Viewpoint

The Outrageous History of Caribbean Tax Treaties With OECD Member States

by Marshall J. Langer

Since about 1980 it has been the tax policy of the United States and many other OECD member states not to have full income tax treaties with any of the smaller Caribbean jurisdictions. Instead, they want to have only tax information exchange agreements (TIEAs) with those nations. Existing tax treaties with many Caribbean countries were arbitrarily and summarily terminated during the 1980s because some third-country residents had used, or abused, the treaties to reduce withholding taxes on investments in OECD countries.

This policy has turned out to be self-defeating. In hindsight, it would have been more appropriate to block the alleged misuse of tax treaties by other means such as legislation and treaty renegotiation. Many smaller Caribbean countries that once imposed normal income taxes have found it necessary to change their tax systems. Some abandoned their income taxes altogether. Others began to impose their taxes only on a territorial basis, exempting all income from foreign sources. Those jurisdictions that were dumped as treaty partners, because they were considered tax havens, became even more successful as offshore financial centers (OFCs) and have caused even greater problems for tax officials in the United States and other OECD countries.

Most tax treaties have two basic goals. They are supposed to eliminate double taxation and prevent fiscal evasion. A TIEA has only one of these goals, the prevention of fiscal evasion. It not only ignores the prevention of double taxation, it also ignores the imposition of outrageously high single taxation by the other party to the TIEA.

The typical income tax treaty prevents double taxation on passive income such as dividends, interest, and royalties by allowing the source country to impose only a low rate of tax on the relevant income and allowing the taxpayer's country of residence to impose an additional tax on such income after giving the taxpayer a foreign tax credit for the tax paid to the source country. The source country normally collects its portion of the tax by imposing a withholding tax at the rate allowed by the treaty. In some cases, the residence country chooses to eliminate double taxation by exempting the

relevant income, with or without taking that income into account in determining the taxpayer's tax rate on his other income.

When source countries first began to impose withholding taxes to collect tax from foreign persons the withholding tax rates were quite low. Source countries learned, however, that it was to their advantage to increase these rates to levels much higher than they were entitled to keep. By doing so they forced residence countries to negotiate tax treaties with them to reduce or eliminate confiscatory taxation by the source countries.

Using the United States as an example, there was no withholding tax on payments of passive income to foreigners until 1937. At that time, after careful study, Congress imposed a 12.5 percent withholding tax on all such payments. In 1942, as a temporary wartime measure, the withholding rate was increased to 30 percent. In 2002, we celebrate the 60th anniversary of that "temporary" wartime increase. The reason it was never reduced is that the U.S. Treasury Department determined that excessively high withholding taxes forced other countries to seek tax treaties with the U.S. government. This enabled the United States to obtain treaty concessions from those countries.

A 30 percent tax may be appropriate for certain types of passive income but it is confiscatory for other types of income, especially for dividends, interest, and royalties. Treasury and the U.S. Congress have recognized that a 30 percent withholding tax is excessive by granting much lower rates on those same types of income in tax treaties that are now in force with over 60 other countries.

Why didn't foreign investors complain about the flat 30 percent withholding tax when the United States continued to impose it long after World War II ended? If such a tax rate was (and is) confiscatory, why haven't most foreign investors voted with their feet by pulling their investments out of U.S. markets? The answer is that a combination of legislative exemptions, income tax treaties, and treaty shopping have brought the effective U.S. tax rate paid by most serious foreign investors on U.S.-source income down to a much lower level.

Instead of complaining about the confiscatory levels of withholding taxes, taxpayers found a way to escape them by treaty shopping. Beginning in the 1950s and 1960s foreign taxpayers investing in the United States used holding companies established in places such as the Netherlands Antilles and the British Virgin Islands to substantially reduce their effective tax rate on U.S.-source income. These taxpayers treated the 30 percent U.S. withholding tax as a myth; they ignored it.

Treasury's 1976 *Report to the Congress on Foreign Portfolio Investment in the United States* contained these interesting comments on the use of tax treaties by residents of third countries. It stated:

> Treaties providing for reduced withholding rates induce foreign investors of countries without treaties with the United States to form either personal holding companies or trusts in the foreign treaty jurisdiction in order to have their investments in the United States receive favorable withholding tax treatment. These entities are then afforded the benefit of treaty tax rates applicable to the jurisdictions in which they are operating.

Testimony at Congressional hearings during the 1960s and 1970s showed that as a result of treaty shopping, the combined effective rate of tax actually imposed by the United States and the Netherlands Antilles on dividends from U.S. sources derived by holding companies owned by third-country residents was about 17 percent and the comparable rate on interest

was about 3 percent. Those effective tax rates, of course, were being applied to income that arguably should have been subject to the statutory 30 percent U.S. withholding rate. There were also allegations that some of these holding companies were beneficially owned by U.S. citizens and residents who masqueraded as foreign persons.

