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ARTICLES

The Proposed Domestic Reverse Hybrid Entity Regulations: Can the Treasury Department Override Treaties?

by Anthony C. Infanti *

By demonstrating an increasing willingness during the past 25 years to exalt its fiscal sovereignty over its obligations to its tax treaty partners, the United States has damaged not only its relations with those treaty partners, but also the interests of its own citizens and residents.[1] This damage has primarily been wrought by Congress through the passage of legislation that is intended to override inconsistent provisions in existing tax treaties under the later-in-time rule.[2] Of late, the Treasury Department — historically, a vocal opponent of these legislative overrides [3] — has also discovered the utility and expediency of the later-in-time rule and has itself begun to promulgate regulations that have the effect of overriding inconsistent treaty obligations.[4] Most recently, on February 27, 2001, the Treasury Department issued proposed regulations that address the tax treatment of payments made by a "domestic reverse hybrid entity" to its interest holders.[5] As described below, these regulations are inconsistent with at least one existing tax treaty and, as a result, raise anew the question whether the Treasury Department has the authority to override tax treaties through

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[1] *See* Infanti, "Curtailing Tax Treaty Overrides: A Call to Action," 62 *U. Pitt. L. Rev.* ____, ____-____ (2001) [hereinafter Infanti].

[2] Under the judicially-developed later-in-time rule, in the event of a conflict between a treaty and a statute, "the one last in date will control the other." *Whitney v. Robertson*, 124 U.S. 190, 194 (1888).

[3] *See, e.g., Tax Treatment of Expatriated Citizens: Hearing Before the S. Comm. on Fin.*, 104th Cong. 5-6 (1995) (statement of Leslie B. Samuels, Assistant Secretary for Tax Policy, U.S. Department of the Treasury); *Tax Conventions with: The Russian Federation, Treaty Doc. 102-39; United Mexican States, Treaty Doc. 103-7; The Czech Republic, Treaty Doc. 103-17; The Slovak Republic, Treaty Doc. 103-18; and The Netherlands, Treaty Doc. 103-6. Protocols Amending Tax Conventions with: Israel, Treaty Doc. 103-16; The Netherlands, Treaty Doc. 103-19; and Barbados, Treaty Doc. 102-41: Hearing Before the S. Comm. on Foreign Relations*, 103d Cong. 9-10 & 20 (1994) (statement of Leslie B. Samuels, Assistant Secretary for Tax Policy, U.S. Department of the Treasury); *Pending Bilateral Tax Treaties and OECD Tax Convention: Hearing Before the S. Comm. on Foreign Relations*, 101st Cong. 13 (1990) (statement of Kenneth W. Gideon, Assistant Secretary for Tax Policy, U.S. Department of the Treasury); "International Taxes: Congress Shows Willingness to Override Treaty Provisions, Treasury Official Says," *Daily Tax Rep.* (BNA) at G-1 (1/29/90); Interview by Eric R. Fox with Philip D. Morrison, International Tax Counsel, U.S. Department of the Treasury (2/27/90), *reprinted in* "One Treaty at a Time, Says International Tax Counsel," 1 *J. Int'l Tax'n* 40 (1990); "Tax Treaties: Treasury Official Warns of Effects of Treaty Overrides," *Daily Tax Rep.* (BNA), at G-3 (11/1/90); *The Technical Corrections Act of 1987: Hearing Before the Subcomm. on Taxation and Debt Mgmt. of the S. Comm. on Fin.*, 100th Cong. 16-21 (1988) (statement of O. Donaldson Chapoton, Deputy Assistant Secretary for Tax Policy, U.S. Department of the Treasury); Interview with Stephen E. Shay, International Tax Counsel, U.S. Department of the Treasury (Aug. 20, 1987), *available at* LEXIS 87 *TNI* 34-3; Letter from James A. Baker III, Secretary of the Treasury, to Dan Rostenkowski, Chairman, U.S. House Committee on Ways and Means (July 31, 1986), *reprinted in Daily Tax Rep.* (BNA), at G-8 (8/1/86); Letter from James A. Baker III, Secretary of the Treasury, to Robert Packwood, Chairman, U.S. Senate Committee on Finance (4/7/86), *reprinted in* Daily Tax Rep. (BNA) at J-1 (4/16/86).

