Establishment of Principle for Prevention of Treaty Override

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Establishment of Principle
For Prevention of Treaty Override

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ABSTRACT

Over the past tens of years, international transactions have been greatly increased and a number of states have concluded a tax treaty in order to improve international transactions through the prevention of double taxation. In the meantime, treaty shopping activities using the loophole of tax treaties have been also greatly increased. Thus, the global community has discussed a solution to this problem and it has become an issue whether or not preventing tax avoidance activities by a domestic tax law in case where a tax treaty does not provide otherwise comes under a treaty override.

Since a tax treaty normally consists of approximately 30 articles, it is actually difficult to resolve all issues related to international transactions by only 30 articles. Accordingly, there has been being discussed a necessity of applying domestic tax laws where a tax treaty itself cannot resolve the related issues.

The position supporting the application of domestic tax law is based on the fact that the purpose of a tax treaty lies in the prevention of double taxation and tax evasion and OECD Model Commentaries allow the application of domestic anti-avoidance rule. On the other hand, the position objecting to the application of domestic tax law is based on the Vienna Convention which provides “Every treaty in force is binding upon the parties to it and must be performed by them in good faith” and “A party may not invoke the provisions of its internal law as justification for its failure to perform a treaty.”

A contracting state’s unilateral treaty override action results in infringing on the taxing rights of the other contracting state and hampering international transactions. If the global community cannot resolve this important matter on a reasonable basis, the global community will continue to face with tax disputes. Thus, this thesis focuses on analyzing the related issue and seeking out a reasonable solution to the controversial problem.

The problems related to the execution of a tax treaty can be classified into three kinds of pattern as follows: 1) a problem related to the interpretation of terms used in the article of a tax treaty, 2) a problem related to the interpretation of tax treaty provisions, and 3) a problem related to applying a domestic tax law (such as anti-avoidance rule) to what is not provided otherwise in the tax treaty.

First, where a tax issue occurs in relation to the interpretation of terms, it can be resolved by applying the standard provided in Paragraph 2, Article 3 of the OECD Model Tax Convention and the related tax treaty without a treaty override issue.

Paragraph 2, Article 3 of OECD Model Tax Convention provides “As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State over a meaning given to the term under other laws of that State.”

Second, a problem related to the interpretation of tax treaty provisions can also be resolved without a treaty override issue.

Commentary 3 on Introduction of the 2005 OECD Model Tax Convention emphasizes that “Member countries, when concluding or revising bilateral conventions, should conform to this Model Convention as interpreted by the Commentaries thereon and having regard to the reservation contained therein and their
tax authorities should follow these Commentaries, as modified from time to time and subject to their observations thereon, when applying and interpreting the provisions of their bilateral tax conventions that are based on the Model Convention.”

When necessary, competent authorities of contracting states can resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of a tax treaty and refer to the commentaries of the OECD Model Tax Convention or the technical explanations of the US Model Tax Convention in the case of a tax treaty with the United States.

Third, a problem related to applying a new domestic tax law (such as anti-avoidance rule) to what is not provided otherwise in the tax treaty should be approached in a more careful way.

Commentary 9.2 on Article 1 of the OECD Model Tax Convention states “To the extent these anti-abuse rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability, they are not addressed in tax treaties and are therefore not affected by them. Thus, a general rule, there will be no conflict between such rules and the provisions of tax conventions.”

Where a contracting state concludes a tax treaty with the other contracting state, two states should respect the concluded tax treaty. In addition to this, two states should, as an OECD member country, resolve related matters by applying the commentaries of the OECD Model Convention which is agreed upon by member countries and respect the recommendation of the OECD. Further, a tax treaty plays a role of coordinating the differences of contracting states’ domestic tax laws which are differently made according to their respective tax policy and determining the taxing rights of two contracting states based on its conclusion contents. In this respect, it can be said that a tax treaty is clearly distinguished from other international laws and thus a principle suitable to the purpose of a tax treaty is required.

In order to eradicate an unnecessary dispute, it is necessary to establish a clear and reasonable principle to ascertain a true treaty override action as follows: Only where the legislation which comes under a treaty override action unilaterally infringes upon the taxing rights of other contracting state and significantly hampers the legal stability, must it be treated as a treaty override legislation which violates the Vienna Convention. On the other hand, where a newly established domestic tax law is applied in accordance with the purpose of a tax treaty, it must not be treated as a treaty override action.

As there are a number of international laws other than a tax treaty, it is necessary to resolve the related treaty override problems using a practical “field by field approach” rather than a simple theoretical approach.

However, if there is still a necessity of taking a theoretical approach, it is necessary to classify international laws field by field and apply both the “later-in-time principle” and the “special law priority principle” harmoniously in order to secure the harmonious execution of an international law and a domestic law.

If some states adhere to the later-in-time principle to do treaty override legislation and other states respect the treaty priority principle, the global community will continue to face with tax disputes. Therefore, it is necessary to minimize tax disputes by establishing a clear and reasonable principle for the development of the global community.
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I. Introduction

In company with the increase of international transactions, treaty shopping activities using the loophole of tax treaties have been greatly increased. The opinions of the global community are not unified with regard to how to establish the interrelationship between a tax treaty and a domestic tax law and solve the related problems. The issue focuses on whether or not preventing tax avoidance activities by a domestic tax law in case where a tax treaty does not provide otherwise comes under a treaty override.

Since a tax treaty normally consists of approximately 30 articles, it is difficult to resolve all issues related to international transactions by only 30 articles. Accordingly, the issue becomes whether the domestic tax law can be applied to matters which are not provided in a tax treaty and the treaty shopping activities can be regulated by the anti-avoidance rule of domestic tax law even in case where a tax treaty has no anti-avoidance rule.

The position supporting the application of domestic tax law is based on the fact that the purpose of a tax treaty lies in the prevention of double taxation and tax evasion and OECD Model Commentaries allow the application of domestic anti-avoidance rule.

On the other hand, the position objecting to the application of domestic tax law is based on the Vienna Convention which provides “Every treaty in force is binding upon the parties to it and must be performed by them in good faith.” and “A party may not invoke the provisions of its internal law as justification for its failure to perform a treaty.” Thus, it is necessary to analyze the related issue in more depth in order to seek out a reasonable solution to the controversial problem.

Where a certain contracting state wants to effectively prevent the treaty shopping activities through the roundabout transactions, it should insert the anti-avoidance rules into every treaty. However, it is not practically possible to immediately amend all treaty tries with other contracting states and thus there is a necessity of inserting a well-organized anti-avoidance rule into a domestic tax law. The problem is that if one contracting state does so, the other contracting states can argue that it is a treaty override. Thus, the international community should establish a principle of ascertaining the treaty override legislation in order to prevent the taxing rights dispute between contracting states. Here is a necessity of discussion.

Although a treaty override is normally recognized the exclusion of a treaty by the new domestic legislation, its concept has not been clearly established. Accordingly this thesis establishes the clear concept of a treaty override by analyzing the cases which come under a treaty override and gropes for a reasonable solution to this matter.

II. Review of Issues

1. Domestic Law and Tax Treaty

In establishing the relationship between a treaty (international law) and a domestic law, the monism treats a treaty as a part of national legal system whereas the dualism treats a treaty as a legal system distinguished from national legal system. Meanwhile, a treaty is classified into either a self-executing treaty which can be executed without a separate special legislation or a
non-self-executing treaty which needs a separate special legislation for execution as in the United States.\(^2\)

Accordingly, although it might be necessary to handle these kinds of issues when discussing the relationship between a domestic law and a tax treaty, this paper will focus only on problems taking place in relation to the interpretation of a tax treaty.

“International agreements, like a domestic law, require interpretation. The need for interpretation can arise from a difference of opinion between the contracting States; the agreement will then be interpreted by these States, or, if they have subjected themselves to its jurisdiction in general or for a particular case, by the International Court of Justice. Questions of interpretation with regard to application of a treaty can also arise, however, before domestic administrative authorities or courts.”\(^3\)

Whether or not domestic tax law can be applied in interpreting a tax treaty in case where the tax treaty does not provide otherwise often becomes an issue. This is because a tax treaty normally consists of around 30 articles whereas a domestic tax law has much more detailed provisions which can resolve related issues.

Since the form of international transactions is becoming more complex and diverse, and a tax treaty does not provide a satisfactory solution to tax disputes between taxpayers and tax authorities, we need to study how to resolve this matter.

Each country secures the fiscal revenue based on its own domestic tax law. Accordingly, where a multinational enterprise performs business activities in its own country and foreign countries, the enterprise is subject to the tax laws of its own country and foreign countries.

Where a U.S. multinational enterprise (A) which has a branch (B) in Korea realizes $700,000 of income in the U.S. and B $300,000 of income in Korea, but for the Korea-US tax treaty, A should pay the U.S. government $350,000 of tax for $1,000,000 ($700,000 + $300,000) and B the Korean government $90,000 of tax for $300,000 of Korean taxable income.\(^4\) As a result, A makes a double payment to both the governments for $300,000 of Korea source income. However, since Korea and the U.S. concluded a tax treaty of which the purpose is to prevent double taxation, A is entitled to $90,000 of tax credit\(^5\) from the US government and gets free from double taxation.

If the U.S. and Korea respectively exercise its taxing rights as in the above example, a taxpayer is subject to double taxation and as a result international transactions shrink. Accordingly, each country resolves a double taxation problem by concluding a tax treaty.

The above example is just a simple one related to double taxation. Where a multinational

\(^2\) See Kristen B. Rosati, The United Nations Convention against Torture: A Self-Executing Treaty that Prevents the Removal of Persons Ineligible for Asylum and Withholding of Removal, 26 DENV. J. INT’L & POL’Y 533, 553 (1998). (“The Supremacy Clause of the Constitution declares that treaties are of equal stature to other federal laws. The federal courts, however, have long held that an individual may not enforce a treaty in U.S. courts unless the treaty provision being applied is ‘self-executing’, so that legislation is not required to implement the treaty rights. Whether a treaty provision is self-executing is an exceedingly confusing area in federal law which has spurred inconsistent cases and a great deal of academic commentary.”).

\(^3\) See VOGEL ET AL., KLAUS VOGEL ON DOUBLE TAXATION CONVENTIONS 33 (3rd ed. 1999).

\(^4\) The tax amount is calculated under the assumption that US corporate tax rate is 35% and Korean corporate tax rate is 30%.

\(^5\) Under the assumption that tax credit is within the limitation.
enterprise performs transactions across contracting states, it will face more complex and diverse tax issues surrounding the cross-border transactions.

That is, there arise numberless issues such as “whether an enterprise in issue comes under a resident” and “how to define and tax a permanent establishment, immovable property income, business income, and royalty, etc.”

Accordingly, it is difficult to resolve all the issues only by a tax treaty which consists of approximately 30 articles. What is more, since domestic tax laws of contracting states are different from each other, the problem becomes more complex.

The problems related to the execution of a tax treaty can be classified into three kinds of pattern as follows: 1) a problem related to the interpretation of terms used in the article of a tax treaty, 2) a problem related to the interpretation of tax treaty provisions, and 3) a problem related to applying a domestic tax law (such as anti-avoidance rule) to what is not provided otherwise in a tax treaty.

Of course, the interpretation of a treaty term is covered by the interpretation of treaty provisions. However, since a tax treaty normally mentions only how to interpret a tax treaty term but does not make any reference to the interpretation of tax treaty provisions, the interpretation of a tax treaty term is set forth distinguished from the interpretation of a tax treaty provision. As discussed later, the interpretation of a term and a provision would not normally lead to the treaty override issue.