The U.S. Internal Revenue Service published a report in January 1981 called *Tax Havens and Their Use by United States Taxpayers,* written by Richard A. Gordon, IRS Special Counsel for International Taxation. The Gordon Report has served as a blueprint of how the U.S. Treasury and the IRS should deal with tax havens. After finishing his report, Gordon became the key legal advisor to the tax-writing committees of Congress on international tax matters and tax treaties. As Deputy Chief of Staff of the Joint Committee on Taxation, he assisted Congress in carrying out many of his recommendations before returning to private practice. Let us look at a few of Gordon's recommendations and the extent to which they have been implemented:

- Gordon recommended that the treaty extensions to current and former U.K. and Dutch overseas territories be terminated. This was done. Today, the United States has full tax treaties in the Caribbean only with Barbados, Jamaica, and Trinidad and Tobago.
- Gordon recommended that the United States sign TIEAs with most Caribbean countries and that these countries be offered one tax benefit — permitting American taxpayers to deduct their travel expenses for attending foreign business conventions there. As executive agreements, the TIEAs would not require individual approval by the U.S. Senate. Such TIEAs were authorized by the 1983 Caribbean Basin Initiative (CBI) legislation. Two other tax benefits were added later but neither of these is currently operational. The successful result: 14 TIEAs entered into force during the 1980s and 1990s and six more have been signed during the past year.
- Gordon also recommended several nasty steps that the United States might take to isolate countries designated as "abusive" tax havens. None of those steps have been taken yet, but one of them is contained in the proposed *Tax Haven and Abusive Tax Shelter Reform Act of 2002* (S. 2339), a bill introduced by Senator John F. Kerry, D-Massachusetts, on 26 April 2002, over 21 years after the Gordon Report was published. It would deny foreign tax credits for taxes paid on income from a designated tax haven. Other steps he suggested to isolate an abusive tax haven would include prohibiting direct airline flights between the United States and the targeted tax havens and prohibiting U.S. banks from making wire transfers to or from such places.

The law of unintended consequences has not been repealed. The termination of their tax treaties with the United States and other OECD countries has led some Caribbean countries to abolish income taxes or limit them to local-source income. Some of these countries have become aggressive OFCs. The OECD recently targeted 41 OFCs as "harmful tax regimes" and pressured most of them into signing commitment letters promising to establish transparent tax systems and to exchange tax information with OECD countries. Eighteen of those targeted OFCs are in the Caribbean area.

Let us review the situation as it has affected different groups of Caribbean countries, starting with the British Caribbean territories.

British Caribbean Territories

The United States and the United Kingdom signed their first income tax treaty in 1945, which was subsequently amended by several protocols. The

treaty authorized extension to either country's overseas territories that imposed *taxes substantially similar in character* to those covered by the treaty. At the request of the British government, the amended 1945 U.K.-U.S. treaty was extended in 1959 to apply to 20 U.K. territories that were then still British colonies. Although many of those jurisdictions subsequently became independent countries, the U.K.-U.S. treaty continued to apply to most of them. The 13 Caribbean territories covered by the extended treaty were: Anguilla (then part of St. Kitts-Nevis-Anguilla), Antigua (now Antigua and Barbuda), Barbados, British Honduras (now Belize), the British Virgin Islands (BVI), Dominica, Grenada, Jamaica, Montserrat, St. Christopher and Nevis (then part of St. Kitts-Nevis-Anguilla), St. Lucia, St. Vincent (now St. Vincent and the Grenadines), and Trinidad and Tobago.

Both the U.S. Treasury and the U.S. Senate fully accepted the claim by the British government that all of these territories then imposed taxes substantially similar to those of the United Kingdom. The United States did not request extension to Puerto Rico, the U.S. Virgin Islands or any of its other overseas territories.

The 1945 U.K.-U.S. income tax treaty as extended to the British Caribbean territories contained then customary provisions for the exchange of information (Article XX), assistance in collection (Article XIX A), mutual assistance (Article XX A), and nondiscrimination (Article XXI). It also contained several tax benefits including reductions in U.S. withholding taxes from the 30 percent flat statutory rate to 5 percent on qualified intercorporate dividends, 15 percent on all other dividends, zero on royalties, and 15 percent on non-business real property rentals. There was, however, no tax rate reduction on interest because the interest exemption provision (Article VII) did not apply to the overseas territories.