[4] *See, e.g.*, Guenther, "Tax Treaties and Overrides: The Multiple-Party Financing Dilemma," 16 *Va. Tax Rev.* 645, 668-70 (1997) (arguing that regulations relating to the characterization of multiple-party financing arrangements override treaty obligations); Carlisle & Lanning, "Tax Treatment of Substitute Payments Under Securities Lending and Sale Repurchase Transactions," 15 *J. Tax'n Inv.* 246 (1998) (arguing that regulations relating to the source and character of substitute dividend and interest payments override treaty obligations); T.D. 8658, 1996-1 C.B. 161, 162 (indicating that "the provisions of §1.882-5 constitute the *exclusive* rules for allocating interest expense to the income from the U.S. trade or business of all foreign corporations, including foreign corporations that are residents of countries with which the United States has an income tax treaty") (emphasis added).

[5] Treaty Guidance Regarding Payments with Respect to Domestic Reverse Hybrid Entities, 66 Fed. Reg. 12,445 (proposed 2/27/01) (to be codified at Regs. §1.894-1) [hereinafter Proposed DRH Regulations]. All section references herein are to the Internal Revenue Code, as amended, and the regulations thereunder, unless otherwise stated.

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the promulgation of inconsistent regulations.[6] Having recently argued elsewhere that Congress lacks the constitutional authority to override tax treaties and having further advocated the relentless questioning of this authority,[7] I would like to take this opportunity to greet the promulgation of the Proposed DRH Regulations with an equal dose of reprobation.

SUMMARY OF PROPOSED DRH REGULATIONS

A domestic reverse hybrid entity (a "DRH") is "a domestic entity that is treated as not fiscally transparent for U.S. tax purposes and as fiscally transparent under the laws of the interest holder's jurisdiction, with respect to the item of income received by the domestic entity." [8] For U.S. federal tax purposes, an entity is treated as *not* fiscally transparent if it is classified as a corporation (or if it is an "eligible entity" and elects to be treated as a corporation), but is treated as fiscally transparent if it is classified as a partnership or is disregarded as a separate entity.[9] An entity will generally be treated as fiscally transparent with respect to an item of income under the laws of the interest holder's jurisdiction "to the extent that the laws of the interest holder's jurisdiction require the interest holder resident in that jurisdiction to separately take into account on a current basis the interest holder's respective share of the item of income paid to the entity, whether or not distributed to the interest holder, and the character and source of the item in the hands of the interest holder are determined as if such item were realized directly from the source from which realized by the entity." [10] Thus, an example of a DRH would be a domestic limited liability company or partnership that elects to be treated as a corporation for U.S. federal tax purposes, but which continues to be treated as akin to a partnership under the laws of the jurisdiction of one or more of its foreign members.

The final §894 regulations,[11] which address the ability of hybrid entities to claim treaty benefits, provide that neither a DRH nor its foreign interest holders can claim treaty benefits with respect to payments of U.S. source income that are made *to* the DRH.[12] This rule is ostensibly based on the application to DRHs of the "saving clause" that is found in (and is peculiar to) U.S. income tax treaties.[13] During the course of promulgating the final §894 regulations, commentators expressed concern that "it was unclear how items of income paid *by* a [DRH] to its interest holders should be treated" [14] under the regulations. The Proposed DRH Regulations, which were issued to address this concern, clarify that an interest holder in a DRH is eligible to claim treaty benefits with respect to payments made *by* the DRH, so long as the interest holder is not itself fiscally transparent.[15] The Proposed DRH Regulations do more, however, than just clarify the ability of an interest holder in a DRH to claim treaty benefits; they also contain an anti-abuse exception. This exception was prompted by reports that taxpayers had begun to exploit the differences between the treatment of DRHs under U.S. and foreign entity classification rules in an attempt to reduce the amount of tax imposed on items of income paid from the United States to foreign interest holders in the DRHs.[16]

In what the Treasury Department has described as a "typical scenario," a foreign investor who is a resident of a treaty jurisdiction establishes a DRH as the holding company for a wholly-owned U.S. operating company.[17] The foreign interest holder capitalizes the DRH with a combination of debt and equity that is designed to avoid the application of the earnings stripping limitations of §163(j).[18] After this structure has been put in place, the U.S. operating company pays dividends to the DRH, while the DRH primarily makes payments of interest to the foreign interest holder.[19]

From a U.S. federal income tax perspective, interposing the DRH between the foreign interest holder and the U.S. operating company produces two valu-

