credit for taxes that may not have actually been paid.[90] The 1967 treaty contained a tax sparing provision which caused the Senate Foreign Relations Committee to submit the treaty to the full floor with reservations, effectively tabling the treaty.[91]

The article would have granted an unusual kind of tax sparing. It provided that the United States would give its residents a tax credit equal to seven percent of their investments in buildings and equipment in Brazil.[92] This credit mimicked a similar credit available at that time for domestic investments.[93]

The Committee argued that "[i]n view of the increasing deterioration in this country's domestic and international fiscal condition, the Committee does not believe that it would be appropriate at this time to encourage

86. Convention Between the United States of America and the Government of the United States of Brazil for the Avoidance of Double Taxation with Respect to Taxes on Income, March 13, 1967, U.S.-Braz., VII INTERNATIONAL TAX TREATIES OF ALL NATIONS 55 (Diamond and Diamond eds., 1976) [hereinafter "1967 Treaty"].

87. Japan signed a tax treaty with Brazil in 1965. WORLDWIDE TAX TREATY INDEX 21 (David Michael Henry ed., 1996). Sweden signed a tax treaty with Brazil two months before the United States in 1967. *Id.* at 22.

88. The United States did not sign another tax treaty in Latin America until 1981, with Argentina. That treaty has not been ratified. Currently, the United States's only tax treaty in force with a Latin American country is the U.S.-Mexico Treaty. *Id.* at 115-121.

89. David R. Tillinghast, *Tax Treaty Issues*, 50 U. MIAMI L. REV. 455, 475 (1996).

90. *See, e.g.*, Convention Between the Federative Republic of Brazil and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Mar. 8, 1990, Braz.-Neth., XXXB INTERNATIONAL TAX TREATIES OF ALL NATIONS 473 (Diamond and Diamond, eds., 1995), art. 23, ¶¶ 2-4 [hereinafter "Brazil-Netherlands treaty"].

91. Tax Conventions with Brazil, France, and the Philippines, S. EXEC. REP. NO. 5, 90th Cong., 2nd Sess. 1-3, *microfilmed on* CIS 90-2-R.5 (Congressional Info. Serv.) (1968) [hereinafter "Senate Report"].

92. 1967 Treaty, *supra* note 86, art. 22.

93. *See* 26 U.S.C. §§ 38 (granting the credit), 46 (establishing the amount of the credit), 48 (establishing the expenditures that qualify for the credit) (CCH 1967).

investments in foreign countries."[94] In light of Congress' current obsession with balancing the budget, this argument could be made today

The Committee also objected to a the 1967 treaty provision that would have given U.S. residents U.S. tax deductions for charitable contributions to Brazil, similar to the deductions allowed for contributions to domestic charities.[95] The Committee argued that domestic legislation, not tax treaties, are the appropriate vehicle for granting new charitable deductions.[96] While the United States has not reversed itself on this policy, it has extended similar treaty-based deductions for charitable contributions given to Canada and Mexico.[97]

Brazil has continued to hold out for tax sparing since then, despite briefly dropping the demand in 1990. Meanwhile, the United States has remained firmly opposed to tax sparing.[98] However, the legal, political, and economic circumstances surrounding treaty negotiations have changed dramatically since 1967

1. Legal and Political Change

In 1967 Brazil imposed fifty eight federal taxes, employed a territorial taxation system, and did not impose corporate level taxation.[99] Such a tax system provided a strong incentive for export. Brazil's lack of corporate level taxation also invited foreign investors to accumulate wealth tax-deferred in Brazilian corporations. This system ran contrary to the U.S. policy of capital export neutrality [100]

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94. Senate Report, *supra* note 91, at 2.

95. *See* I.R.C. § 170 (1997).

96. Senate Report, *supra* note 91, at 3.

97. Convention Between the United States of America and Canada with Respect to Taxes on Income and Capital, Sept. 26, 1980, U.S.-Can., 1 TAX TREATIES (CCH) ¶ 1903, art. 21; Convention Between the United States of America and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Sept. 18, 1992, U.S.-Mex., 2 TAX TREATIES (CCH) ¶ 5903, art. 22 [hereinafter "U.S.-Mexico treaty"].

98. *See, e.g.*, Letter from Jesse Helms to Robert E. Rubin, supra note 1 ("I certainly commend the Treasury for firmly maintaining a position that prohibits tax sparing provisions in ALL United States bilateral tax treaties.").