2. Interpretation of Tax Treaty Terms

Which meaning must be given to the term which is not provided otherwise in a tax treaty often leads to a tax dispute.

Thus, Paragraph 2, Article 2 of OECD Model Tax Convention provides “As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State over a meaning given to the term under other laws of that State.”

Paragraph 2, Article 2 of the Korea-U.S. tax treaty also provides “Any other term used in this Convention and not defined in this Convention shall, unless the context otherwise requires, have the meaning which it has under the laws of the Contracting State whose tax is being determined. Notwithstanding the preceding sentence, if the meaning of such a term under the laws of one Contracting State is different from the meaning of the term under the laws of the other Contracting State, or if the meaning of such a term is no readily determinable under the laws of one of the Contracting States, the competent authorities of the Contracting States may, in order to prevent double taxation or to further any other purpose of this Convention, establish a common meaning of the term for the purpose of this Convention.”

Accordingly, the term which is not provided in the tax treaty can be interpreted as the meaning which it has under the laws of a contracting state. However, where the meaning of a term cannot be easily interpreted based on the laws of a contracting state and the laws of both contracting states define the same term differently from each other, how to interpret this term can become an issue. In this case, it would be a desirable solution to resolve this matter through mutual
Let’s make an example for the purpose of explanation. A Korean businessman X is doing business in both Korea and the U.S. X stays in Korea for 6 months and in the U.S. for 6 months for his business. Thus, the residency judgment problem of whether X must be treated as a U.S. resident or a Korean resident takes place in terms of taxation.

Paragraph 1, Article 3 of the current Korea-US tax treaty provides “The term ‘resident of the United States’ means (i) a United States corporation and (ii) any other person resident in the United States (except a corporation or an entity treated under United States law as a corporation) for purposes of its tax, and the term ‘resident of Korea means ‘(i) a Korean corporation and (ii) any other person resident in Korea for purposes of its tax (except a corporation or any entity treated under Korean law a corporation).”

Since the Korea-U.S. tax treaty requires the concept of an individual resident to be determined according to the domestic tax law of both contracting states, whether the Korean or U.S. domestic tax law must be applied in determining X’s residency status becomes an issue. What is more, the fact that the Korean income tax law applies a different standard from the U.S. income tax law in determining the individual residency makes a problem more complex.

Paragraph 1, Article 1 of the Korean Income Tax Law provides “An individual who has domicile in Korea or abode for more than one year shall be a Korean resident.”

Article 2 of the Presidential Decree, the Korean Income Tax Law provides “The domicile shall be determined based on the objective facts such as a family living together and a property situated in Korea, and the abode shall be the place where an individual stays for a substantial period but does not lead a normal life unlike a domicile.”

Also it provides “Where an individual who resides in Korea has i) an occupation which requires more than one year of continuous stay in Korea or ii) has a family living together and is judged to reside for more than one year in light of his occupation and property, he shall be treated as having a domicile in Korea.”

On the other hand, Section 7701(b) of the U.S. Internal Revenue Code treats an alien individual as a U.S. resident where such an individual is i) lawfully admitted for permanent residence, or ii) meets the substantial presence test, or iii) makes a first year election.

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6 See U.S. MODEL INCOME TAX CONVENTION art. 3, para. 2., Tech. Exp. (2006). (“…If the meaning of a term cannot be readily determined under the law of a Contracting State, or if there is a conflict in meaning under the laws of the two States that creates difficulties in the application of the Convention, the competent authorities, as indicated in paragraph 3(f) of Article 25 (Mutual Agreement Procedure), may establish a common meaning in order to prevent double taxation or to further any other purpose of the Convention…”)

7 With increase of commerce and sports & cultural exchange, the double residency problem of businessmen, athletes and artists will continue to increase.

8 Treas. Reg.§301.7701(b)-1(b)(1). (1992). (“Under this standard called ‘green card test’, a lawful permanent resident is an individual who has been lawfully granted the privilege of residing permanently in the United States as an immigrant in accordance with the immigration laws. Resident status is deemed to continue unless it is rescinded or administratively or judicially determined to have been abandoned.”).

9 An individual meets the substantial test with respect to any calendar year if i) such individual was present in the United States on at least 31 days during the calendar year, and ii) the sum of the number of days on which such individual was present in the United States during the current year and the 2 preceding calendar years (when multiplied by the applicable multiplier: current year – 1, 1st preceding year – 1/3, 2nd preceding year – 1/6) equals or exceeds 183 days.
Therefore, if the Korean businessman X meets the requirements of both the Korean tax law and the U.S. tax law at the same time, \(^{10}\) X becomes a resident of both Korea and the U.S. at the same time and as a result both contracting states will try to exercise their taxing rights resulting in double taxation. In this case, this problem should be resolved according to the tie-breaker rule (Paragraph 2, Article 3 of the Korea-U.S. tax treaty)\(^ {11}\).

As set forth in the above example, where a tax issue occurs in relation to the interpretation of a term, this issue can be resolved by applying the standard provided in Paragraph 2, Article 3 of the OECD Model Tax Convention and the related tax treaty. Furthermore, although there could be a practical difficulty with regard to the interpretation of a term, it would be still possible to find out a reasonable solution to this issue.

### 3. Interpretation of Tax Treaty Provisions

As already set forth above, the problems occurring in relation to the interpretation of tax treaty terms may be resolved by what is provided in the tax treaty. Then, how to resolve a conflict related to the interpretation of tax treaty provisions other than tax treaty terms becomes an issue.

Paragraph 2, Article 3 of the OECD Model Tax Convention provides a guideline as to how to interpret the terms of a tax treaty but does not mention anything concerning how to interpret the provisions of a tax treaty.

Commentary 3 on Introduction of the 2005 OECD Model Tax Convention emphasizes that “Member countries, when concluding or revising bilateral conventions, should conform to this Model Convention as interpreted by the Commentaries thereon and having regard to the reservation contained therein and their tax authorities should follow these Commentaries, as modified from time to time and subject to their observations thereon, when applying and interpreting the provisions of their bilateral tax conventions that are based on the Model Convention.”

“When drafting the 1977 Model Convention, the Committee on Fiscal Affairs examined the problems of conflicts of interpretation that might arise as a result of changes in the Articles and Commentaries of the 1963 Draft Convention. At that time, the Committee considered that existing conventions should, as far as possible, be interpreted in the spirit of the revised Commentaries, even though the provisions of these conventions did not yet include the more precise wording of the 1977 Model Convention. It was also indicated that Member countries wishing to clarify their positions in this respect could do so by means of an exchange of letters between competent authorities in accordance with the mutual agreement procedure and that, even in the absence of such an exchange of letters, these authorities could use mutual agreement.

\(^{10}\) If \(X\) stays 180 days every year in the United States during the 3 consecutive years, \(X\) stays total 271 days in the United States for 3 years (180 days in the current year, 61 days in the 1\(^{st}\) preceding year, 30 days in the 2\(^{nd}\) preceding year) and becomes a US resident according to the US tax law.

\(^{11}\) Where by reason of the provisions of paragraph (1) an individual is a resident of both Contracting States: (a) He shall be deemed to be a resident of that Contracting State in which he maintains his permanent home; (b) If he has a permanent home in both Contracting States or in neither of the Contracting States, he shall be deemed to be a resident of that Contracting State with which his personal and economic relationships are closest (center of vital interests); (c) If his center of vital interests is in neither of the Contracting States or cannot be determined, he shall be deemed to be a resident of that Contracting State in which he has a habitual abode; (d) If he has a habitual abode in both Contracting States or in neither of the Contracting States, he shall be deemed to be a resident of the Contracting State of which he is a citizen; and (e) If he is a citizen of both Contracting States or of neither Contracting States the competent authorities of the Contracting States shall settle the question by mutual agreement. For the purpose of this paragraph, a permanent home is the place where an individual dwells with his family.
procedures to confirm this interpretation in particular cases.”\textsuperscript{12}

“Needless to say, amendments to the Articles of the Model Convention and changes to the Commentaries that are a direct result of these amendments are not relevant to the interpretation or application of previously concluded conventions where the provisions of those conventions are different in substance from the amended Articles. However, other changes or additions to the Commentaries are normally applicable to the interpretation and application of convention concluded before their adoptions, because they reflected the consensus of the OECD Member countries as to the proper interpretation of existing provisions and their application to specific situations.”\textsuperscript{13}

Reflecting this purport, Paragraph 3, Article 25 of the OECD Model Tax Convention provides “The competent authorities of the Contracting States shall endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.”

Also, Paragraph 2, Article of the Korea-U.S. tax treaty provides “The Competent authorities of the Contracting States shall endeavor to resolve by mutual agreement any difficulties or doubts arising as to the application of this Convention. In particular, the competent authorities of the Contracting States may agree – (a) to the same attribution of industrial or commercial profits to a resident of the Contracting States and its permanent establishment situated in the other Contracting State; (b) to the same allocation of income, deductions, credits, or allowances between a person subject to the taxing jurisdiction of one of the Contracting States and any related person; (c) to the same determination of the source of particular items of income; (d) to the uniform accounting for income and deductions; or (e) to the same meaning of any term used in this Convention.”

Thus, competent authorities of contracting states can resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of a tax treaty and refer to the commentaries of the OECD Model Tax Convention or the technical explanations of the US Model Tax Convention in the case of a tax treaty with the United States. Of course, the court should refer to the OECD Model or the U.S. Model in interpreting tax treaties.\textsuperscript{14}

Let’s take an example to understand this mechanism. A Korean auto maker X sells the Korea-made automobiles in the United States through a U.S. subsidiary Y (distributor). A U.S. company Z makes a lawsuit against Y claiming that Y infringed upon Z’s patent right. Z contends that since X’s certain auto part was made in violation of Z’s patent right and Y sells X’s automobiles in the United States, Y infringed upon Z’s U.S. patent right. For the purpose of compromise, X which used Z’s patent in the manufacturing process agreed with Z to bear all expenses which are to be borne by its subsidiary Y.

\textsuperscript{12} See Commentary 33 on Introduction of the OECD Model Tax Convention (2005).
\textsuperscript{13} See Commentary 35 on Introduction of the OECD Model Tax Convention (2005).
\textsuperscript{14} See Michael Dezsi, \textit{U.S. Taxation of International E-Commerce: The Organization for Economic Cooperation and Development's New Commentary to its Model Tax Convention Redefining Permanent Establishment}, 79 U. Det. Mercy L. Rev. 123, 147 (2001). (“A nonresident alien having income effectively connected with a U.S. trade or business may look to a bilateral tax treaty for relief from double taxation. If the alien's country of residency has entered into a bilateral tax treaty (similar to the OECD’s Model Tax Convention) with the United States, then U.S. taxing authority may extend only if the alien (or foreign corporation) has a permanent establishment in the United States. The income that is produced from the permanent establishment is subject to U.S. taxation under Article 7 of the OECD’s Model Tax Convention. To determine if the alien has a permanent establishment, courts have used the commentary to the convention as persuasive authority.”).
The U.S. tax authority contends that the source of income is within the US since the patent right was infringed in the United States whereas the Korean tax authority asserts that the source of income is within Korea because a parent company X used the patent right in Korea. The U.S. tax authority further asserts that the source of income must be determined based on the place of patent registration (the U.S.).