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[6] For prior treatment of this subject, see Guenther, "Tax Treaties and Overrides: The Multi-Party Financing Dilemma," 16 *Va. Tax Rev.* 645, 664-75 (1997); Doernberg, "Overriding Tax Treaties: The U.S. Perspective," 9 *Emory Int'l L. Rev.* 71, 114 (1995) [hereinafter Doernberg, "Overriding Tax Treaties"]; and Doernberg, "Treaty Override by Administrative Regulation: The Multiparty Financing Regulations," 2 *Fla. Tax Rev.* 521, 533-44 (1995) [hereinafter Doernberg, "Override by Administrative Regulation"].

[7] Infanti, fn. 1 above, at ____-____.

[8] Regs. §1.894-1(d)(2)(i).

[9] *See* Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶1.07[2] (7th ed. 2000); McKee et al., *Federal Taxation of Partnerships and Partners* ¶2.02[1]-[2] (3d ed. 1997); Regs. §301.7701-2; Regs. §301.7701-3.

[10] Regs. §1.894-1(d)(3)(iii)(A).

[11] T.D. 8889, 2000-30 I.R.B. 124.

[12] Regs. §1.894-1(d)(2)(i).

[13] T.D. 8722, 1997-2 C.B. 81, 84. The saving clause reserves to the United States the right to tax its citizens and residents as if the treaty had never entered into force. *See, e.g.*, U.S. Model Income Tax Convention art. 1, para. 4 (1996), *reprinted in* 1 *Tax Treaties* ¶214.01 (1998).

[14] Proposed DRH Regulations, at 12,445 (emphasis added).

[15] *Id.* at 12,447.

[16] *Id.* at 12,446.

[17] *Id.*

[18] *Id.*

[19] *Id.*

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able benefits. First, the DRH is treated, for the most part, as making deductible interest payments to the foreign interest holder (rather than nondeductible dividend payments). Second, assuming that the treaty concluded by the United States with the foreign interest holder's jurisdiction eliminates the withholding tax on payments of interest and caps the withholding tax on payments of related party dividends at 5%, the payments to the foreign interest holder are converted from taxable dividends into tax-free interest.

From the perspective of the tax laws of the foreign interest holder's jurisdiction, the interest holder is treated as receiving the dividend payments directly from the U.S. operating company because the DRH is considered to be fiscally transparent. This treatment may redound to the benefit of the foreign interest holder, if it can take advantage of the mechanism (e.g., a tax credit) that its jurisdiction has adopted for integrating the taxation of corporations and shareholders.[20]

The anti-abuse exception in the Proposed DRH Regulations is targeted at preventing this arbitrage, and, accordingly, is premised on a structure similar to the one described above (i.e., a foreign investor who holds an interest in a "related" DRH that has an interest in a "related" domestic entity).[21] If the requisite structure is established, then the Proposed DRH Regulations recharacterize certain payments made by the DRH to its foreign interest holder as dividends, but only if: (i) the domestic entity makes a payment to an entity (the DRH) that is treated as a dividend under either the laws of the United States or the laws of the jurisdiction of the foreign interest holder; (ii) the payee entity is a DRH as to the payment (i.e., under U.S. law, the entity is treated as a corporation, but under the laws of the jurisdiction of the foreign interest holder the entity is fiscally transparent meaning that the foreign interest holder is treated as deriving its proportionate share of the payment made by the domestic entity to the DRH); and (iii) the DRH makes a payment to the foreign interest holder that is of a type that is deductible for U.S. federal income tax purposes and for which a reduction in the U.S. withholding tax rate would normally be allowed.[22] If these requirements are satisfied, then the payment made by the DRH to the foreign interest holder is recharacterized as a dividend for all purposes of the Internal Revenue Code as well as for purposes of the applicable income tax treaty.[23] This recharacterization results in the disallowance of the DRH's deduction for the payment made to the foreign interest holder and causes this payment to be subject to a higher rate of withholding tax.[24]

TREATY OVERRIDE POTENTIAL

An issue not addressed by the Treasury Department in the preamble to the Proposed DRH Regulations is their consistency with existing[25] U.S. treaty obligations. Yet, even a cursory review of the dividend and interest articles in existing tax treaties reveals the potential inconsistencies between the Proposed DRH Regulations and these treaty obligations. By way of example, consider the effect of the Proposed DRH Regulations on the following structure: A resident of Poland forms a U.S. partnership and capitalizes it with a combination of debt and equity. The U.S. partnership elects to be treated as a corporation for U.S. federal tax purposes, but is treated as a fiscally transparent entity for Polish tax purposes[26] (and, therefore, is classified as a DRH). The U.S. partnership then acquires all of the stock of a U.S. operating company. The U.S. operating company periodically pays dividends to the U.S. partnership, which, in turn, makes payments primarily of interest to its Polish interest holder.