99. Kathleen Matthews, *U.S. IFA Branch Explores Capital Flows to and from Argentina*, 7 TAX NOTES INT'L 1611, 1611 (1993); Albertina Fernandez, 14 TAX NOTES INT'L 21, 22 (1997).

100. For a discussion of capital export neutrality, *see generally*, Labrenda Garrett-Nelson, *The Future of Deferral*, *in* TAXING AMERICA (Karen B. Brown and Mary Louise Fellows eds., 1996) at 233-237. The United States partially counterbalancing that in-

In contrast, Brazil presently imposes four federal taxes, exercises worldwide taxation jurisdiction, and taxes corporate income.[101] This greater legal symmetry reduces the number of issues on the table in tax treaty negotiations. Brazil's unilateral adoption of the United States's policy on worldwide taxation and corporate taxation also has the effect of a concession to the United States.

Brazil has also established a wide network of tax treaties, both with developing and developed countries.[102] Brazil is now a member of more tax treaties than any other Latin American state.[103] This participation signifies Brazil's heightened valuation of tax treaty relationships; moreover, it illustrates the competitive advantage afforded to an increasing number of foreign businesses in the Brazilian marketplace that U.S. businesses do not enjoy

The United States's recent and rapid expansion of its tax treaty network with developing countries also demands significance. The United States now has tax treaties with China, India, Mexico, Khazakstan, Ukraine, Thailand and other developing nations.[104] Except for China, all of these treaties have been concluded in this decade.[105] The United States displays eagerness to enter into tax treaties with developing nations as well as experience in negotiating them. Among developing nations, the U.S. Treasury is targeting Latin America for high priority in tax treaty negotiations.[106]

Another important legal change is the emergence since 1967 of regional free trade treaties.[107] The United States and Brazil are currently signatories of NAFTA and MERCOSUR, respectively. Both countries have shown interest in expanding their trade treaties to include one another.[108] Presumably if this happens, the economic relationship between

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centive through the 1962 Foreign Controlled Corporations laws *See generally* I.R.C. §§ 951-964 (1997).

101. Matthews, *supra* note 99, at 1611 ("Brazil's tax reform measures if implemented would reduce the number of taxes from 58 to 4.").

102. *See* WORLDWIDE TAX TREATY INDEX 17-18 (David Michael Henry and Marion Marshall eds., 1997).

103. *See generally id.*

104. *Id.*

105. *Id.*

106. Joseph H. Guttentag, *An Overview of International Tax Issues*, 50 MIAMI L. REV. 445, 450 (1996).

107. *Id.* (Stating that the United States is "encouraged by the expansion of NAFTA.").

108. At 1995 "Summit of the Americas" hosted by the United States, summit members proposed a "Free Trade Area of the Americas" by 2005. *Id.* at 445. MERCOSUR mem-

the United States and Brazil will become more intimate. The United States currently has tax treaties with both of its NAFTA partners, and Brazil will likely desire a similar treaty if it becomes a party to NAFTA.[109]

2. *Economic Changes*

Since the U.S.-Brazilian negotiation of the 1967 Treaty, Brazil has become an increasingly important market for businesses located in the United States and other industrialized countries. An examination of Brazil's current position in the global marketplace highlights the exigency of concluding a U.S.-Brazil tax treaty

Brazil has a Gross Domestic Product of $465 billion and is the U.S.' third largest trading partner after Canada and Mexico.[110] Between 1984 and 1994 the dollar value of United States exports to Brazil increased from $2.5 billion to $7.2 billion.[111] Investment from the United States accounts for almost thirty-four percent of foreign direct investment in Brazil.[112]

The U.S. government has identified Brazil as a "Big Emerging Market" (BEM).[113] The classification as a BEM signals U.S. government commitment to assist U.S. businesses and investors in their attempts to enter the Brazilian market and take advantage of Brazil's future growth.[114] The United States has tax treaties with seven of the fifteen countries identified as BEMs by the government, and is currently in negotiations with several others.[115]

Brazil maintains significant economic relationships with other wealthy countries. Brazil's tax treaties with other countries may make those treaty countries' goods, services, and capital cheaper to Brazil than similar exports from the United States. Not only does this threaten the

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bers seem particularly excited about the possibility. *See MERCOSUR, Results Already Achieved, web page* (visited Sept. 26, 1997) <http://www.demon.co.uk/Itamaraty/msul29.html>

109. Including, perhaps, treaty-based deductibility of U.S. residents contributions to Brazilian charities. *See* discussion *infra* Part 4.A.

110. According to U.S. government trade information, *see Brazil BEMS home page* (visited Sept. 26, 1997) <http://www.stat-usa.gov:80/bems/bemsbraz/bemsbraz.html>.