During the 1960s and 1970s these tax benefits were of considerable value to residents of some of the Caribbean overseas territories. The treaty extensions were used as intended by residents of the Caribbean territories to which the treaty had been extended. The problem was that they were also used to an even greater extent by holding and investment companies beneficially owned by third-country residents who paid only modest taxes to the overseas territories.

The United States currently has both comprehensive income tax treaties and separate TIEAs in force with the three largest former British Caribbean colonies: Barbados, Jamaica, and Trinidad and Tobago. The other 10 British Caribbean colonies were treated as too small to bother with and have been considered as suitable only for TIEAs. Every one of these 10 jurisdictions is now considered an OFC. Each of them has been targeted by the OECD as a "harmful tax regime" and each of them has recently signed a commitment letter to the OECD promising to establish a transparent tax system and to exchange tax information with OECD countries.

Let us look at other developments in each of them individually:

- *Anguilla* declared its independence from St. Kitts-Nevis-Anguilla in 1967 and it has since been a separate British overseas territory. The 1945 U.K.-U.S. treaty continued to apply to Anguilla until the treaty was terminated unilaterally by the U.S. government as of the end of 1983. Anguilla has indefinitely suspended its income taxes.
- *Antigua and Barbuda* became an independent country in 1981. The 1945 U.K.-U.S. treaty continued to apply to Antigua and Barbuda until it was terminated by Antigua and Barbuda in August 1983. Antigua and Barbuda has eliminated income taxes for resident individuals and offshore companies. The United States

and Antigua and Barbuda signed a proposed TIEA in December 2001 that is not yet in force.

- *Belize* (formerly British Honduras), became an independent country in 1981. The 1945 U.K.-U.S. treaty continued to apply to Belize until it was unilaterally terminated by the United States as of the end of 1983. Belize has eliminated income taxes for offshore companies and some new resident individuals.
- The *British Virgin Islands (BVI)* remains a British overseas territory. In 1981, the United States and the United Kingdom (acting on behalf of the BVI) signed a proposed BVI-U.S. income tax treaty. The U.S. Senate returned the proposed treaty to the President for renegotiation. Subsequent attempts to renegotiate the proposed treaty were unsuccessful. The United States unilaterally terminated the 1945 U.K.-U.S. treaty as it applied to the BVI as of the end of 1982, a year earlier than it did so for most other jurisdictions. The BVI thereafter changed its tax system and it prospered as the world's leading OFC for tax-free international business companies (IBCs). The United States and United Kingdom (acting on behalf of the BVI) signed a proposed BVI-U.S. TIEA in April 2002 that is not yet in force.
- *Dominica* became an independent country in 1978. The 1945 U.K.-U.S. treaty continued to apply to Dominica until it was unilaterally terminated by the United States as of the end of 1983. The United States and Dominica signed a TIEA in 1987 that entered into force in 1988. It made Dominica eligible to receive three CBI tax benefits but two of these are no longer operational. Dominica still imposes income taxes but it makes no attempt to impose taxes on foreign-source income.
- *Grenada* became an independent country in 1974. The 1945 U.K.-U.S. treaty continued to apply to Grenada until it was unilaterally terminated by the United States as of the end of 1983. The United States and Grenada signed a TIEA in 1986 that entered into force in 1987. It made Grenada eligible to receive three CBI tax benefits but two of these are no longer operational. Grenada stopped imposing income taxes for several years; it resumed imposing income taxes in 1994 but it exempts all income from foreign sources derived by either companies or individuals.
- *Montserrat* remains a British overseas territory. The 1945 U.K.-U.S. treaty continued to apply to Montserrat until it was unilaterally terminated by the United States as of the end of 1983. Montserrat has since been devastated by a volcanic eruption and much of the island is now uninhabitable.
- *St. Kitts and Nevis* became an independent country in 1983. The 1945 U.K.-U.S. treaty continued to apply to St. Kitts and Nevis until it was unilaterally terminated by the United States as of the end of 1983. St. Kitts and Nevis has eliminated individual income taxes and it exempts offshore companies.
- *St. Lucia* became an independent country in 1979. There was some doubt as to whether the 1945 U.K.-U.S. treaty continued to apply to St. Lucia because the country may not have recognized the treaty after attaining its independence. In any case, the treaty was terminated by the United States as to St. Lucia and all other remaining current and former U.K. territories to which it still applied as of the end of 1983. The United States and St. Lucia signed a TIEA in 1987 that entered into force in 1991. It made St. Lucia eligible to receive three CBI tax benefits but two

of these are no longer operational. St. Lucia still imposes income taxes but it exempts offshore companies.