However, given the fact that a parent company X used the patent right in Korea and made an actual royalty payment for the patent right, if the Korean tax authority cannot exercise its taxing right (right to withhold tax) against the royalty payment, it will result in a tax treaty and a tax law being overridden by the patent law. A patent law cannot override a tax treaty and a tax law in terms of hierarchy as far as a tax matter is concerned. This is because a tax treaty and a tax law must have priority over other laws in resolving tax matters.

Paragraph 3, Article 6 of the Korea-U.S. tax treaty provides “Royalties described in paragraph 4 of Article 14 (Royalties) for the use of, or the right to use, property... described in such paragraph shall be treated as income from sources within one of the Contracting States only if paid for the use of, or the right to use, such property within that Contracting State.”

Accordingly, in order to resolve this problem relating to the interpretation of tax treaty provision, both tax authorities should determine the meaning of phrases such as “the use of, or the right to use such property within that Contracting State” and “only if paid for the use, or the right to use” based on the Korea-US tax treaty itself, the U.S. Model technical explanations and the OECD Model commentaries, and refer to the domestic tax law of Korea or the United States if necessary.15

4. Application of Domestic Anti-Avoidance Rule to Tax Treaty

With the increase of international transaction, the treaty shopping activities using the loopholes of a tax treaty have greatly increased and there is a great diversity of global community opinions concerning how to establish the relationship between a tax treaty and a domestic law in terms of tax treaty enforcement to prevent these activities. Thus, it is necessary to review the related issues and seek out a solution to this matter.

A. Opinions of Global community16

Klaus Vogel17 is of the following opinion:

“Being restricted to cross-border taxation of residents of the two contracting States, tax treaties are equivalent to special legislation (lex speciales) compared to the contracting States’ general tax law (lex generalis). Thus according to the old rule “Lex specialis derogat legi generali” (“Special legislation overrides general legislation”), treaties override the domestic tax law that is effective at the time of their implementation. Under a supplementary rule of “Lex posterior generalis non derogat legi priori speciali” (“Later general legislation does not overrule earlier special legislation”), changes of domestic tax law normally will not affect existing treaties. This

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15 Since the U.S. Model was made based on the U.S. domestic tax law, there is a necessity to refer to the U.S. domestic tax law when interpreting the Korea-U.S. tax treaty.
16 The below contents were excerpted from “Tax Treaties and Domestic Law” which was based on the presentations made at the Tax Treaties and Domestic Law seminar held in Milan on November 21, 2005 and was edited by professor Gulielmo Maisto.
17 Professor Emeritus, University of Munich.
later rule does not apply, however, if the legislator, when changing the general law, expressly or implicitly intended to repeal the special law. General law then overrules the special (domestic) legislation. A legislation that contradicts an existing international treaty, however, is a violation of international law.”

Jan Wouters\(^{18}\) and Maarten Vidal\(^{19}\) took the following position:

“Even if a tax treaty override is perfectly lawful under the municipal law of the overriding State, and even if there are good economic reasons for it, it is very likely that the application of this legislation will be unlawful under international law. Hence, the overriding State’s international responsibility will be incurred unless circumstance precluding wrongfulness can be demonstrated. These circumstances are to be interpreted restrictively and have to be proven by the overriding State.”

Brain J. Arnold\(^{20}\) and Stef van Weeghel\(^{21}\) made a brief description of the 2003 changes to Commentaries of the OECD Model Tax Convention and commented those changes as they related to the relationship between tax treaties and domestic anti-avoidance rules. Especially they focused on Commentaries 7\(^{22}\), 9.1\(^{23}\), 9.5\(^{24}\) and 9.6\(^{25}\) on Article 1 in order to emphasize the necessity of applying domestic anti-avoidance rules.

Reuven S. Avi-Yonah\(^{26}\) took the following position:

“The U.S. treaty override practice can usually be defended as consistent with the underlying purpose of tax treaties, which is, as the OECD Report states, the prevention of both double taxation and double non-taxation: Tax treaties aim primarily at the avoidance of double taxation and the prevention of fiscal evasion but also have the objective of allocating tax revenues equitably between Contracting States. Thus, any interpretation achieving these objectives would be preferable to one leading double taxation or to an inappropriate double exemption.”\(^{27}\)

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\(^{20}\) Associated with Goodmans LLP, Toronto, and Visiting Professor, Harvard Law School.

\(^{21}\) Partner, Stibbe, Amsterdam and Professor of International Tax Law, University of Amsterdam.

\(^{22}\) “The principle purpose of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons. It is also a purpose of tax conventions to prevent tax avoidance and evasion.”

\(^{23}\) “This raises two fundamental questions that are discussed in the following paragraphs: whether the benefits of tax conventions must be granted when transactions that constitute an abuse of the provisions of these conventions are entered into; and whether specific provisions and jurisprudential rules of the domestic law of a Contracting State that are intended to prevent tax abuse conflict with tax conventions.”

\(^{24}\) “It is important to note, however, that it should not be lightly assumed that a taxpayer is entering into the type of abusive transactions referred to above. A guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favorable tax position and obtaining that more favorable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions.”

\(^{25}\) “The potential application of general anti-abuse provisions does not mean that there is no need for the inclusion, in tax conventions, of specific provisions aimed at preventing particular forms of tax avoidance. Where specific avoidance techniques have been identified or where the use of such techniques is especially problematic, it will often be useful to add to the Convention provisions that focus directly on the relevant avoidance strategy. Also, this will be necessary where a State which adopts the view described in paragraph 9.2 above believes that its domestic law lacks that anti-avoidance rules or principles necessary to properly address such strategy.”

\(^{26}\) Professor of Law, The University of Michigan.

\(^{27}\) See Richard L. Doernberg, Treaty Override by Administrative Regulation: The Multiparty Financing Regulations, Florida Tax Review, 2 Fla. Tax Rev. 521, 531-533 (1995). (“In a series of early cases, the Supreme Court ruled that under the Supremacy Clause, statutes and treaties have equal status. As a consequence, the Court reasoned, a treaty ‘may supersede a prior act of Congress, and an act of Congress may supersede a prior treaty.’ In the Internal Revenue
B. Necessity of Issue Analysis

a. Pros and Cons

Opinions of the global community concerning “treaty override” are broadly divided into pros and cons.

The opinion which supports the treaty override is based on that the purpose of a tax treaty is to prevent double taxation and fiscal evasion, and allocate tax revenues equitably between Contracting States. It also cites the Commentary of the OECD Model Tax Convention which allows the application of domestic anti-avoidance rules.29

The opinion which objects to the treaty override cites, as a ground of its objection, the Vienna Convention which provides “Every treaty in force is binding upon the parties to it and must be performed by them in good faith”30 and “A party may not invoke the provisions of its internal law as justification for its failure to perform a treaty.”31

The argument remains unresolved since two sides are as far apart as ever. Thus, it is necessary to perform an in-depth analysis on issues to get a reasonable solution to this matter.

b. Analysis of Issue

First of all, it is necessary to make clear the concept of “treaty override” in order to clarify the issue. Once we examine the current discussions by the global community, it seems that debaters treat the treaty override as nullifying a tax treaty.

   a). Domestic Tax Law Relating to Interpretation of Terms and Provisions of Tax Treaty

As discussed in “the interpretation of terms” and “the interpretation of tax treaty provisions” above, the domestic tax law of two contracting states affects the interpretation of a tax treaty regardless of whether it is related to the interpretation of terms or the interpretation of provisions.

Accordingly, whether or not applying domestic tax laws to the interpretation of tax treaty terms or provisions can be treated as a treaty override becomes an issue. As applying related domestic laws to the interpretation of tax treaty terms and provisions is allowed by the provision of a tax treaty itself, however, it cannot be treated as a treaty override.

Code, the doctrine of equal status is codified in section 7852(d)(1), which provides: ‘For purposes of determining the relationship between a provision of a treaty and any law of the United States affecting revenue, neither the treaty nor the law shall have preferential status by reason of its being a treaty or law.’ Section 7701(l) does not directly express a congressional intent to authorize an override. The provision does nothing more than grant authority to promulgate regulations necessary to prevent the avoidance of tax through conduit arrangements.”).28

28 The US treaty override cases include “branch profit tax”, “earnings stripping rule”, “multiparty financing regulation” and “reverse hybrid rule”, etc.

29 See Commentary 9.2 on Article 1 of the OECD Model Tax Convention (2005). (“...To the extent these anti-avoidance rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability, they are not addressed in tax treaties and are therefore not affected by them. Thus, as a general rule, there will be no conflict between such rules and the provisions of tax conventions.”).


31 Article 27 of the VIENNA CONVENTION (1969).
Even if there is an amendment of domestic tax law affecting the interpretation of tax treaty terms and provisions after the conclusion of a tax treaty, the possibility that the amended domestic law has a great effect on the current tax treaty is very low and the competent authorities of two contracting states can resolve an interpretation problem, if any, through the mutual agreement procedure.

b). Treaty Override

Then it is necessary to ascertain when and why a treaty override problem takes place. When the United States imposed the branch profit tax which was enforced in 1986, the United States government faced the criticism from contracting states that such legislation comes under a treaty override.

Before the enforcement of the branch profit tax, a foreign corporation which carried on its business through a U.S. branch in the United States had an obligation to pay only corporate income tax for profit realized by the U.S. branch but no obligation to pay dividend tax. However, after the U.S. government started to impose the branch profit tax, the tax burden of a foreign corporation which carries on its business through a U.S. branch has been increased whereas the taxing rights of a state in which the foreign corporation is situated has been decreased. Then it led to a dispute between contracting states. Thus, it is necessary to ascertain whether the enforcement of the branch profit tax rule made by the United States after the conclusion of a tax treaty comes under a treaty override.

Under the Internal Revenue Code Section 884(a), a tax equal to 30 percent of the dividend equivalent amount is imposed on any foreign corporation. IRC§884(e) provides “No treaty between the United States and a foreign country shall exempt any foreign corporation from the branch profit tax unless (i) such treaty is an income tax treaty and (ii) such foreign corporation is a qualified resident of such foreign country” and IRC§884(e)(4) provides “The qualified resident means, with respect to any foreign country, any foreign corporation which is a resident of such foreign country unless (i) 50 percent or more of the stock of such foreign corporation is owned by individuals who are not residents of such foreign country and who are not United States citizens or resident aliens, or (ii) 50 percent or more of its income is used to meet liabilities to persons who are not residents of such foreign country or citizens or residents of the United States.”

However, under the special rule for publicly traded corporations, a foreign corporation which is a resident of a foreign country shall be treated as a qualified resident of such foreign country if (i) the stock of such corporation is primarily and regularly traded on an established securities market in such foreign country, or (ii) such corporation is wholly owned by another foreign corporation which is organized in such foreign country and the stock of which is so traded. Further, under the special rule for corporations owned by publicly traded domestic corporations, a foreign corporation which is a resident of a foreign country shall be treated as a qualified resident of such foreign country if (i) such corporation is wholly owned by a domestic corporation and (ii) the stock of such domestic corporation is primarily and regularly traded on

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32 Let’s assume that a Korean corporation A does business in the United States through a U.S. branch B and realizes $100,000 of income. If the U.S. income tax rate is 35% and there is no other tax other than income tax, B pays $35,000 of income tax to the U.S. government and can remit the remaining $65,000 to A (Korean head office). However, if the U.S. government imposes the branch profit tax, A must pay 30% of branch profit tax on the remaining $65,000 to be remitted in addition to $35,000 of federal income tax.
an established securities market in the United States.\textsuperscript{34}

Under Reg.\$1.884-1(g)(3), the branch profit tax shall not be imposed on the portion of the dividend equivalent amount with respect to which a foreign corporation satisfies the requirements of paragraphs (g)(1) and (2) of this section for a listed country so long as the income tax treaty between the United States and that country, as in effect on January 1, 1987, remains in effect, except to the extent the treaty is modified on or after January 1, 1987, to expressly provide for the imposition of the branch profits tax. Korea is a listed country.