111. U.S.-Brazil trade information, *see U.S. Export Growth to Brazil* (visited Sept. 26, 1997) <http://www.stat-usa.gov:80/bems/pictures/braexp.gif>.

112. *MERCOSUR web page*, *supra* note 108.

113. *Id.*

114. *Id.*

115. *Id.* (list of BEMS); *See* WORLDWIDE TAX TREATY INDEX, *supra* note 87, at 115-21 (listing all U.S. tax treaties).

United States's current market share in Brazil, but it also allows foreign businesses to establish themselves in Brazilian markets for the long term.

The European Economic Community (EEC) and the United states have alternated the role of being largest exporter to Brazil since 1986[116]. Many EEC countries have tax treaties with Brazil.[117] Japan has retained about six percent of the export market to Brazil since 1986,[118] and has also recently entered into a tax treaty with Brazil.[119] The Japan-Brazil tax treaty provides for less source based taxation than any other Brazilian tax treaty[120] As a result, Japan may possess new advantage in certain segments of the Brazilian market.

B. Developing Country Treaty Issues

In a tax treaty between two developed countries where income flows more or less equally between the two, shifting taxing authority to country of residence is the most equitable mechanism for jurisdiction determination. In such a situation, both countries forego roughly equal amounts of source based tax dollars in exchange for roughly equal amounts of residence based tax dollars.

However, when such an agreement is between a developed and a developing country, the situation may be less equitable. The developed country will, presumably, be a net exporter of capital, goods, and services, and the developing country a net importer.[121] With such an imbalance in the flow of goods and services, the tax revenue of the developed country will increase while tax revenue of the developing country will decrease.[122] Such would be the case in a tax treaty between the United States and Brazil.[123]

Additionally, developing countries often strive to create reinvestment incentives for foreign investors in order to retain foreign income within the

116. 1995 INT'L TRADE STAT. Y.B. 123, U.N. Doc. ST/ESA/STAT/SER.G/44.

117. Maggi, *supra* note 79.

118. 1995 INT'L TRADE STAT Y.B., *supra* note 116, at 123.

119. *Id.*

120. *Id.*

121. Samuels, *supra* note 62, at 19.

122. *Id.*

123. For a bizarre but respectable opinion that the United States and Brazil should have the same treaty goals, *see generally* Mike McIntyre, *Tax Treaties: Honeybees and Spiders*, 2 TAX NOTES INT'L 1235 (1990).

developing country.[124] Source based taxation of repatriated income well serves this purpose because it allows international actors to accumulate partially or fully tax deferred wealth as long as they continue to reinvest it in the country of income source. One of these incentives is a tax on repatriation of income.[125]

For these reasons, developing countries generally want treaties which allow for greater source jurisdiction to tax dividends and interest, inculcate minimal permanent establishment thresholds for source based taxation of trade or business income, and create some incentive for foreign investors to invest in the developing country.[126] Brazil's policy, as indicated by its existing tax treaties, is to allow treaty partners to maintain all or most of its source taxation on income from dividends, interest, and royalties.[127] Brazil also demands tax sparing from wealthy treaty partners as an incentive for domestic investment by foreign investors.[128]

The U.S. tax treaty policy, as indicated in the 1996 Model Treaty, is to eliminate withholding on interest and royalties, and to set relatively low withholding rates for dividends.[129] In other words, the U.S. policy is to favor residence based taxation. The United States also remains vehemently opposed to tax sparing.[130]

C. Continuing Points of Impasse

The United States's current tax treaty network with developing countries indicates a willingness to concede a higher level of source based taxation in its negotiations with developing countries.[131] This willingness

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124. Letter from Andy Yood, Taxation Director, American Petroleum Institute, to James R. Mogle, International Tax Counsel, United States Treasury (Jan. 11, 1993), *available in* LEXIS, 93 TNI 19-11 (1993).

125. *Id.*

126. This is why the U.N. Model (designed as a template for treaties between developed and developing countries) has provisions for withholding of interest and royalties by the source country payor, whereas the 1996 Model does not. *See* U.N. Model, *supra* note 61, arts. 11 ¶ 2, 12 ¶ 2; *cf.* 1996 Model, *supra* note 63, arts. 11 ¶ 1, 12 ¶ 1.

127. Maggi, *supra* note 79.

128. *See, e.g.*, Brazil-Netherlands treaty, *supra* note 90, art. 23, ¶¶ 2-4.

129. 1996 Model, *supra* note 63, arts. 10-12.