- *St. Vincent and the Grenadines* (formerly St. Vincent) became an independent country in 1979. The 1945 U.K.-U.S. treaty continued to apply to St. Vincent and the Grenadines until it was unilaterally terminated by the United States as of the end of 1983. St. Vincent and the Grenadines still imposes income taxes but it exempts offshore companies.

The Netherlands Antilles and Aruba

The United States and the Netherlands signed an income tax treaty in 1948 that contained a territorial extension provision similar to the one contained in the 1945 U.K.-U.S. income tax treaty. Notes exchanged between 1952 and 1955 and a 1955 protocol extended the 1948 Netherlands-U.S. income tax treaty to the Netherlands Antilles (which then included Aruba). The treaty as extended to the Netherlands Antilles contained then customary provisions for the exchange of information (Article XXI), assistance in collection (Article XXII as modified), and nondiscrimination (Article XXIV). It also contained some significant tax benefits including reductions in U.S. withholding taxes from the 30 percent statutory rate to 5 percent on qualified intercorporate dividends, 15 percent on all other dividends, zero on interest and zero on royalties. These tax benefits were of considerable value to the Antilles. Admittedly, these benefits were abused by thousands of Netherlands Antilles holding and investment companies owned by third-country residents who paid taxes of less than 3 percent to the Antilles. This abuse was partially blocked by a 1963 protocol to the treaty that required the Antilles to impose higher taxes on companies that benefited from treaty reductions and exemptions.

Proposed new Netherlands Antilles-U.S. and Aruba-U.S. income tax treaties were signed in 1986, but the U.S. Senate did not consent to ratification of those treaties and they never entered into force. The United States subsequently canceled the old extended treaty as it applied to the Netherlands Antilles and Aruba, first as to all provisions except those exempting interest (in 1988) and then as to the interest exemption (in 1995).

The OECD has recently pressured the Netherlands Antilles and Aruba into signing commitment letters in which they have promised to provide information on demand to all OECD countries without receiving any benefits in return, not even a nondiscrimination clause. They will now be pressured into signing TIEAs with all OECD countries. In April 2002, the Netherlands Antilles and the United States signed a TIEA that provides for the exchange of information but no benefits other than a promise made by U.S. Treasury Secretary Paul O'Neill when the TIEA was signed that the United States would commence negotiations for a proposed new income tax treaty with the Antilles within one year. Other targeted countries that are pressured into signing a TIEA with the United States and other OECD countries should insist on a similar promise.

America's Caribbean Territories

Another discriminatory aspect of U.S. tax treaty policy has been the Treasury's refusal to extend any of the more than 60 U.S. income tax treaties to Puerto Rico, the U.S. Virgin Islands (USVI) and other U.S. overseas territories. The current OECD model income tax treaty and many older U.S. income tax treaties contain articles authorizing extension to either country's overseas territories that have a substantially similar tax system to that of the mainland. During the 1940s and 1950s the Treasury and Senate agreed to extend income tax treaties to a number of British, Dutch, and

Belgian colonies. But U.S. tax treaties were never extended to any of the U.S. overseas territories.

Under the "mirror theory," the USVI generally applies the entire U.S. Internal Revenue Code as it is amended from time to time to USVI residents. With minimal exceptions, USVI residents pay the same income taxes as those paid by mainland residents, but they pay their taxes to the USVI government instead of the federal government. Puerto Rico applies an older U.S. Internal Revenue Code as modified by its own legislature but it certainly has a substantially similar tax system to that of the mainland. Residents of Puerto Rico and the USVI who derive income from U.S. treaty partners are stuck with excessively high withholding taxes for which they receive insufficient relief. Some years ago Puerto Rico was denied permission to enter into tax treaty negotiations with Spain.

The OECD recently pressured the governor of the USVI into signing a commitment letter which states that effective exchange of information with respect to the USVI is already available to foreign countries under U.S. law, U.S. tax treaties, and TIEAs, and the tax implementation agreement between the United States and the USVI. The OECD press release concerning the governor's letter added that the United States currently is able to use its compulsory powers in the USVI to obtain information to respond to requests from U.S. tax treaty partners. It added that information provided by the USVI to the U.S. government under the tax implementation agreement " . . . may be redisclosed to third countries pursuant to the provisions of an applicable treaty." That statement seems to be inaccurate and misleading.

This is yet another example of a Caribbean jurisdiction getting only the worst half of a tax treaty. It must give information, but it gets nothing in return. In this case it not only gets no benefits, it isn't even able to get information from U.S. tax treaty partners to prevent evasion of its own tax laws.