Thus, where a Korea corporation having a U.S. branch does not satisfy the above requirements, it is subject to 30\% of branch profit tax. When there was no branch profit tax rule, it was impossible to impose the branch profit tax since the Korea-U.S. tax treaty does not allow it. However, the enforcement of new tax rule made it possible to impose the branch profit tax unless a taxpayer satisfies the requirements.

The Korea and the United States concluded a tax treaty including Paragraph 1, Article 14 (Royalties) which provides “The tax imposed by one of the Contracting States on royalties derived from sources within that Contracting State by a resident of the other Contracting State shall not exceed 15 percent of the gross amount.”

Then what if Korea enforces a new domestic tax rule which fixes the tax treaty withholding tax rate at 20\% in order to equalize the limited withholding tax rate of existing tax treaties with all contracting states in terms of equity? If contracting states including the United States do not recognize this new rule, taxpayers will face double taxation. Thus, it is no doubt that the enforcement of the new rule which is against the existing tax treaties comes under a treaty override.

What if the United States government applies the new branch profit tax rule to a Korean branch in the United States after the conclusion of the Korea-U.S. tax treaty? Logic would be the same.

A Korean enterprise which is interested in the U.S. business should review the Korea-U.S. tax treaty and the U.S. domestic tax law before starting its U.S. business. Since a Korean enterprise starts its business under the belief that the Korea-U.S. tax treaty has priority over the U.S. domestic tax law, if the U.S. government taxes what has not been subject to taxation under the Korea-U.S. tax treaty by enforcing the new tax law, the Korean enterprise is subject to the double taxation.

If the Korean government does not acknowledge the taxation by the U.S. government, the Korean enterprise will be under the difficult situation. Also the taxation by the new tax law of the U.S. government will result in shrinking the taxing right of the Korean government which was not expected at the time of concluding the Korea-U.S. tax treaty.\textsuperscript{35}

The U.S. is of the opinion that since the U.S. government suggested the renegotiation of tax treaties with contracting states in relation to the enforcement of the branch profit tax, it did not

\textsuperscript{34} I.R.C.\$884(e)(4)(C) (1996).

\textsuperscript{35} If the U.S. government does not impose the branch profit tax upon a U.S. branch of a Korean enterprise, the Korean government will allow a foreign tax credit only against the corporate income tax paid in the U.S. by the Korean enterprise. On the other hand, if the U.S. government imposes the branch profit tax upon the U.S. branch, the Korean government should allow the foreign tax credit against both the corporate income tax and the branch profit tax, which will result in shrinking the taxing right of the Korean government.
come under treaty override. However, taking into consideration the provisions of the Vienna Convention which prohibits treaty override and the purport of tax treaty conclusion, it is not convincing.

The U.S. also emphasizes the necessity of branch profit tax in terms of “equity between a subsidiary and a branch”. Thus, it is necessary to review a problem taking place in the case of presenting “equity between a subsidiary and a branch” as a logical ground.

If the branch profit tax must be imposed upon U.S. branches in order to maintain the equity between a subsidiary and a branch in terms of prevention of fiscal evasion, the same taxation approach ought to be applied also to partnerships in terms of equity. That is to say, taxation at the level of both partnerships and partners should be made in order to maintain the equity policy. In this case, the U.S. government must nullify all related tax treaties with other states by adopting a new partnership taxation approach. Thus, it cannot be said that the U.S. position is reasonable.

“The prevention of fiscal evasion” is for prohibiting tax evasion activities which are not intended by a tax treaty. Thus, it must be distinguish from treaty override which nullifies a tax treaty through enforcement of a new domestic tax law which is not in accordance with the intention of a tax treaty.

The enforcement of the branch profit tax rule was effective for some states but not for other states. Thus, it was possible for a taxpayer to abuse a tax treaty of a state to which the branch profit tax rule cannot be applied and thus the U.S. government inserted a limitation-on-benefits provisions into the branch profit tax rule in order to prevent the abuse. The purpose of inserting is to complement the loopholes of the new branch profit tax rule.

In conclusion, the taxation through enforcement of a new tax item which is not allowed under a tax treaty could not be justified under any logic.

Although it is understood that the domestic legal principle of the United States adheres to the

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36 See GUGLIELMO MASTO, TAX TREATIES AND DOMESTIC LAW 75-76 (Vol.2, 2006). (“But a problem arose: many US tax treaties forbade taxing distributions from foreign corporations resident in a treaty country to their foreign shareholders even if the distribution came out of earnings of a US branch, and arguably the branch profits tax violated the spirit of this rule (although not its letter). So did the United States resort to treaty override? It did not. Instead, it announced that the branch profit tax would not apply to residents of those treaty countries until the treaties were renegotiated to permit the branch profit tax. In fact, by now most US treaties have been so renegotiated and other countries have adopted the branch profit tax in their own laws.”)

37 See Richard L. Doernberg, Legislative Override of Income Tax Treaties: The Branch Profits Tax and Congressional Abrogation of Authority, 42 TAX LAW. 173, 201 (1989). (“In the case of the branch profits tax, there can be no serious argument that section 884(c) is merely inconsistent with existing treaties. The provision on its face, supported by the legislative history, is clearly intended to override pre-existing treaty obligations. Moreover, there is little question that, as a matter of domestic law, Congress has the right to override pre-existing treaties. It should be noted that, although a subsequent act of Congress may supersede a provision of a prior treaty as domestic law, this 'does not relieve the United States of its international obligation[s] or the consequences of a violation. Moreover, the right to override does not make override right as a matter of policy.' ”)

38 The imposition of the branch profit tax by the U.S. government results in only transferring the taxing rights from the Korean government, which has jurisdiction over the Korean headquarters, to the U.S. government. This matter has nothing to do with treaty shopping activities by a taxpayer.

39 See Supra note 35, at 76. (“But this left the U.S. in a difficult position, because while treaties were slowly renegotiated, it could collect the BPT on some branches but not on others. At the time, there were not limitation-on-benefits provisions in US treaties, leading to a concern that there would be widespread treaty shopping (i.e., setting up a corporation in a treaty jurisdiction just to benefit from the treaty). So the US inserted a limitation-on-benefits provisions into the BPT rule in the Code and made that an explicit treaty override.”)
later-in-time rule, it is not desirable to put contracting states and taxpayers under a difficult situation by enforcing a new domestic tax law which is not accordance with the purport of a tax treaty. The treaty override legislation of the United States is confronted with a harsh criticism even in the United States. Therefore, given the fact that the United States is just a member of the global community, it would be reasonable that the later-in-time rule must be applied to only the domestic laws established in the United States.

c). Application of Domestic Anti-Avoidance Rule

As mentioned in the commentary of the OECD Model Tax Convention, the principal purpose of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons. It is also a purpose of tax conventions to prevent tax avoidance and evasions.

However, where there is no anti-avoidance rule in a tax treaty, a third party who is not a resident of both contracting states can enjoy the treaty benefit which is not intended by the tax treaty. Accordingly, whether a domestic anti-avoidance rule can be applied to this kind of treaty shopping activity has become a controversial issue.

The OECD Model Tax Convention basically takes a positive attitude toward the application of domestic anti-avoidance rules and explains its opinion concerning a domestic anti-avoidance rule as follows:

“To the extent these anti-abuse rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability, they are not addressed in tax treaties and are therefore not affected by them. Thus, a general rule, there will be no conflict between such rules and the provisions of tax conventions. Other states prefer to view some

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40 See Timothy S. Guenther, Tax Treaties and Overrides: The Multiple-Party Financing Dilemma, 16 VA. TAX REV. 645, 646-647 (1997). (“Courts have held that the definition of a treaty under the United States Constitution includes income tax conventions… Therefore, conflict can arise between a domestic statute and a treaty. To resolve this conflict, the courts have adopted an equal status doctrine, which holds that neither statutes nor treaties have more legal significance. Therefore, even though treaties and statutes are both “supreme,” Congress can enact legislation which will override a treaty. In addition, if a treaty is ratified subsequent to an inconsistent statute, the mere re-enactment of the statute will not override the treaty… To override a treaty by the re-enactment of a statute, Congress must clearly convey its intention to do so.”)

41 See Anthony C. Infanti, Curtailing Tax Treaty Overrides: A Call to Action, 62 U. Pitt. L. Rev. 677, 687 (2001). (“Congress’ failure to respect our treaty obligations harms the United States in a number of ways. First, each time it enacts a legislative override, Congress causes the United States to violate international law, damaging the United States’ reputation as a member of the global community as well as the international legal order itself. Second, because treaties are really no more than contracts between sovereign nations, legislative overrides erode the assurance of our treaty partners by undermining their expectation that the United States will remain faithful to its treaty obligations. Finally, legislative overrides harm U.S. citizens and residents who may wish to avail themselves of the benefits of tax treaties, because (i) concern with the congressional proclivity for enacting legislative overrides has led an increasing number of our treaty partners to insist upon a right to renegotiate or retaliate in the event of a legislative override, and (ii) the Department of the Treasury has indicated that “it is also becoming increasingly difficult to negotiate reciprocal concessions when the foreign government fears that the United States may unilaterally reverse the bargain by legislative action.”)."

42 See David Sachs, Is the 19th Century Doctrine of Treaty Overriding Good Law for Modern Day Tax Treaties, 47 TAX LAW. 867, 874 (1994). (“As might be expected, the Treasury Department, which has the principal responsibility for tax-treaty negotiation, has been opposed to the statutory override of such treaties. When the 1986 overrides were under consideration by Congress, then Secretary of the Treasury Baker wrote to the Chairman of the Senate Finance Committee urging Congress to give the Treasury time to renegotiate treaties rather than to override them. His request was not heeded.”)

43 With regard to the priority issue between a domestic tax law and a tax treaty, each state can take a different position. However, given the fact that a tax treaty is performing a function adjusting the difference of domestic tax laws of both contracting states, it would be desirable that a tax treaty has a priority over a domestic tax law in terms of securing an international order unless there is a special reason.
abuses as being abuses of the convention itself, as opposed to abuses of domestic law. These states, however, then consider that a proper construction of tax convention allows them to disregard abusive transactions, such as those entered into with the view to obtaining unintended benefits under the provisions of these conventions. This interpretation results from the object and purpose of tax conventions as well as the obligation to interpret them in good faith. Under both approaches, therefore, it is agreed that states do not have to grant the benefits of a double taxation convention where arrangements that constitute an abuse of the provisions of the convention have been entered into. It is important to note, however, that it should not be lightly assumed that a taxpayer is entering into the type of abusive transactions referred to above. A guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favorable tax position and obtaining that more favorable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions. The potential application of general anti-abuse provisions does not mean that there is no need for the inclusion, in tax conventions, of specific provisions aimed at preventing particular forms of tax avoidance. Where specific avoidance techniques have been identified or where the use of such techniques is especially problematic, it will often be useful to add to the convention provisions that focus directly on the relevant avoidance strategy. Also, this will be necessary where a state which adopts the view described in paragraph 9.2 above believes that its domestic law lacks the anti-avoidance rules or principles necessary to properly address such strategy.44

A tax treaty usually makes clear its purpose of preventing double taxation and fiscal evasion through a headline “A convention between X state and B state for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income...” Given the fact that the abuse of a tax treaty can give a third party, who is not a resident of either contracting state, a chance to enjoy the treaty benefit which was not initially intended by both contracting states and as a result infringe upon the taxing right of contracting states, although a tax treaty does not include anti-avoidance rules, it would desirable to allow the application of domestic anti-avoidance rules to a tax treaty in order to accomplish the purpose of a tax treaty.45

Especially since a tax treaty is normally effective for tens of years upon its conclusion and it is not easy to insert an anti-avoidance rule into a tax treaty whenever necessary considering the change of economic circumstance, there is a necessity of applying domestic anti-avoidance rules to a tax treaty.