130. Letter from Jesse Helms to Robert E. Rubin, *supra* note 1.

131. *See, e.g.*, U.S.-Mexico treaty, *supra* note 97, arts. 11 ¶ 2, 12 ¶ 2., Convention Between the United States of America and the Government of Kazakhstan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, 23 Oct. 1993, U.S.-Kaz., 2 TAX TREATIES (CCH) ¶¶ 5303 *et seq.*, arts. 11 ¶ 2, 12 ¶ 2.

probably reflects an acknowledgment by Congress that other industrialized nations are profiting from competitive advantages that follow from similar concessions. Under this reasoning, Congress should be anxious to conclude a tax treaty with Brazil, which currently has tax treaties with most OECD countries. However, efforts to conclude such a treaty are currently being thwarted by disagreement over issues on tax sparing and withholding of taxes on fees for technical services.[132]

1. Tax Sparing

Tax sparing is the practice of allowing domestic taxpayers a foreign tax credit for foreign taxes not actually paid. In general, a tax sparing provision guarantees that a wealthy treaty party will give residents a foreign tax credit for certain taxes whether or not actually paid.[133] Tax sparing provides an incentive for foreign investment in the developing country.[134] Most wealthy countries offer tax sparing in tax treaties with developing countries, but the United States does not.[135]

The Brazil-Netherlands tax treaty offers an example of a typical tax sparing provision.[136] If a Dutch lender receives ten dollars of interest from a Brazilian resident in a taxable year, the income would be subject to Brazil's fifteen percent withholding tax, which is the maximum percentage permitted under the treaty (with some exceptions).[137] Under the tax sparing provision, the interest is exempt from tax in the Netherlands.[138] In addition, the Dutch lender is allowed a tax credit in the Netherlands equal to a deemed paid tax of twenty percent of the interest.[139] Thus, the taxpayer pays one dollar and fifty cents in tax and receives two dollars in tax credits, netting an extra fifty cents of income at the expense of the Dutch treasury If the creditor were Brazilian and the debtor Dutch, the Brazilian creditor would not get the benefit of tax sparing.[140]

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132. Letter from Joseph L. Andrus to Phillip D. Morrison, *supra* note 1.
133. *See, e.g.*, Brazil-Netherlands treaty, *supra* note 90, art. 23, ¶¶ 2-4.
134. Tillinghast, *supra* note 89, at 475.
135. *Id.*
136. Brazil-Netherlands treaty, *supra* note 90, art. 23, ¶¶ 2-4.
137. *Id.* art. 11.
138. *Id.* art. 23 ¶ 3.
139. *Id.* art. 23 ¶ 4.
140. *Id.* art. 23.

Moreover, tax sparing is desired by some developing countries because the efficacy of tax holidays increases.[141] A tax holiday is a temporary reduction or elimination of business taxes designed to attract foreign capital. Without tax sparing, any tax holiday given by a developing country may fail to entice foreign investors because what foreign investors gain in tax breaks may be counterbalanced by the loss of foreign tax credits.[142]

However, the desirability of tax sparing in order to increase tax holiday efficacy is debatable. One reason the United States has opposed tax sparing is because it would "encourage investors to 'shop' for deals, and unwisely erode the developing country's revenue base."[143] Countries desiring tax sparing view this argument as too paternalistic.[144]

The United States has several other reasons for opposing tax sparing. One reason offered is the U.S. policy of "tax neutrality," the idea that U.S. tax law does not favor either domestic or international transactions.[145] Another reason offered is that tax sparing uses tax treaties and the foreign tax credit for purposes of which they were not intended.[146] The cogency of these reasons is not self-evident, although arguments can be made in their defense.[147]

Whatever the ideological reason behind U.S. policy, in reality it is unlikely that the United States will ever relent. Granting tax sparing to Brazil will set an undesired precedent for future negotiations with other developing countries; moreover, other treaties already in effect promise to grant tax sparing in the event that any other country should get tax sparing

141. Tillinghast, *supra* note 89, at 455, 474-75.
142. *Id.*
143. *Id.*
144. *Id.*
145. Samuels, *supra* note 62, at 19.
146. Tillinghast, *supra* note 89, at 455, 474-75.
147. *See, e.g.*, Beverly I. Moran, *Economic Development: Taxes, Sovereignty and the Global Economy*, *in* TAXING AMERICA 197 (Karen B. Brown & Mary Louise Fellows eds., 1997).

in a U.S. tax treaty[148] In other words, giving tax sparing to Brazil obliges the United States to give it also to India and China.[149]

