One issue that both political parties currently agree on is the need to reform U.S. taxation of profits made overseas. Multinational corporations are clamoring for change, deriding the U.S. system of international taxation as being overly complicated and harming the competitiveness of U.S. companies operating overseas. International tax reform could also support economic recovery in the United States, especially if the system encourages U.S. multinationals to repatriate the profits they made overseas.

Even though the outcome of the 2012 presidential election will determine the precise focus of any international tax reform, it is important for the new system to increase the competitiveness of U.S. multinational companies overseas while also reducing the high levels of tax avoidance that plague the current system. Reducing tax avoidance is an area in which tax treaties can play an important role. The U.S. Treasury should use the political desire for international tax reform as an opportunity to renegotiate U.S. tax treaties and strengthen their potential to limit tax avoidance. This paper focuses on one particular strategy that the U.S. Treasury could adopt to strengthen U.S. tax treaties: replacing the limitation on benefits (LOB) provision with a general anti-avoidance regulation (GAAR).

U.S. tax treaties are designed to reduce the incidence of taxation on companies resident in the signatory countries; however, these treaties are subject to abuse. Companies can incorporate in countries that are signatories to tax treaties with the United States solely to obtain treaty benefits (known as “tax treaty shopping”). The United States attempted to prevent this abuse by including LOB provisions in its tax treaties. The LOB provision is a strict residency test, designed to prevent companies from incorporating in treaty partner countries solely to obtain treaty benefits. LOB provisions attempt to block tax treaty shopping by adding an additional test after the company has satisfied an initial, more basic, test of residency. An LOB provision denies treaty benefits to entities not controlled by residents of the contracting state under which the company is claiming the benefits.

LOB provisions can undoubtedly prevent some instances of tax treaty shopping, but they are seriously flawed and should be replaced. There are three main criticisms of LOB provisions: (1) they are in conflict with European Union law; (2) they are based on objective criteria that make them subject to abuse; and (3) they are overly complicated.

This paper proposes replacing LOB provisions with GAARs as a more effective way to combat tax avoidance that attempts to abuse U.S. tax treaties. GAARs are less complicated than LOB provisions are and would provide more flexibility to domestic courts. Courts would be able to prevent genuine instances of tax treaty shopping and would allow transactions that are motivated by a business purpose that is not related to taxes. The GAAR should be supported by examples, included within the text of the treaty itself, to guide courts in its application. GAARs are usually harder to avoid than provisions that rely on objective criteria, like LOB provisions, and therefore a well-constructed GAAR could significantly reduce the incidence of tax avoidance through the inappropriate use of tax treaties between the United States and foreign nations. TFL

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