What is more, when a multi-national enterprise starts its business in the other state, it can usually seek an advice on tax treaties and domestic tax laws from an expert. Thus, it wouldn’t be a problem to apply domestic anti-avoidance rules to a tax treaty.

Also, although the application of domestic anti-avoidance rules results in infringing on the taxing rights of contracting states, since competent authorities of contracting states could resolve this problem though the mutual agreement procedure, it wouldn’t be against the purpose of a tax treaty.

However, in order to minimize a tax dispute related to the interpretation of domestic anti-avoidance rules and promote international transactions, the domestic anti-avoidance rules must be clear and minute.

44 See Commentaries 9.2–9.6 on Article 1 of the 2003 OECD Model Tax Convention.
45 See JAE SOO LEE, A STUDY ON THE REGULATION OF ABUSE OF TAX TREATIES IN INTERNATIONAL LAW, 49 (Master’s Thesis of Sungkyunkwan University 2001). (“Article 17 of Protocol, the 1967 Germany and Belgium Tax Treaty allowed the application of domestic anti-avoidance rule.”).
III. Establishment of Reasonable Principle

As explained in “Interpretation of terms”, “Interpretation of tax treaty provisions”, “Treaty Override” and “Application of Domestic Anti-Avoidance Rule”, the interpretation of terms and tax treaty provisions is not related to the treaty override. Furthermore, the application of domestic anti-avoidance rule does not come under the treaty override since the OECD Model Tax Convention does acknowledge the application of domestic anti-avoidance rule.46

Therefore, it is necessary to establish a clear and reasonable principle to ascertain a true treaty override action as follows: Only where the legislation which comes under a treaty override action unilaterally infringes upon the taxing rights of other contracting state and significantly hampers the legal stability, must it be treated as a treaty override legislation which violates the Vienna Convention. On the other hand, where a newly established domestic tax law is applied in accordance with the purpose of a tax treaty, it must not be treated as the treaty override legislation.

If some states continue to do treaty override legislations under the later-in-time rule whereas other states respect the principle of treaty priority, the global community will continue to face with a dispute. Accordingly it is necessary to minimize tax disputes by establishing a clear and reasonable principle.47

IV. Review on the Existing Thesis

International learned circles have shown a deep interest in the treaty override matter. Korean learned circles have also continued to discuss “how to establish the interrelationship between a tax treaty and a domestic tax law” which is a hot issue, and Seoul National University of Korea published a doctoral thesis which intensively studied this matter in February 2007.48 As this topic is a very important matter relating to the development of the global community including Korea, it is necessary to study the meaning of desirable tax treaty policy by making a detailed analysis on the existing thesis.

1. Theoretical Ground of Tax Treaty Override by Domestic Law

Lee, Jae Ho (2007) presents, as a theoretical ground that a domestic law can override a tax treaty, i) US court cases, ii) treaty override legislation cases of several states and iii) Korean

46 See Richard L. Doernberg, Overriding Tax Treaties: The U.S. Perspective, 9 EMORY INT'L L. REV. 71, 74 (1995). (“In one sense, the OECD Commentary discusses the issue of treaty overrides in its discussion of the relationship between domestic law and treaty language. It may be more accurate, however, to say that it addresses the problem of treaty undermine rather than the problem of treaty override. Domestic legislation that does not directly violate a treaty should not be considered a treaty override. As the OECD points out, domestic legislation threatens to ‘empty a convention of some of its substance’ and, thus, undermine its application by seriously altering the balances struck when the treaty was negotiated. Nevertheless, undermining is not overriding. A treaty override occurs when a contracting state intentionally applies domestic law or regulation to accomplish specifically what a treaty forbids. In a 1989 Report on Tax Treaty Overrides, the OECD's Committee on Fiscal Affairs lists several types of possible overrides including interpretative, definitional, and inadvertent overrides as not being overrides at all, or as being, at most, overrides in a technical sense.”)

47 The further in-depth study on this matter must be made for the development of the global community.

treaty override legislation cases. Accordingly, in order to verify whether his assertion has a legal and theoretical ground, it must be analyzed and reviewed whether or not three items presented as a theoretical ground by this thesis are appropriate. Because it is an important matter, it is necessary to observe whether three grounds presented by the thesis’ author have an enough legal and theoretical justification.

2. US Supreme Court Cases

Lee, Jae Ho (2007) explains that “the US Supreme court has established a case law that a domestic law can override a treaty”, and presents as a theoretical ground that “i) a state has sovereignty, ii) treaties are of equal stature to other federal laws according to the US constitution, and iii) the judiciary lacks a judicial power to judge treaty override.” In order to support his assertion, he introduces the following cases:

- The Cherokee Tobacco, 78 U.S. (11 Wall) 618 (1870): (Tobacco Tax)
- Chew Heong v. United States, 112 U.S. 536 (1884): (Immigration)
- Head Money Cases, 112 U.S. 580 (1884): (Customs Duties)
- Whitney v. Robertson, 124 U.S. 190 (1888): (Customs Duties)
- Botiller v. Dominguez, 130 U.S. 238 (1889): (Ejectment)
- Case Chan Ping v. United States, 130 U.S. 581 (1889): (Immigration)
- Cook v. United States, 288 U.S. 102 (1933): (Customs Duties)

A. Problems of Approach

“The above US cases were determined in the 1880s and the US Supreme Court did not make any judgment concerning treaty override any longer after the 1880s.” The reason why this thesis cites “Cook v. United States 288 U.S. 102 (1933)” is that this case made a clear judgment concerning a condition that a domestic law can override a treaty unlike the cases in the 1880s.

Since the US Supreme Court clarified a condition of treaty override, the US Congress should clarify the intention of treaty override when making a law overriding a treaty. Thus, it could be said that the purport of the US Supreme Court judgment is to prevent rather than instigate a treaty override.

Unlike civil law countries which have a written law system, common law countries having a case law system have a merit of timely and flexibly resolving the legal problems related to the changing social and economic phenomena through the establishment of case laws. Thus, it is presumed that the US Supreme Court has not made a case law causing frictions with other countries since the 1880s considering the changing international circumstance.

49 Supra note 47, at i-v.
50 Supra note 47, at 52.
51 Supra note 47, at 52-53
52 Cook v. United States, 288 U.S. 102, 119-120(1933). (It held “Third, The Treaty was not abrogated by re-enacting section 581 in the Tariff Act of 1930 in the identical terms of the act of 1922. A treaty will not be deemed to have been abrogated or modified by a later statute, unless such purpose on the part of Congress has been clearly expressed.”)
53 That the U.S. congress must manifest the intention of treaty override at the time of legislation means that the U.S. congress ought to clarify a ground to justify treaty override at the time of legislation. Thus, if the ground of treaty override is not solid, the United States will face criticism from treaty partners and it will make the treaty override legislation more difficult.
The OECD Model Tax Convention came into being in 1963 and its 2005 version has been published after several revisions. And from 2003, it started to emphasize the necessity of tax avoidance & evasion and application of domestic anti-avoidance rules. The United States is an OECD member country and thus has an obligation to respect the commentaries of OECD Model Tax Convention which reflected the opinions of member countries. Accordingly, it is thought that the US Supreme Court will consider it when judging related issues.

Especially, a federal statute and a treaty enjoy equal status under the US Constitution and the US Constitution does not have any provision of justifying the override of a treaty by a domestic law. Accordingly, since whether or not a treaty has priority over a domestic law and vice versa is an issue which is a matter of legal construction as well as a matter of policy affecting the global community, it is expected that the US Supreme Court will continue to keep its existing position that the judiciary has no authority to judge a treaty override.

Thus, setting aside the appropriateness of the above US cases in terms of treaty override judgment, explaining the international tax matters currently occurring in the global community based on the above US cases and asserting, on based these cases, that Korea could also override a tax treaty by a domestic tax law can cause a problem in terms of an issue approach. What is more, most of major industrial countries have signed and ratified the Vienna Convention.

The United States signed but not ratified it yet. Thus, there might be a room for the United States to show a different view from other countries with regard to the execution of a treaty. Regardless of the ratification by the US Congress, however, the U.S. Department of State recognizes the Vienna Convention as the authoritative guideline to current treaty law and practice.

B. Customs Duties and National Taxes

The above US cases are related to customs duties, tobacco tax and immigration, etc. but not related to the execution of a tax treaty at all. If a tax treaty is overridden by a domestic law, there takes place a double taxation problem. However, as customs duties, tobacco tax and immigration are not related to a tax treaty, there cannot be a problem of double taxation and also they don’t infringe upon the taxing rights of contracting states.

54 U.S. CONST. art. VI. (“This Constitution, and the laws of the United States which shall be made in pursuance thereof; and all treaties made, or which shall be made, under the authority of the United States, shall be the supreme law of the land; and the judges in every state shall be bound thereby, anything in the Constitution or laws of any State to the contrary notwithstanding.”)

55 See JAMES J. FREELAND ET AL., FUNDAMENTALS OF FEDERAL INCOME TAXATION, 24 (1994). (“In the hierarchy of laws in the United States, a federal statute and a treaty enjoy equal status. Treaties made under the authority of the United States are the supreme law of the land, along with laws made in pursuance of the Constitution and the Constitution itself. Consequently, a tax treaty, of which we now have many can supersede a provision of the Internal Revenue Code.”).

56 Of course there could be a necessity of reviewing the past US cases from the historical perspective.

57 See Robert Thornton Smith, Tax Treaty Interpretation by the Judiciary, 49 TAX LAW. 845, 852 (1996). (“In May, 1969, at Vienna, a United Nations Conference adopted, and opened for signature, the Vienna Convention. The Vienna Convention came into effect when the thirty-fifth country ratified it in January 1980. Most of the major industrial countries have signed the agreement. In 1971, the President of the United States transmitted the Vienna Convention to the Senate for its consent to ratification, but the Senate has not yet done so.”).

58 See BARRY E. CARTER ET AL., INTERNATIONAL LAW 111 (2nd ed. 1995). (“Since the Vienna Convention is largely, though not entirely, a codification of the existing customary international law of treaties, it constitutes a useful depository of international legal rules even for countries, like the United States, which are not yet parties to it. So, for example, the U.S. Department of State recognizes the Vienna Convention as ‘the authoritative guide to current treaty law and practice.’ Similarly, the Restatement of the Foreign Relations Law of the United States (Revised) ‘accepts the Vienna Convention as presumptively codifying the customary international law governing international agreements.’”).

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Therefore, it would be difficult to award a legal and logical justification to asserting that a tax treaty can be overridden by Korean domestic tax laws based on the US cases related to a commercial treaty or agreement having a quite different character from a tax treaty.

3. Ascertainment of Tax Treaty Override Legislation

Lee, Jae Ho (2007) introduced the legislation examples of principal countries in order to assert that a domestic tax law can override a tax treaty. Thus, it is necessary to observe whether or not there were actually the examples of treaty override legislation in these countries as he asserts.