2. *Withholding of Fees for Technical Services.*

Withholding of fees for technical services is the other major sticking point in U.S.-Brazil tax treaty negotiations.[150] Brazilian domestic law subjects fees remitted abroad for technical assistance to a source based withholding tax. Brazil's tax treaties all preserve this right. Brazil's tax treaties also preserve Brazil's right to withhold fifteen percent of "payments of any kind received as a consideration for the rendering of technical assistance and technical services."[151] Brazilian tax authorities have interpreted the phrase "technical services" broadly, to encompass, in practice, most kinds of services.[152]

Under U.S. domestic law and the U.S. Model Treaty, fees for services are sourced in the country where the services are performed,[153] and royalties are sourced where the rights purchased are to be used.[154]

The discrepancy between U.S. and Brazilian treatment of services creates large pockets of source/source double taxation. If, for example, a Brazilian manufacturing company were to employ a U.S.-based company to design a new manufacturing system for use in their Brazilian operations, the payments remitted to the U.S. company would be subject to substantial source based taxation in Brazil, and be both taxable and non-creditable in

148. Convention Between the United States of America and the Government of the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Letter of Understanding, Sept. 12, 1989, U.S.-India, 2 TAX TREATIES (CCH) ¶ 2137; Convention Between the United States of America and the Government of the Peoples Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion, Letter of Agreement, Apr. 30, 1989, U.S.-P.R.C., 1 TAX TREATIES (CCH) ¶ 2137.

149. Convention Between the United States of America and the Government of the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, *supra* note 150; Convention Between the United States of America and the Government of the Peoples Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion, *supra* note 150.

150. Letter from Joseph L. Andrus to Phillip D. Morrison, *supra* note 1.

151. *Id.*

152. *Id.*

153. I.R.C. §§ 861(a)(3), 862(a)(3) (1997).

154. *Id.* §§ 861(a)(4), 862(a)(4).

the United States as a result of being deemed domestic source by U.S. law[155]

In order for a U.S. model treaty to effectively eliminate this double taxation, one country must concede taxation jurisdiction to the other. Thus far, negotiations have not produced such a concession.

Only those close to the negotiations know the precise reason for the intractability of this issue. However, at least two reasons for each country's resolute stance on this issue arise from the very nature of the issue. First, because these services typically flow from the United States to Brazil, Brazil stands to lose a significant source of revenue which would not be compensated for by increased residence-based taxation of the same kinds of transactions.[156] The United States, for its part, is also probably not eager to forgo the right to tax this large and growing sector of the U.S. economy

Second, double taxation of fees for services remitted abroad makes such transactions artificially more expensive than similar transactions conducted domestically, thus giving domestic residents a competitive advantage in the domestic market for services. Brazil may appreciate this as a way to create jobs for skilled residents. The United States, however, has traditionally held to the policy that tax treaties should eliminate tax-based preferences for either domestic or foreign transaction. This policy of tax neutrality is clearly undermined by Brazilian taxation of fees for services remitted abroad.

IV. Future Negotiations

Tax treaties are multifaceted agreements with much room for negotiation. Compromises on large issues may be reflected throughout a treaty, often in ways that are not evident from the facial language of the treaty.

Some compromises, such as allowing deductions for expenses against income subject to withholding taxes, and heightened or lowered permanent establishment thresholds, are narrow approaches to tax treaty negotiations. Both of these possibilities are discussed below

155. Strictly speaking, all foreign taxes are creditable. *Id.* § 901(d). However, foreign tax credit is limited to the taxpayers pro rata share of U.S. tax on foreign source income. *Id.* § 904(a).

156. Not only is the United States a net exporter of goods and services to Brazil, but the U.S. government expects that U.S. sales of advanced technology products to Brazil will continue to increase. *See generally Brazil BEMS home page* (visited Sept. 26, 1997) <http://www.stat-usa.gov:80/bems/bemsbraz.html>

Other policy objectives may also move tax treaty negotiations. For example, the larger trade relationship between parties may play a large factor in negotiations. Thus China, a country with which the United States is very eager to establish healthy trade ties, received extremely favorable tax treaty terms from the United States.[157] Mexico also received certain unusual tax treaty terms because of the then impending North American Free Trade Agreement.[158]

The United States is in a good position to facilitate negotiations by placing a wide variety of values on the table if it is serious about concluding tax treaties, as it appears to be.[159] The variety of values adds a level of complexity to negotiations because the values on the bargaining table are increasingly more varied and of uncertain worth. But if any entity is particularly well situated to carefully determine value, it is the modern day, nation-state government. It is large, bureaucratic, and replete with institutions that assess value. Examples of such U.S. institutions are the Central Budget Office and the General Accounting Office.