Wealthy Asians, South Americans, and Europeans hesitate to move to the USVI or Puerto Rico today because they become subject to confiscatory source-country withholding taxes on their foreign investment income. Puerto Rico and the USVI should either be able to have their own tax treaties or they should be able to become covered by U.S. tax treaties.

Canadian Treatment of the Caribbean

Canada has also terminated most of its income tax treaties with smaller Caribbean countries. Canada now has tax treaties in the Caribbean only with Barbados, the Dominican Republic, Guyana, Jamaica, and Trinidad and Tobago. It has negotiations pending for a tax treaty with St. Lucia and a new tax treaty with Barbados.

Canada previously had a tax treaty relationship with several other Caribbean countries, including Antigua, Belize (then British Honduras), the BVI, Grenada, Montserrat, St. Kitts and Nevis, St. Lucia, and St. Vincent. All of them were covered by the 1946 Canada-U.K. income tax agreement when it was extended to 23 British colonies in 1951 and 1952. That treaty contained an information exchange article. It also exempted copyright royalties and reduced Canadian tax on other unearned income such as dividends and interest to 15 percent. The tax treaty and its extensions were subsequently terminated.

Canada imposes a withholding tax on payments of dividends, interest, royalties, and several other types of passive income paid to nonresidents. Like other OECD countries, Canada has a "retail" standard withholding tax rate of 25 percent on payments of such income to persons resident in nontreaty countries and a much lower "wholesale" rate for payments of such

income to persons resident in treaty countries. The wholesale rate varies from one treaty to another. A 10 percent treaty rate often applies to royalties.

Prior to 1976, the standard Canadian non-treaty withholding tax rate on payments to nonresidents was only 15 percent and that lower rate continues to apply to dividends and interest under most Canadian tax treaties. For example, the current treaties with Barbados and Guyana provide a 15 percent tax on dividends and interest and a 10 percent tax on royalties.

Canada now has 75 income tax treaties in force and many of them are with less developed non-OECD countries outside the Caribbean. These include Algeria, Argentina, Bangladesh, Brazil, Bulgaria, Cameroon, Chile, Croatia, Cyprus, Ecuador, Ivory Coast, Jordan, Kazakhstan, Kenya, Kyrgyzstan, Malta, Nigeria, Papua New Guinea, Singapore, Sri Lanka, Tanzania, Uzbekistan, Vietnam, Zambia and Zimbabwe. Canada has also signed tax treaties that are not yet in force with Kuwait, Lebanon, Peru and Senegal. It is currently negotiating tax treaties with Armenia, Azerbaijan, Colombia, Gabon, Mauritius, Moldova, Mongolia and the United Arab Emirates.

Payments of dividends, interest, and royalties by Canadian residents to individuals resident in Anguilla, Antigua and Barbuda, Aruba, the Bahamas, Belize, Bermuda, the BVI, the Cayman Islands, Dominica, Grenada, Montserrat, the Netherlands Antilles, Panama, Puerto Rico, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Turks and Caicos, and the USVI all pay the "retail" withholding tax rate of 25 percent because Canada does not have tax treaties with any of these countries. As noted above, it did have a tax treaty relationship with some of them years ago.

French Treatment of the Caribbean

All French tax treaties generally apply to French overseas departments, including Guadeloupe and Martinique. France has income tax treaties in force with over 100 countries, including virtually every country in Africa, but it has only two tax treaties with Caribbean countries. These are with Jamaica and Trinidad and Tobago.

France imposes withholding taxes on payments of dividends, interest, royalties, and other types of passive income paid to nonresidents. Like many other OECD countries, France imposes a "retail" withholding tax rate on payments to persons resident in non-treaty countries and a much lower "wholesale" rate for payments to persons resident in treaty countries.

- The retail rate on dividends paid to non-EU countries with which France does not have a tax treaty is generally 25 percent. The wholesale rate varies considerably from one treaty to another. In many cases, including Jamaica and Trinidad and Tobago, it is 15 percent. In some cases it is 10 percent or even zero.
- The retail rate imposed on interest paid to non-treaty countries is 15 percent. The wholesale rate varies considerably from one treaty to another. It can be 10 percent, 5 percent, or even zero.
- The retail rate imposed on gross royalties paid to non-treaty countries is 33⅓ percent. The wholesale rate varies considerably from one treaty to another. It can be 10 percent, 5 percent, or even zero.

Many of France's tax treaties are with OECD countries, but France also has tax treaties with many less developed non-OECD countries, including Algeria, Argentina, Bangladesh, Benin, Bolivia, Brazil, Burkina Faso, Cameroon, the Central African Republic, Congo, Gabon, Georgia, Ghana,

Iran, Ivory Coast, Jamaica, Jordan, Kenya, Lebanon, Madagascar, Malawi, Mali, Mauritania, Mauritius, Mongolia, Namibia, New Caledonia, Niger, Nigeria, Senegal, Singapore, Togo, Trinidad and Tobago, Tunisia, Turkmenistan, Vietnam, Zambia, and Zimbabwe.