A. England

Lee, Jae Ho asserts that the section 62 of the Finance (No 2) Act which was established in 1987 in order to reverse the decision of Padmore v. IRC (a case related to partnership) comes under the treaty override legislation.59

However, this case handled an interpretation problem related to partnership taxation and the U.K. Congress established the Finance (No 2) Act judging that the court’s judgment has an interpretation flaw. The purpose of this newly established Finance Act is to establish the standard of interpretation concerning the Arrangement (i.e., a kind of tax treaty) with the States of Jersey (“the Jersey Arrangement”) other than override the effect of the Jersey Arrangement. Thus, it cannot be said that this Finance Act comes under the tax treaty override legislation.60

Let’s review the principal contents of this case for clear understanding again.

Mr. Padmore, a UK resident, is a partner of Computer Patent Annuities (“CPA”). The U.K. Inland Revenue taxed the income which Mr. Padmore received as a partner of CPA from 1976 to 1987.

Mr. Padmore asserted that he as a resident of the U.K. was entitled to exemption from income tax in respect of his share of profits as a partner in CPA for the years 1976-1987.

CPA is a partnership, or series of partnerships, first established in Jersey on the 1st April 1969. It has carried on the businesses of furnishing a world-wide renewals service in connection (since it was established) with letters patent and (since 1976) with trade marks and other equivalent forms of incorporeal property. There are some 297 partners, of whom 223 are partners or employees in various firms of patent and trade mark agents practicing in the United Kingdom and resident and domiciled in the United Kingdom for tax purposes. The business of CPA has always been carried on from its offices in Jersey and its day-to-day business is dealt with by three managing partners who are Jersey residents.

Mr. Padmore claimed that under section 497(1)(a) of the 1970 Act those profits were exempt from United Kingdom income tax by virtue of paragraph 3(2) of the Jersey Arrangement as there were the profits of a Jersey partnership, and that he could not therefore be taxed in the United Kingdom on his share of those profits.

Paragraph 3(2) of the Jersey Arrangement read as follows: “(2) The industrial or commercial

59 Supra note 47, at 149-151.
60 Since a tax treaty normally consists of approximately 30 articles, there can always exist a conflict of opinion surrounding the interpretation of a tax treaty.
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profits of a Jersey enterprise shall not be subject to United Kingdom tax unless the enterprise is engaged in trade or business in the United Kingdom through a permanent establishment situated therein.”

On the 1st December 1986 the court allowed Mr. Padmore’s appeal. The court’s decision prompted the Government of the day to promote legislation to remove the exemption exploited by Mr. Padmore. As is reported in Hansard, the Financial Secretary in proposing clause 62 of the Finance (No 2) Bill 1987, later enacted as section 62 of the 1987 Act, stated that its purpose was: “to restore the general understanding of the law to what it was before a decision of the High Court last December in a case involving foreign partnerships. That case was [Padmore] similar decisions might well have been made in the case of several of our double taxation agreements.”

To this end section 62 was inserted into section 153 of the 1970 Act as follows:

“In any case where -- (a) a person resident in the United Kingdom (in this subsection and subsection (5) below referred as “the resident partner”) is a member of a partnership which resides or is deemed to reside outside the United Kingdom, and (b) by virtue of any arrangements falling within section 497 of this Act (double taxation relief) any of the income or capital gains of the partnership is relieved from tax in the United Kingdom, the arrangements referred to in paragraph (b) above shall not affect any liability to tax in respect of the resident partner’s share of any income or capital gains of the partnership.”

In the above case, the U.K. Government exercised its taxing rights over the income which Mr. Pardmore received from a partnership in Jersey. However, since paragraph 3(2) of the Jersey Arrangement provides that the industrial or commercial profits of a Jersey enterprise shall not be subject to United Kingdom tax unless the enterprise is engaged in trade or business in the United Kingdom through a permanent establishment situated therein, whether or not the United Kingdom Government has a taxing rights on this income became an issue. That is to say, how to interpret the Jersey Arrangement became a focus of tax dispute.

In the present case, the court judged that since a partnership in Jersey didn’t carry on its business through a permanent establishment in the United Kingdom, the United Kingdom Government cannot tax Mr. Padmore who is a partner of CPA partnership as a U.K. resident.

In fact, i) taxation on the income which a partnership in Jersey acquires from the U.K. is a quite different problem from taxation on a U.K. partner’s income, which is distributed by a Jersey partnership, by the U.K. Government. The U.K. Government had overridden the High Court’s decision by establishing a new statute in order to restore the general understanding of the law to what it was before a decision of the High Court. Thus, we cannot say that there was a tax treaty override since the new law was made in order to override the High Court’s decision (interpretation), but not a tax treaty.

B. Germany

a. Article 20(2) of International Transactions Tax Act (Aussensteuergesetz; ASitG)

“In 1992, Germany newly established Articles 10(6), 20(2) and (3) of AStG of which the legislation purport is to prevent the treaty shopping activities of capital investment. At that time, according to the Germany-Ireland Tax Treaty, interest and dividend which a Germany company
derives from its Ireland subsidiary or permanent establishment are exempted from taxation in Germany. Thus, German companies, especially banks, started to make an investment through Ireland in order to get the benefit of Germany-Ireland treaty and the Germany parliament established these new Articles to prevent such an investment through Ireland for the purpose of deterring revenue loss. The new rules of ASTG focused on two mechanisms. One is to treat the profit of an overseas subsidiary established in Ireland as the dividend of a Germany parent company by applying the Germany CFC rule to an overseas capital investment company which enjoys the tax exemption benefit by a tax treaty and tax the profit in Germany. Another is not to award the tax exemption benefit by a tax treaty in case of an overseas permanent establishment but allow a foreign tax credit in case where the overseas permanent establishment is actually involved in the capital investment activity. Thus, although an overseas entity enjoys a tax treaty benefit in Ireland, it is subject to taxation in Germany and as a result all the tax exemption effect in Ireland is absorbed by the German Government.61

As set forth in the above “Establishment of Reasonable Principle”, since the new rules of ASTG does not affect the taxing rights of Ireland Government, it cannot be said that the establishment of these new rules comes under a true treaty override case. The German Government also asserted that the new legislation should be justified since these new rules are intended to prevent treaty shopping activities.

b. Article 50(d) of Income Tax Act (Einkommensteuergesetz; EStG)

“Article 50(d)(1)(a) of EStG came into force in order to prevent treaty shopping activities in 1994. According to this rule, a foreign corporation (a non-resident) which comes under certain conditions cannot claim the limited tax rate benefit awarded by a tax treaty and the conditions are as follows: i) Where a shareholder is not entitled to tax relief when he/she directly receives income, ii) Where a non-resident uses a foreign corporation without economic and other justifiable reason, iii) a non-resident does not perform inherent business activities. After that, the German Government newly established Articles 43 and 50(a)(4) of EStG to withhold taxes by applying a domestic tax rate in spite of the limited tax rate by a tax treaty with regard to the investment income which is paid to a non-resident, and introduced an “advance exemption application” and “refund application after review” system.62

As Article 50(d)(1)(a) of EStG is intended to prevent tax avoidance activities by applying a domestic tax law to what is not provided in a tax treaty, it is judged that this rule can be justified according to the OECD opinion. However, Articles 43 and 50(a)(4) of EStG enforced the application of tax rate by a domestic tax law in spite of the limited tax rate by a tax treaty. Thus, it would come under a true treaty override case.63

C. France

“According to Article 55 of the France Constitution, a treaty or an agreement ratified or approved according to legal procedure has priority over general laws upon its proclamation.”64 Thus, a law cannot override a tax treaty in France.

61 Supra note 47, at 159-160.
62 Supra note 47, at 160-161
63 Article 98-5 of the Korean Corporate Tax Law will be set forth to the same effect infra.
64 Supra note 47, at 163
D. Japan

“Majority opinion in Japan is that a treaty has priority over a law. Thus, where a treaty collides with a law, the law is nullified. Since Japan has a treaty priority principle in terms of constitutional interpretation, a later-in-time domestic law cannot override a treaty and there were no such legislation cases in Japan.”

E. Swiss

“According to Article 5 of the Swiss Constitution, an international law has priority over a domestic law.”

Paragraph 1, Article 1 of the Decree provides “Reduction of tax withheld at source (hereinafter referred to as 'tax relief') granted by the other Contracting State in an international convention for the avoidance of double taxation concluded by the Swiss Confederation (hereinafter referred to as 'tax convention') shall not benefit persons not entitled to such reduction under the tax convention (hereinafter referred to as 'persons not entitled to a tax convention')” and Paragraph 2 provides “The use of a tax relief shall be deemed improper: (a) if the requirements specified in the tax convention, such as residence (domicile or registered office) in Switzerland, beneficial ownership, tax liability, etc., are not fulfilled; (b) if it constituted an abuse.”

“Subparagraph 1, Paragraph 2, Article 2 of the Decree provides ‘A tax relief is claimed abusively by an individual, a legal person or a partnership resident in Switzerland if, through such claim, a substantial part of the tax relief would benefit, directly or indirectly, persons not entitled to a tax convention’ and Subparagraph 2 provides ‘In particular, a tax relief is claimed abusively if it relates to any income (a) a substantial part of which is used, directly or indirectly, to satisfy the rights or claims of persons not entitled to a tax convention; as a rule, income used to write off assets the equivalent of which has accrued or is accruing, directly or indirectly, to persons not entitled to a tax convention is deemed to be income used to satisfy rights or claims; (b) which benefits a legal person resident in Switzerland, in which persons not entitled to a tax convention have, directly or indirectly, a substantial interest by way of participation in the financial structure or otherwise, and which does not make appropriate profit distributions; (c) which benefits, by virtue of a fiduciary relationship, a person not entitled to a tax convention; (d) which benefits a family foundation resident in Switzerland or a partnership resident, but not carrying on business, in Switzerland, in which persons not entitled to a tax convention are substantially interested.”

Thus, since the Decree by the Swiss Federal Council is established in accordance with the purpose of a tax treaty in order to complement what is not provided in a tax treaty, it can be said that it does not conflict with a tax treaty and come under a true treaty override case.

F. Denmark

“For the prevention of double taxation, the past Denmark domestic tax law calculated the exemption amount based on the gross income. However, there took place tax-avoidance
activities using the Denmark-Ireland tax treaty which adopted the exemption method, and the Denmark Government changed its domestic tax law from the gross income principle to the net income principle in order to prevent tax avoidance activities in 1993. Thus, taxpayers must calculate the exemption amount after deducting the expenses corresponding to the foreign source income in computing a foreign tax credit. The Denmark Parliament and Government was of opinion that since a tax treaty does not specifically provide a calculation method for the prevention of double taxation, the new tax law does not collide with a tax treaty.”

Where a tax treaty does not specifically provide concerning a foreign tax credit method, a domestic tax law can provide what is not provided in a tax treaty. Therefore, it cannot be said that the Denmark domestic tax law overrode tax treaties.

G. Austria

“Under Paragraph 3, Article 11 of the Austria-Spain tax treaty, government securities were taxed only in the issuance state. Once the Spain Government issued the government securities, lots of capital moved from Austria to Spain in order to use the issuance state’s exemption rule of a tax treaty. Thus, the Austria tax authority gave up its existing position to take a new position that the government securities provided in Paragraph 3, Article 11 of the Austria-Spain tax treaty means only the mid or long-term securities. In order to avoid disputes relating to the interpretation of the Austria-Spain tax treaty, the Austria Parliament adopted a new domestic law providing that Paragraph 3, Article 11 of the Austria-Spain tax treaty shall not be effective from January 1, 1995 and then amended the existing Austria-Spain tax treaty.”