Viewing U.S.-Brazil negotiations from the perspective of larger trade goals suggests several new possibilities to add renewed vitality to U.S.-Brazil tax treaty negotiations. Two of the more interesting possibilities are considered below None of these possible compromise positions need be exclusive. Any one could be used in conjunction with any of the others or with a compromise position not considered here.

A. Deductability of Expenses Against Withholding Taxes

A future tax treaty with Brazil may provide for the deduction of expenses against the Brazilian withholding tax on fees for services.[160] As discussed above, Brazil currently withholds on the gross amounts of payments for services performed by non-residents.[161] The advantage of imposing a withholding tax on gross payments is the ease of enforcement.[162] Brazil does not have to try to extract tax dollars from income already in the

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157. *See generally* Paul D. Reese, *United States Tax Treaty Policy Toward Developing Countries: The China Example*, 35 U.C.L.A. L. REV. 369 (1987).

158. *See generally* Philip D. Morrison, *U.S.-Mexico Treaty Breaks New Ground—Implications for the New U.S. Model and for Latin America*, 5 TAX NOTES INT'L 825 (1992).

159. *See generally* McLachlan, *supra* note 2, at A1.

160. Letter from Joseph L. Andrus to Phillip D. Morrison, *supra* note 1.

161. *Id.*

162. Samuels, *supra* note 62, at 17.

hands of non-residents, nor does it have to process tax returns from non-residents.

The problem with this mechanism from the service provider's perspective is that payment for services often includes a large portion of compensation for expenses.[163] Under domestic tax laws these expenses are ordinarily deductible, but this is not the case for fees remitted from Brazil to the United States.[164] The result is that U.S. businesses must charge more for services performed for Brazilian residents in order to cover the tax on expenses.

A future U.S.-Brazil tax treaty that allows some withholding for fees for services performed abroad may also contain some provision for allowing service providers to deduct their expenses from their Brazilian tax base. This could be accomplished through a refund system whereby Brazil would still require withholding on gross payments, but allow U.S. residents to apply for tax refunds of the difference between the tax on gross payment and the tax on net payment. It could also be accomplished more easily, if somewhat more crudely, by a provision allowing a fixed percentage of gross payments as a deduction for expenses.

Such a compromise would only partially eliminate double taxation, because the taxpayer's net income from such transactions would still be taxed in both countries. However, such an agreement would eliminate double taxation on the part of the income that reflects compensation for expenses, which can be a large part of fees for services.

While no U.S. treaty has adopted this approach to taxation of fees for services, the U.S.-Spain tax treaty contains a similar provision which allows Spain to withhold taxes on fees for services performed in Spain in connection with intangible property on which royalties are being paid.[165] Although this provision would not work, in the case of a U.S.-Brazil tax treaty to eliminate double taxation of fees for services, the provision indicates an awareness on the part of U.S. negotiators that allowances for deductions against withholding taxes can be an effective compromise position.

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163. The primary expense obviously being the salaries and wages of those who perform the services.

164. Brazil, *supra* note 32, at VIII.B.

165. Convention Between the United States of America and the Kingdom of Spain for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion, Feb. 22, 1990, U.S.-Spain, art. 12, ¶ 2, 3 TAX TREATIES (CCH) ¶ 8403.

B. Permanent Establishment Threshholds

The permanent establishment threshold is another possible vehicle for compromise on the issue of withholding of fees and royalties. However, it is not clear whether raising, lowering, or raising and lowering the threshold is the best compromise.

A future U.S.-Brazil tax treaty, for example, may establish a relatively high permanent establishment threshold.[166] As a result, U.S. businesses will have a relatively long safe harbor period before construction, mining, and drilling projects in Brazil expose them to source-based taxation. A presence for as long as twenty four months (as opposed to twelve months under the 1996 Model Treaty)[167] may be required before the project may be taxed as a trade or business through a permanent establishment.[168]

A high permanent establishment arrangement could satisfy both parties by reducing source based taxation of trade or business income. Reduction of source based taxation remains in accord with U.S. policy, while leaving intact Brazil's current regime of taxing remittances abroad of fees for services.