Payments of French dividends, interest, and royalties to individuals resident in Anguilla, Antigua and Barbuda, Aruba, the Bahamas, Barbados, Belize, Bermuda, the BVI, the Cayman Islands, Dominica, Grenada, Guyana, Montserrat, the Netherlands Antilles, Panama, Puerto Rico, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Turks and Caicos, and the USVI all pay the retail withholding tax rates because France does not have tax treaties with any of these countries.

Some Other OECD Countries and the Caribbean

Other OECD countries have generally terminated their tax treaties with smaller Caribbean countries. Japan, for example, used to have a tax treaty relationship with the BVI and Montserrat. Switzerland had a tax treaty relationship with Anguilla, Antigua, Barbados, Belize, the BVI, Dominica, Grenada, Montserrat, St. Kitts and Nevis, St. Lucia, and St. Vincent.

Denmark, Norway, and Sweden had tax treaty relationships with Anguilla, Antigua, Belize, the BVI, Dominica, St. Kitts and Nevis, St. Lucia, and St. Vincent until the late 1980s. Norway also had a tax treaty relationship with Grenada and Montserrat. New Zealand used to have a tax treaty relationship with Antigua, the BVI, Grenada, Jamaica, Montserrat, St. Kitts and Nevis, St. Vincent, and Trinidad and Tobago.

The United Kingdom still has tax treaties in force with some of its former Caribbean colonies. They are Antigua and Barbuda, Barbados, Belize, Grenada, Guyana, Jamaica, Montserrat, St. Kitts and Nevis, and Trinidad and Tobago.

Reviewing 20th Century Caribbean Tax Treaty Developments

In the absence of a tax treaty, the source country imposes its full retail withholding tax on passive income such as dividends, interest, and royalties. Any further tax on that income imposed by the taxpayer's country of residence clearly results in either double taxation or excessive taxation by the source country.

Many of the former British colonies in the Caribbean used to have normal tax systems and some tax treaties. These tax treaties were extensions of those entered into by the United Kingdom with other developed countries. Thus, for example, 50 years ago Grenada had a colonial type income tax act and it had a tax treaty relationship with Canada, New Zealand, Norway, South Africa, Switzerland, the United Kingdom, and the United States. Some other British Caribbean colonies also had tax treaties with Denmark, Japan, and Sweden.

Virtually all of these tax treaty extensions were summarily terminated by the developed countries in the 1980s. New tax treaties were signed by some of the developed countries with the larger Caribbean countries: Barbados, Jamaica, and Trinidad and Tobago. None were signed with the smaller Caribbean countries and many of the smaller countries found it easier to abandon their traditional tax systems. Some of them no longer impose any income tax on individuals and/or companies. Others, like Grenada, now impose an income tax only on local-source income.

Unilateral Termination Was the Wrong Approach

The 1981 Gordon Report recommended elimination of the tax treaty extensions to the Netherlands Antilles and U.K. overseas territories and

empowering the president to enter into TIEAs. This approach was followed by the Treasury and Congress. In retrospect it was wrong.

A proposed new treaty between the United States and the BVI was signed in February 1981, a month after the Gordon Report was issued. The Senate returned the proposed treaty to President Reagan for renegotiation because it appeared to offer a potential for treaty shopping by residents of third countries. The failure of the United States to conclude a satisfactory new treaty with the BVI led that territory to become one of the world's leading OFCs with hundreds of thousands of tax-free IBCs. The U.S. government did manage to conclude new income tax treaties with Barbados, Jamaica, and Trinidad and Tobago and it also signed TIEAs with each of them.

The Treasury chose to ignore most of the other current and former U.K. Caribbean territories with which it had canceled its tax treaty arrangements in 1982 and 1983. It apparently felt that jurisdictions such as Anguilla, Antigua and Barbuda, Belize, Dominica, Grenada, Montserrat, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines were too small to bother with. The loss of their U.S. tax treaty relationship led several of these countries to give up their income tax altogether or to impose income tax only on a territorial basis. The United States effectively turned most of these jurisdictions into the allegedly "harmful tax regimes" that the OECD claims they are today.