Therefore, as set forth in the above “Establishment of Reasonable Principle”, the new domestic law comes under a true treaty override case since it overrides the existing tax treaty.

H. Australia

“Tax treaties which Australia concluded with other states are enforced according to the International Tax Agreements Act ("ITAA") which was established in 1953. According to Paragraph 2, Article 4 of ITAA, a tax treaty has priority over a domestic tax law. The Australian Parliament established Article 3A of ITAA under which the real estate capital gains provision is extended to the indirect real estate share owned through the interposed entities. But this provision is effective only to tax treaties which were concluded before April 27, 1998.”

The above new rule retroactively affects tax treaties which were concluded before April 27, 1998 and causes double taxation. Therefore, if the Australian Government didn’t get the consent of contracting states, the new rule comes under a true treaty override case as set forth in the above “Establishment of Reasonable Principle”.

I. Summary

We have observed the related cases of England, Germany, France, Japan, Swiss, Denmark, Austria and Australia in relation to a treaty override. However, we could not find out a true treaty override case in 5 countries except Germany, Austria and Australia.

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70 Supra note 47, at 177
71 Supra note 47, at 179.
72 Supra note 47, at 179-180.
1) Articles 43 and 50(a)(4) of ESTG which enforced the application of tax rate by a domestic tax law in spite of the limited tax rate by a tax treaty, 2) Austrian domestic tax law which suspended the effect of a tax treaty unilaterally and 3) Article 3A of ITAA under which the real estate capital gains provision is extended to the indirect real estate share owned through the interposed entities can come under a true treaty override action.

These kinds of treaty override activities are in conflict with the Vienna Convention and are not helpful to the development of the global community. Therefore, to assert that a domestic tax law can override a tax treaty only based on these few cases violating the Vienna Convention cannot be justified.

4. Is There Any Treaty Override Case in the Korean Tax Law?

Lee, Jae Ho (2007) explains the cases in the Korean domestic law in order to justify a treaty override and presents i) thin capitalization rule, ii) CFC rule and iii) anti-avoidance rule as a ground of his assertion. Accordingly, it is necessary to make an in-depth analysis as to whether or not his assertion is proper.

A. Thin Capitalization Rule

According to Paragraph 1, Article 14 of the Law for Coordination of International Tax Affairs (“LCITA”), where the amount of a loan borrowed from an overseas controlling shareholder and from a third party by the payment guarantee of an overseas controlling shareholder exceeds three times the amount of paid-in capital by an overseas controlling shareholder, the interest related to the excessive loan shall not be deductible and treated as dividend or other disposition.

Thus, if a taxpayer wants to enjoy the benefit awarded by Paragraph 3, Article 14 of LCITA, the taxpayer shall submit data establishing that a loan in issue does not come under an actual paid-in capital when considering an interest rate, a maturity date, a payment method, a possibility of capital conversion and priority with other loans, etc. according to Article 27 of the Presidential Decree of LCITA. Accordingly, where the taxpayer establishes that the loan in issue does not come under an actual paid-in capital and the loan transaction is done based on arm’s length principle, the thin capitalization rule does not apply to the loan transaction in issue. This rule is to prevent a conflict with a tax treaty.

However, Lee, Jae Ho (2007) asserts “If a loan causing the excessive interest does not come under an actual paid-in capital when considering an interest rate, a maturity date, a payment method, the possibility of capital conversion and priority with other loans, etc., such excessive interest cannot be treated as dividend under Paragraph 3, Article 4 of the OECD Model Tax Convention because such excessive interest derived from the loan in issue has no character as a consideration against risk burden. Thus, the rule which treats the excessive interest as dividend collides with a tax treaty.”

However, as set forth above, if a taxpayer establishes that a loan in issue does not come under a paid-in capital according to Paragraph 3, Article 14 of LCITA and Paragraph 1, Article 27 of the

73 Supra note 47, at 248~249.
Presidential Decree of LCITA, the excessive interest shall be deductible and cannot be treated as dividend. Thus, there does not take place a situation where LCITS does collide with a tax treaty. It seems that Lee, Jae Ho misunderstood the related rules.

In addition, Lee, Jae Ho (2007) asserts “First, although OECD is of opinion that the excessive interest comes under dividend according to Paragraph 3, Article 10 of the OECD Model Tax Convention and therefore the deemed dividend provision does not collide with a tax treaty, since there is a room to think that a loan comes under interest under Paragraph 3, Article 11 of the OECD Model Tax Convention if the loan related to the excessive interest comes under a true loan, OECD’s opinion is not definitely right. Accordingly, as long as the excessive interest can be treated as interest under a tax treaty, the deemed dividend provision collides with the interest provision of a tax treaty. Secondly, although the excessive interest can be treated as dividend under the OECD opinion, the deemed dividend provision collides with Paragraph 6, Article 11 of the OECD Model Tax Convention.”

Simply speaking, however, the deemed dividend provision of a tax treaty does not collide with its interest provision. Even though there is a collision, it is a collision between the provisions of a tax treaty. Thus, it has nothing to do with a treaty override by a domestic tax law.

As set forth above, there does not take place a situation where LCITA collides with tax treaties. Therefore, it would be difficult to acknowledge his assertion.

B. CFC Rule

Lee, Jae Ho (2007) makes an assertion concerning the Korean CFC rule as follows:

“There are two provisions in a tax treaty which conflict with the CFC rule. One is the business income provision. Another is the anti extra-territorial taxation provision. If a resident corporation X of a state A (assuming that A is Malaysia and a tax heaven area) derives income from a state B (assuming that B is Korea), B cannot exercise its taxing rights over X’s accumulated earnings. However, regardless of whether the accumulated earnings of a foreign affiliate established in a tax heaven area of a Korean corporation includes income earned in Korea, the Korean CFC rule treats the accumulated earnings as dividend to tax it. Thus the Korean CFC rule conflicts with the anti-extraterritorial taxation provision.”

However, it is judged that he came to such a conclusion since he did not exactly understand the meaning of anti-extraterritorial taxation provision. Thus, we need to grasp what the anti extra-territorial provision means.

Under Paragraph 5, Article 10 of the OECD Model Tax Convention (what is called anti-extraterritorial taxation provision), where a company which is a resident of a Contracting State derives profits or income from the other Contracting State and pays the dividends a resident of the Contracting State or a resident of a third State, that other Contracting State cannot impose any tax on the dividends paid by the company. This rule is legally justified. However, where the company of the Contracting State pays the dividends to a resident of that other Contracting State or its permanent establishment situated in that other Contracting State, that other Contracting State can tax the dividends. As such taxation by that other Contracting State is done against its own resident or a permanent establishment situated in its territory, it is

74 Supra note 47, at 253.
75 Supra note 47, at 262-264.
legally justified.

Accordingly, where a Malaysian company derives profits or income from Korea and pays the dividends to a Malaysian resident or a resident of a third state other than Korea and Malaysia, the Korean tax authorities may not impose any tax on the dividends paid by the Malaysian company.

However, the CFC rule, which allows taxation on the accumulated earnings, has nothing to do with the anti-extraterritorial taxation rule. Where the headquarters of a company pays a resident of its resident state or a resident of a third state the dividends from income earned in a state in which its permanent establishment is situated, the anti-extraterritorial taxation rule prevents the extraterritorial taxation by the state in which the permanent establishment is situated. Thus, it is clear that there is no nexus between the CFC rule and the anti-extraterritorial taxation rule.

Now, let’s take another example related to the CFC rule. If a Korean company X establishes a wholly owned subsidiary Y in Malaysia (assuming that Malaysia’s corporate tax rate is 10%) and Y realizes KRW 10 billion of accumulated earnings in Malaysia, the KRW10 billion of accumulated earnings must be treated as X’s dividends and X must pay a corporate tax on the dividends in Korea according to the Korean CFC rule.

Therefore, the fact that the Korean tax authorities may tax the accumulated earnings owned by a Malaysia subsidiary of a Korean company is quite different from the fact that the Korean tax authorities may not exercise an extraterritorial taxing rights over the profits which a Malaysian company acquired through its Korean permanent establishment. It seems that he misunderstood what a tax treaty means.

In relation to this matter, OECD explains as follows:

“It has sometimes been argued, based on a certain interpretation of provisions of the Convention such as paragraph 1 of Article 7 and paragraph 5 of Article 10, that this common feature of controlled foreign companies legislation conflicted with these provisions. For the reasons explained in paragraphs 10.1 of the Commentary on Article 7 and 37 of the Commentary on Article 10, that interpretation does not accord with the text of the provisions. It also does not hold when these provisions are read in their context. Thus, whilst some countries have felt it useful to expressly clarify, in their conventions, that controlled foreign companies legislation did not conflict with the Convention, such clarification is not necessary. It is recognized that controlled foreign companies legislation structured in this way is not contrary to the provisions of the Convention.”

“The purpose of paragraph 1 of Article 7 is to provide limits to the right of one Contracting State to tax the business profits of enterprises that are residents of the other Contracting State. The paragraph does not limit the right of a Contracting State to tax its own residents under controlled foreign companies provisions found in its domestic law even though such tax imposed on these residents may be computed by reference to the part of the profits of an

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76 Commentary 34 on Article 10 of the OECD Model Tax Convention (2005) states “Paragraph 5 rules out the extra-territorial taxation of dividends, i.e. the practice by which States tax dividends distributed by a non-resident company solely because the corporate profits from which the distributions are made originated in their territory (for example, realized through a permanent establishment situated therein). There is, of course, no question of extra-territorial taxation when the country of source of the corporate profits taxes the dividends because they are paid to a shareholder who is a resident of that State or to a permanent establishment situated in that State.”

77 See Commentary 23 on Article 1 of the OECD Model Tax Convention (2005).
enterprise that is resident of the other Contracting State that is attributable to these residents’ participation in that enterprise. Tax so levied by a State on its own residents does not reduce the profits of the enterprise of the other State and may not, therefore, be said to have been levied on such profits (see also paragraph 23 of the Commentary on Article 1 and paragraphs 37 to 39 of the Commentary on Article 10).”\(^{78}\)

“It might be argued that where the taxpayer’s country of residence, pursuant to its controlled foreign companies legislation or other rules with similar effect seeks to tax profits which have not been distributed, it is acting contrary to the provisions of paragraph 5. However, it should be noted that the paragraph is confined to taxation at source and, thus has no bearing on the taxation at residence under such legislation or rules. In addition, the paragraph concerns only the taxation of the company and not that of the shareholder.”\(^{79}\)

C. Article 98-5 of the Corporate Tax Law

According to this rule, where a Korean withholding agent withholds taxes from the payments of interest, dividend, royalty and capital gains of securities which are paid to a foreign company that is situated in a state or an area designated in the Notice by the Ministry of Finance and Economy, he/she must withhold taxes by applying a withholding tax rate of a domestic tax law in spite of the limited tax rate stipulated in a tax treaty. Only where a foreign company gets an advance approval from the Commissioner of the National Tax Service, can a Korean withholding agent withhold taxes according to a tax treaty.

In terms of smooth execution of a tax treaty, however, it is not desirable to infringe upon the taxing rights of a contracting state and impose a burden to a resident of the contracting state by applying a domestic tax law instead of a tax treaty unless there is a unilateral advance approval from the Korean government. In addition, there is no legal justification that the Korean government exercises a discriminative treaty override policy only against specific states.