On the other hand, if Brazil relented on taxing all remittances abroad of fees for services, the United States could offer a relatively low permanent establishment threshold. This arrangement eliminates the general double taxation of fees for services while allowing Brazil to tax more trade or business income of U.S. residents than is the case under the U.S. Model Treaty[169]

Finally, in the alternative, compromise could be reached by (1) setting a relatively high permanent establishment threshold for business activities which do not generally involve remittances of fees for services, such as mining and manufacturing, and (2) setting a relatively low permanent establishment threshold for activities that generally do involve remittances of fees for services, such as sales of high technology equipment. Under this alternative, Brazil collects relatively more revenue from taxation of fees for services than would be allowed under the U.S. Model Treaty.[170] This

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166. Such a provision has been recommended by the American Petroleum Institute. Letter from Andy Yood to James R. Mogle, *supra* note 126.

167. 1996 Model, *supra* note 63, art. 5, ¶ 3.

168. Letter from Andy Yood to James R. Mogle, *supra* note 126.

169. Presumably because casting a wider net will result in higher tax revenues. *See* 1996 Model, *supra* note 63.

170. 1996 Model, *supra* note 63, art. 5.

alternative also decreases source based taxation of other business activities, which is in accord with U.S. policy Because this approach concedes the least to Brazil, it is probably most appropriate in a treaty in which Brazil lowers, without eliminating, withholding on fees for services.

C. Extending 501(c)(3) Status to Brazilian Charities.

Another possibility would be to afford Brazilian charities Internal Revenue Code (IRC) section 501(c)(3) status. Section 501(c)(3) entities are non-profit corporations:

> organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sport competition . . , or for the prevention of cruelty to children or animals, . no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation , and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.[171]

Donations to section 501(c)(3) organizations may appeal to Brazil because they are tax deductible, subject to certain limitations, to U.S. taxpayers.[172] Thus, giving Brazilian organizations section 501(c)(3) status provides an incentive for U.S. residents to donate to Brazilian charities. Given that U.S. residents donate more than one hundred billion dollars annually to section 501(c)(3) organizations, this could be a very attractive concession to Brazil.[173]

Section 501(c)(3) status is likely to cost the United States very little. Currently, although section 501(c)(3) corporations must be incorporated in the United States, no geographic restriction on where the charities spend their money exists.[174] Thus, making a deductible charitable contribution to Brazil is already possible so long as the donation goes through the hands of

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171. I.R.C. § 501(c)(3) (1997).

172. *See generally id.* § 170.

173. Total U.S. charitable giving in 1994 was about $120 billion. *Expiring Tax Provisions, hearing before the Subcommittee on Oversight of the House Committee on Ways and Means,* 104th Cong., 1st Sess. 244 (1995) (Statement of James A. Joseph, President and CEO, Council on Foundations).

174. Zack D. Mason, *Foreign Charitable Contributions: A Shift in U.S. Tax Treaty Policy?,* 7 EXEMPT ORG. TAX REV. 624, 625 (1993).

a U.S. section 501(c)(3) corporation.[175] Also, the amount deductible to section 501(c)(3) corporations is restricted to a percentage of income under section 170 of the IRC.[176] This restriction limits whatever impact an increase in charitable contributions would have on the U.S. Treasury.

While costing the U.S. Treasury very little, such a treaty provision may make a tax treaty without tax sparing more acceptable to the Brazilian government for two reasons. First, it could open the door for more charitable contributions flowing from the U.S. to Brazil.

Second, it lays a brick in the path toward negotiating a free trade agreement with Brazil. This is true because currently NAFTA signatories Mexico and Canada are two of only three countries who receive this treatment in their tax treaties with the United States. Mexico received this treatment due to the then-impending North America Free Trade Agreement.[177] Since NAFTA was signed there has been talk of bringing in South and Central American countries to turn the agreement into a continent-wide free trade agreement.[178] Presumably, Brazil would want the same tax treatment afforded to current NAFTA members.

However, several obstacles to this compromise exist. For example, the 1967 Treaty had just such a provision. However, the 1967 version of the provision was the secondary reason, after tax sparing, that the Senate Committee on Foreign Affairs killed the treaty.[179] If the government's policy on tax sparing is indicative of the persistence of policy in this area, extending deductibility to donations to Brazilian charities seems unlikely.

Another obstacle is the current spate of section 501(c)(3) scandals. In 1996, both Newt Gingrich and Al Gore were embroiled in scandals involving misuse of section 501(c)(3) organizations.[180] This prompted Congress to pass a new law giving the Internal Revenue Service (IRS) new tools to punish those who abuse tax-free organizations.[181] In this climate

175. *Id.*

176. *See* I.R.C. § 170(b) (1997).