The Treasury did manage to get some of these smaller U.K. jurisdictions to sign TIEAs by promising them tax benefits that have generally turned out to be worthless. So-called *North American treatment* for Americans attending business conventions may be of some value to jurisdictions like the Bahamas and Bermuda that have lots of hotels and convention business. It is almost worthless to a country such as Dominica or Grenada with few hotels and little or no business conventions. It is the only "bone" that Treasury can still give to qualified CBI countries that sign a TIEA in the form of an executive agreement as authorized by the 1983 Caribbean Basin Economic Recovery Act. Treasury gave this bone to Antigua and Barbuda when it signed a TIEA in December 2001 and to the Bahamas (effective only in 2006) when it signed a TIEA in January 2002. It did not and could not give even this bone to the Cayman Islands when it signed its TIEA in November 2001 because Cayman had never become a qualified CBI jurisdiction.

The other CBI tax benefits no longer exist. Barbados was one of the few Caribbean countries (excluding U.S. possessions) to benefit from forming foreign sales corporations (FSCs) but this benefit is no longer operational as a result of successful attacks by the WTO. Not even one new FSC was formed in Barbados during the year 2001. One or two of the smaller Caribbean jurisdictions may have benefited by receiving funds from Puerto Rico under twin-plant programs but these have been discontinued as a result of Congressional repeal of the implementing legislation.

U.S. TIEAs are executive agreements rather than tax treaties. They are authorized by the 1983 CBI legislation. Since they are not treaties, they do not require ratification or Senate oversight or consent. Nor do they give taxpayers of the other TIEA party any of the basic tax benefits typically given by tax treaties such as reduced withholding taxes, a nondiscrimination clause, and mutual assistance. They give the United States the primary thing it wants — the ability to obtain information from the other country. Although the U.S. TIEAs are generally worded as agreeing to provide information on a reciprocal basis, the other country may have no use for such information.

The old U.K.-U.S. and Netherlands-U.S. treaties as extended to the Caribbean applied and were abused in the days before the United States had invented and perfected the limitation on benefits (LOB) provisions found in many U.S. tax treaties today. A well drawn LOB provision could stop any similar treaty abuse today. Such a clause was included in the proposed Netherlands Antilles-U.S. and Aruba-U.S. income tax treaties signed in 1986 that never entered into force. The United States subsequently canceled the old treaty as it applied to the Netherlands Antilles and Aruba.

Who Should Receive Tax on Cross-Border Investment Income?

Most of the smaller Caribbean countries now lack the ability to tax foreign-source income effectively. Their residents who derive dividends, interest, and royalties from the developed countries do pay tax but most or all of that tax now goes to the source country in the form of a high non-treaty withholding tax on investment income. None of that tax is shared with the residence country.

Which country has a greater entitlement to that income? Should tax on dividends, interest, and royalties be kept by the source country? Should it all belong to the residence country? Or, should it be divided between the source country and the residence country? Under most tax treaties, such income is divided equitably between the two countries.

In April 2000, the OECD published its Model Tax Convention on Income and on Capital together with a commentary on the articles of the model treaty. Commentaries 5 and 6 on Article 10 of the OECD model say that as a general rule the taxation of dividends exclusively by the source country is not acceptable and that the taxation of such income exclusively in the beneficiary's residence country is not feasible. Commentary 13 on that article suggests that a 15 percent rate for source-country tax on portfolio dividends is a maximum rate. It suggests that the countries may negotiate a lower rate.

The OECD model and its commentaries suggest a maximum source-country tax of 10 percent on interest and they further suggest negotiations for a lower source-country tax or even exclusive taxation of interest in the beneficiary's residence country. The OECD also recommends exclusive taxation of royalties in the beneficial owner's residence country.

The OECD Model TIEA

We are now faced with a situation in which 30 OECD countries have pressured 31 non-OECD countries into signing letters committing themselves to exchange information with each of the OECD countries. In April 2002, the OECD published its model TIEA. There are two versions. One is a *multilateral* version in which any country foolish enough to sign it will be forced to adhere to the entire OECD wish list without getting anything in return. The other is a *bilateral* version that also offers the non-OECD countries nothing but to which other provisions might be added during negotiations.

No country should sign the multilateral version. The obvious reason why the OECD prefers a multilateral version is that if all 31 committed OFCs sign individual TIEAs with all 30 OECD member countries there will be over 900 separately negotiated agreements. Even worse, if negotiations result in any benefits being given to the OFCs, all of these agreements will probably require parliamentary approval in both countries.

A normal tax treaty has two aspects. It provides for exchange of information and administrative assistance to prevent fiscal evasion. That is what

the OECD wants and it has taken measures to force the OFCs to agree to give it. A normal tax treaty also provides for the elimination of double taxation by limiting the source country's right to tax certain types of income. The OECD and its member countries don't want to be bothered with giving any such benefits to a bunch of small less-developed countries, many of which don't have sophisticated revenue services.