D. Summary

Lee, Jae Ho (2007) tries to explain the examples in the Korean tax law in order to justify the treaty override. However, as set forth above, it is clear that he misunderstood the related rules with regard to the thin capitalization and the relationship between CFC rules and the anti-extraterritorial taxation rules. Furthermore, Article 98-5 of the Korean Corporate Tax Law comes under a true treaty override case and as a result cannot be justified as set forth in the above “Establishment of Reasonable Principle”. Accordingly, his assertion has no ground of an argument.

V. Diverse Opinions of Korean Learned Circles

As it is very important to the development of the global community to set up a right relationship between international laws and domestic laws, there have been many discussions on this matter in the global community. However, because specialists who are in different fields from each other are discussing this matter within the scope of their knowledge and experience, it does not seem easy to find out a meeting point.

\(^{78}\) See Commentary 10.1 on Article 7 of the OECD Model Tax Convention (2005).

\(^{79}\) See Commentary 37 on Article 10 of the OECD Model Tax Convention (2005).
The problems which derive from the execution of international laws are related to constitutional law, tax law and other laws, and the characters of problems related to these laws are often different from each other. Thus, if we want to get a reasonable solution to the problems in issue, it would be desirable to adopt a “field by field approach” rather than a “uniform approach” in establishing the relationship between international laws and domestic laws. For the purpose of explanation, the diverse opinions of Korean learned circles are briefly summarized.

1. Learned Circle of Constitutional Law

"With regard to the relationship between international laws and domestic laws, theories are divided. The monism is of opinion that international laws and domestic laws constitute a unified order, and the monism is again divided into the international law priority theory and the domestic law priority theory. According to the dualism, international laws are different from domestic laws in terms of order of law. International laws are effective only in the international relationship and domestic laws are effective only in Korea, and thus two laws do not affect each other. Paragraph 1, Article 1 of the Korean Constitution provides that treaties concluded and promulgated based on the Korean Constitution and generally approved international rules have the same effect as domestic laws. Thus, the Korean Constitution is based on the equal status theory." 80

"Treaties have the same effect as domestic laws. However, there is a room of controversy in defining the exact meaning of domestic laws. Minority scholars assert the treaty priority theory in terms of international cooperation but majority scholars assert the constitution priority theory. A treaty is concluded by the constitution which was made by the ‘constitution establishment power’ based on the democracy and the constitution is the supreme law of the land. Further Article 5 of Supplementary Provision of the Korean Constitution provides that laws and treaties are effective only in the case where they do not infringe upon the Constitution. Thus, treaties cannot infringe upon the Constitution. Treaties which are approved by the National Assembly have the same effect as domestic laws. Where treaties are in conflict with domestic laws, the priority must be determined by either the later-in-time rule or the special law priority rule." 81

2. Learned Circle of International Law

"From the standpoint of international law, the constitution, laws and enforcement decrees are merely domestic laws. Accordingly, the logical development that international laws are inferior to the constitution but superior to domestic laws is a too simple approach based on the wrong understanding of international law concept and legal system. Regardless of whether it’s the constitution or the general law, if the domestic law has priority over international law, the global community cannot exist as a legal community any longer. If the rules of a certain legal community are inferior to those of a constituent which is subject to the rules of this legal community, this legal community cannot exist any longer." 82

"It is reasonable that the constitution has priority over international laws and domestic laws have the same effect as international laws. However, this kind of interpretation makes sense only in terms of interpretation under domestic laws and thus the responsibility and legality under international laws is a separate issue." 83

80 KIM, CHUL SOO, INTRODUCTION TO THE KOREAN CONSTITUTION 243-244 (Park Young Co. 2004).
81 SUNG, LARK IN, THE KOREAN CONSTITUTION 207 (Bub Moon Co. 2003).
82 YOUI, BYUNG HWA ET AL., INTERNATIONAL LAW I 65 (Bub Moon Co. 1999).
83 KIM, JUNG GUN, INTERNATIONAL LAW I 115 (Park Young Co. 2004).
treaties have the same effect as domestic laws or treaties have priority over domestic laws without considering the character of a treaty. However, if we certainly have to set up a general principle which regulates the relationship between treaties and domestic laws, treaties shall have priority over domestic laws.84

“Although it is thought that international laws have priority over domestic laws, it just means international laws’ priority from an international perspective, and international laws are not in a position to assert their priority from the domestic standpoint. This is because the legitimacy of a certain state’s domestic legal system under which the constitution has priority over other domestic laws does not depend on other legal systems.”85

“Where an international law is in conflict with a domestic law, there should be used the approaches such as ‘the presumption of coincidence of an international law and a domestic law’, ‘the application of the state action theory’ and ‘the treatment as a political problem’. If these approaches are not available, the constitution must be treated as having priority over treaties. And with regard to the relationship between domestic laws and international laws, the priority must be determined by either the later-in-time rule or the special law priority rule.”86

3. Learned Circle of Tax Law

“As the domestic effect of a treaty is recognized by the constitution, majority scholars take an opinion that treaties and international rules are inferior to the constitution which is a supreme law of the land. Where a treaty conflicts with a domestic law, the priority must be determined by either the later-in-time rule87 or the special law priority rule.88 A tax treaty normally regulates only the limited persons and matters, and is in a status of special law over the Corporate Income Tax Law and the Individual Income Tax Law. Thus, a tax treaty as a special law must have a priority over the Corporate Income Tax Law and the Individual Income Tax Law which are a general law.”89

“Where a new domestic rule conflicting with a treaty is established and the new domestic rule is binding, only the new domestic rule can have priority over a treaty and thus the existing general rules cannot have an effect restricting the provisions of a treaty. Where a new domestic rule restricting the provisions of a treaty is made after the conclusion of a treaty, although it is legitimate for a new domestic rule to have a priority over a treaty under a domestic principle of law, it still infringes upon an international law. The interpretation and application of a treaty should be able to be accepted by contracting states. Otherwise the meaning of an agreement between contracting states cannot be maintained.”90

“As treaties concluded and promulgated by the Constitution and generally approved international rules have the same effect as domestic laws according to Article 5 of the Korean Constitution, tax treaties are effective as a tax law and the later-in-time rule is applied in terms

84 Id. at 118
85 KIM, DAE SOON, INTERNATIONAL LAW THEORY 151 (Sam Young Co. 2005).
86 LEE, HAN KEE, LECTURE OF INTERNATIONAL LAW 144 (Park Young Co. 2005).
87 See OH, SE HYUK, STUDY ON CONFLICT BETWEEN RULES AND ITS SOLUTION 118 (Doctoral Thesis of Seoul University 2000). (“The later-in-time rule does not apply to all rules. This rule applies only where an existing rule has an equal status or an inferior status to a new rule but not where it has a superior status to a new rule.”)
88 Id. at 120. (“The special law priority rule is hardly controversial. In general, where there is an existing special rule, the existing special rule has priority over a newly established rule.”).
89 KIM, WAN SEOK, THEORY OF CORPORATE TAX LAW 698-699 (Kwang Kyo TNS Co. 2003).
90 LEE, TAE RO & AHN, KYUNG BONG, LECTURE OF TAX LAW 716-717 (Park Young Co. 2002).
of priority.”

“Although an international law has priority over a domestic law to some extent, the priority is not absolute. This is because where a domestic law infringes upon an international law, there does not exist an international law system which can nullify the infringement.”

4. Summary

As set forth above, even scholars in the same learned circle have a different view over the relationship between an international law and a domestic law. Accordingly, if we approach this matter simply on a theoretical basis, diverse logics are available and as a result it almost becomes impossible to seek out a solution to this matter.

VI. Conclusion

As there are a number of international laws in the global community, it would be necessary to resolve a problem using a practical “field by field approach” rather than an existing theoretical and uniform approach.

There is a conspicuous difference between a tax treaty and other treaties (such as conventions and agreements, etc.) which come under an international law. Unlike general international laws, a tax treaty is normally concluded reflecting the OECD Model or the UN Model. The OECD Draft Model Convention was adopted in 1963 and then there have been several revision works reflecting the opinions of member countries. Accordingly, unless a member country presents observations on the Commentary, it should follow the OECD Model as a member country.

Where the Korean government concludes a tax treaty with the U.S. government, two governments should respect the Korea-U.S. tax treaty. In addition to this, two governments should, as an OECD member country, resolve related matters by applying the commentaries of the OECD Model Convention which is agreed upon by member countries and respect the recommendation of the OECD. Further, a tax treaty plays a role of coordinating the differences of contracting states’ domestic tax laws which are differently made according to their respective tax policy and determining the taxing rights of two contracting states based on its conclusion contents. In this respect, it can be said that a tax treaty is clearly distinguished from other international laws. Thus, it is necessary to establish a principle which is suited to the purpose of a tax treaty.

It has been already explained that “the interpretation of terms”, “the interpretation of tax treaty provisions” and “the application of domestic anti-avoidance rule to tax treaty” have nothing to

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91 LIM, SEUNG SOON, TAX LAW 23 (Park Young Co. 2003).
92 LEE, YOUNG SUP, TAX LAW 117 (Se Kyung Co. 1999).
93 See Aldo Forgione, Weaving the Continental Web: Exploring Free Trade, Taxation, and the Internet, 9-SUM L. & BUS. REV. AM. 513, 542 (2003): “The UN Model attempts to accommodate the interests of developing countries by expanding the scope of source country taxation relative to the OECD Model and by endorsing, in part, the principle of tax sparing. However, since the UN group of experts used the OECD Model as its primary reference point in drafting the UN Model, many people believe that the final text of the UN Model was overly influenced by the OECD Model.”.
94 The United States uses the U.S. Model. However, there is no substantial difference between the OECD Model and the U.S. Model except the U.S. Model provisions reflecting the provisions of the U.S. domestic tax law.
95 Commentary 3 on Introduction of the OECD Model Tax Convention (2005).
do with a treaty override issue. Accordingly, the heart of a problem becomes an action which nullifies a tax treaty by establishing a new domestic tax law which could not be consented by a contracting state and OECD member countries.

Based on the 1989 report on treaty override, the OECD strongly urged OECD member countries to avoid legislation which would constitute a treaty override since a treaty override is not an appropriate manner to modify tax treaty obligations.96

Accordingly, it is difficult to justify a treaty override action which unilaterally infringes on the taxing rights of a contracting state and hampers the legal stability. If some states adhere to the later-in-time principle to do treaty override legislation and other states respect the treaty priority principle, the global community will continue to face with tax disputes.

In handling the treaty override problems of international laws other than a tax treaty, it would be also desirable to study how to practically resolve the pending problems rather than approach them from a theoretical perspective. However, if there is still a necessity of taking a theoretical approach, it would be desirable to classify international laws field by field and harmoniously apply the “later-in-time principle” and the “special law priority principle” in order to secure the harmonious execution of an international law and a domestic law.

96 See Derek Devgan, International Fiscal Wars for the Twenty-First Century: An Assessment of Tax-Based Trade Retaliation, 27 LAW & POL’Y INT’L BUS. 353, 374 (1996): “The OECD Committee on Fiscal Affairs noted in its 1989 report on treaty override that ‘there is growing dissatisfaction with the continued use of [treaty override] legislation which would erode confidence in the international tax treaty network as a whole,’ even in situations where an objective might justify its use (such as to counteract treaty shopping). As a result, the Committee concluded that override was not an appropriate manner in which to modify tax treaty obligations and strongly urged OECD members to avoid legislation that would constitute a treaty override.”