177. Morrison, *supra* note 158, at 833.

178. Guttentag, *supra* note 106, at 445.

179. Senate Report, *supra* note 91, at 3.

180. *Dangerous Money Series: Editorials*, SAINT PETERSBURG TIMES, Apr. 5, 1997, at 18A; Larry Margasak, *Senate Committee to Begin Investigation of Campaign Finances*, FORT WORTH STAR-TELEGRAM, July 6, 1997, at 3.

181. I.R.C. § 4958 (1997). Prior to enacting this code section, the only remedy available to the IRS for curbing abuses of non-profit status was to take away that status, which the service was generally loathe to do except in extreme circumstances. Congressional

granting section 501(c)(3) status to Brazilian charities may be politically unwise.

Finally, it is not clear that NAFTA is politically popular enough to justify public policy that aims to expand NAFTA. Polls show public opinion about NAFTA mixed at best, although approval is slightly higher among the business community[182] On the other hand, Brazil seems very interested in the possibility of linking MERCOSUR and NAFTA.[183]

C. Lowering Interest Rate Withholding in Target Markets.

In the Brazil-Netherlands income tax treaty, there are two rates of maximum interest withholding.[184] One rate is general and the other, lower rate applies to interest on debt used to purchase industrial equipment.[185] Because the Netherlands is a net creditor in that relationship, the cost of lower interest rate withholding falls primarily on the Netherlands.

This provision is not a complete windfall for Brazil. Lower interest rate withholding gives Dutch creditors an advantage in the competition for Brazilian debt, though not as great an advantage as if interest rate withholding applied across the board. This provision also provides an incentive for Brazilian businesses to purchase Dutch industrial equipment because it lowers Dutch sellers' costs of financing such purchases.[186]

The United States could reach a similar compromise. This compromise could extend to high-technology equipment. The United States has identified health care technology, environmental technology, aerospace, and information technology as "big emerging sectors in Brazil."[187] If lower interest withholding rates succeed in spurring Brazilian investment in industrial and technological equipment, presumably much of that debt will be used to purchase goods from the United States.[188] Thus Brazil would get greater access to the equipment needed for growth in key sectors, and the United States would get increased market shares in these

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Research Service, The Tax Treatment of Exempt Organizations: Intermediate Sanctions (1994), CRS 94-9015.

182. Search of LEXIS, ALLNEWS Library (June 1, 1997) (run a keyword search for NAFTA's "Opinion Poll" and "DA(After 1994)").

183. *See MERCOSUR web page*, *supra* note 108 *under heading* United States and NAFTA.

184. Brazil-Netherlands treaty, *supra* note 111, art. 11, ¶ 2.

185. *Id.*

186. *Id.*

187. *MERCOSUR web page*, *supra* note 108.

188. This is because many of the "big emerging sectors" include high-technology. *Id.*

sectors.[189] Such a compromise could help the United States forgo its demand that Brazil relent in its fee and royalty withholding policies.

As a practical matter, the withholding rate would probably have to be lowered to below five percent in order for large creditors to take full advantage of the lower rates.[190] Otherwise, interest rates above five percent fall into a special basket of foreign tax credits in which many lenders are already in an excess credit situation, and prevent large lenders from benefiting.[191]

V. Conclusion

A U.S.-Brazil tax treaty should and almost certainly will be ratified by both countries before the year 2000. The United States cannot allow its businesses to suffer a competitive disadvantage in this large and increasingly important market.

Because this treaty will be the United States's first tax treaty with a South American country, it will serve as an important model for future tax treaties with other South American countries. As forerunner, it will largely define the scope of tax treaty negotiations with other emerging Latin American economic powerhouses such as Chile and Argentina.

This treaty may also indicate the direction of U.S. trade policy. A treaty allowing substantial source based taxation will indicate that the United States is shifting away from regarding tax treaties as tools for building level playing fields, and toward a policy of using them to help U.S. businesses compete in emerging market countries. A treaty largely mirroring the U.S.-Mexico tax treaty may indicate an intent to expand NAFTA or otherwise create a larger, free trade agreement region.

Whatever shape the final agreement takes, it will affect millions of taxpayers and billions of dollars of transactions annually. Thus, a U.S.-Brazil tax treaty will be an enormously important document even if it breaks no new ground in U.S. tax treaty policy.

189. This conclusion is based on the fact that the United States is the world's leading exporter of high-technology products. *Expert Power*, ALBANY TIMES UNION, Sept. 28, 1996, at B3.

190. Morrison, *supra* note 158 at 826-28.

191. *Id.*