Each of the OFCs targeted by the OECD should insist that the OECD countries enter into negotiations with it for a full tax treaty within a one or two-year period and that, in the interim, each proposed TIEA between the OFC and an OECD country should be a mini-treaty that provides some benefits to the OFC.

In looking for suitable interim benefits that should be acceptable to both an OECD country and an OFC, several factors should be taken into account:

- Most OECD countries have well-trained tax officials who regularly negotiate tax treaties. Most of the OFCs don't have any such trained personnel. My colleagues and I are forming a nonprofit organization that will be available to assist OFC tax collecting personnel in negotiating TIEAs and tax treaties with other countries.
- We are planning to establish an on-line course on negotiating tax treaties and TIEAs at St. Thomas University in Miami, Florida, as part of that University's existing program in which it offers a Masters degree in International Taxation. We hope to provide partial or full scholarships for this program for some qualified individuals now working for the tax departments of OFC countries. These individuals would first take basic courses in international taxation and tax treaties and then a specialized course in negotiating tax treaties and TIEAs. The object of the exercise is to bring these people up to the level of their counterparts in the OECD countries.
- An interim solution is required because the OECD is pressing the OFCs to sign TIEAs now. We are preparing a model bilateral TIEA or mini-treaty that will give an OECD country most or all of the tax information exchange and administrative assistance it wants. It will, however, also provide some tax and other benefits to the OFC.
- We have taken note of a similar situation that has recently arisen in the European Union and the solution that has been reached there. The European Union is now completing work on a proposed revised savings tax directive that is supposed to be finalized before the end of 2002. The savings directive would generally provide that interest earned by a resident of one EU country from savings in another EU country would be taxable exclusively by the residence country. To make this work the source country would be required to provide full information concerning the savings interest to the residence country. Three EU countries have been unable to agree to this proposal and they have been granted an interim transition concession that is supposed to last for seven years.
- Austria, Belgium, and Luxembourg will each levy a 15 percent withholding tax on savings interest from 2004-2006 and a 20 percent withholding tax on such interest from 2007-2010 instead of exchanging information. The revised proposed EU savings tax directive provides a revenue sharing scheme covering the tax that is withheld. The country levying the withholding tax will retain 25 percent of the tax and transfer the remaining 75 percent

of the tax to the country of residence of the beneficial owner of the interest.

- We will include similar provisions in a draft model TIEA or mini-treaty that we are preparing for OFC governments to use in their negotiations with OECD countries.

A Better Solution

If the United States and other OECD member countries want information from Caribbean countries, especially those with whom they used to have normal income tax treaties, they should be willing to sign and ratify new income tax treaties with those countries that provide not only for the exchange of information and assistance in collecting taxes but also for nondiscrimination and some reasonable reductions from excessive withholding taxes on passive income, subject to a workable LOB clause designed to prevent treaty abuse.

All of the Caribbean jurisdictions that have been pressured by the OECD into signing commitment letters have agreed to establish transparent tax systems and to exchange information with OECD countries. They are entitled to receive some benefits in return. Thus far they have been offered little or nothing. Offering them information in exchange for information is useless in the case of those countries that have no income tax or no tax on foreign-source income. Most of these countries could use assistance in improving their existing tax systems and perhaps even encouragement to impose a modest income tax and enter into tax treaties. Offering them mini-treaties with a reduction in confiscatory withholding taxes provided they impose an income tax on the tax-benefited income would be a first step in the right direction.

Coupling that with revenue sharing of withholding taxes imposed by the source country on investment income paid to individual residents of the other country would be even more helpful. Such revenue sharing would be entirely consistent with stated OECD policy that cross-border investment income should be taxed primarily by the residence country, not the source country. It would also be consistent with the approach taken by the European Union in its revised draft savings directive. Any such mini-treaties should contain mutual commitments to enter into negotiations within one or two years for a more comprehensive income tax treaty. The OECD should also establish and fund a program to teach non-member countries how to improve their tax systems and how to negotiate tax treaties.

If the United States can have income tax treaties in force with countries such as Armenia, Azerbaijan, Barbados, Belarus, Bermuda, Cyprus, Georgia, Hungary, Iceland, Jamaica, Kazakhstan, Kyrgyzstan, Moldova, Morocco, Romania, Slovenia, Tajikistan, Trinidad and Tobago, and Uzbekistan, it can also afford to have them with Anguilla, Antigua and Barbuda, Aruba, Belize, the BVI, Dominica, Grenada, Montserrat, the Netherlands Antilles, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, and the other Caribbean countries from which it now wants information. ✦