In order to isolate the inconsistency between the treaty and the Proposed DRH Regulations, let us fo-

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[20] *Id. See also* Am. Law Inst., *Federal Income Tax Project: Integration of the Individual and Corporate Income Taxes* 50-53 (1993) (explaining the common mechanisms employed to integrate the taxation of corporations and shareholders).

[21] Whether these persons are related is determined using the rules of §267(b) and §707(b)(1), substituting an 80% ownership threshold for the 50% ownership threshold appearing in those sections and employing the constructive ownership rules of §318 and §267(c). Prop. Regs. §1.894-1(d)(2)(ii)(B)(3), 66 Fed. Reg. 12,448 (2/27/01). In addition, if a person enters into a transaction with the domestic entity, the DRH, or the foreign interest holder, and the effect of that transaction is to avoid the principles of the Proposed DRH Regulations, then that person will be treated as related to the DRH for purposes of the Proposed DRH Regulations. *Id.*

[22] Prop. Regs. §1.894-1(d)(2)(ii)(B)(1)(i)-(ii), 66 Fed. Reg. 12,447 (2/27/01).

[23] Prop. Regs. §1.894-1(d)(2)(ii)(B)(1)(iii), 66 Fed. Reg. 12,447-48 (2/27/01). The payment made by the DRH to the foreign interest holder is recharacterized as a dividend to the extent of the foreign interest holder's share of current or prior dividend payments made by the domestic entity to the DRH, reduced by prior dividend payments (whether actual or recharacterized as such under the Proposed DRH Regulations) made by the DRH to the foreign interest holder. Prop. Regs. §1.894-1(d)(2)(ii)(B)(iii)-(iv), 66 Fed. Reg. 12,447-48 (2/27/01).

[24] Prop. Regs. §1.894-1(d)(2)(iii), *Ex.* 3, 66 Fed. Reg. 12,448 (2/27/01).

[25] In this context, the definition of the word "existing" is open to some question. *See* Doernberg, "Overriding Tax Treaties," fn. 6 above, at 114 (exploring the application of the later-in-time rule to the interaction between regulations and inconsistent treaty obligations); Doernberg, "Override by Administrative Regulation," fn. 6 above, at 544-50 (same).

[26] *See* Org. for Econ. Co-operation & Dev., Issues in International Taxation No. 6: The Application of the OECD Model Tax Convention to Partnerships 113 (1999) (indicating that partnerships are fiscally transparent for Polish tax purposes).

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cus on the treatment of the interest payments from the U.S. partnership to its Polish interest holder — first under the income tax treaty between the United States and Poland [27] and then under the Proposed DRH Regulations. Under the U.S.-Poland Treaty, interest is defined as "income from bonds, debentures, Government securities, notes, or other evidences of indebtedness, whether or not secured and whether or not carrying a right to participate in profits, and debt-claims of every kind, as well as all other income which, under the taxation law of the Contracting State in which the income arises, is assimilated to income from money lent." [28] If structured correctly, the interest payments from the U.S. partnership to its Polish interest holder should fall within the purview of this broad definition of "interest," and, as a result, should benefit from the U.S.-Poland Treaty's elimination of the U.S. withholding tax on interest payments.[29]

Once finalized, the Proposed DRH Regulations would recharacterize these interest payments from the U.S. partnership as dividends — for purposes of both the Internal Revenue Code *and* the U.S.-Poland Treaty.[30] This recharacterization, which would cause the payment from the U.S. partnership to be subject to a 5% withholding tax [31] where no withholding tax would otherwise be due, is "in clear contradiction" [32] to U.S.' obligations under the U.S.-Poland Treaty. Because the United States and Poland chose not to define the term "dividend" for treaty purposes,[33] the power to define that term devolved to the United States — but only when, as here, it is the amount of U.S. federal income tax that is to be determined.[34] The power to define the term "dividend" is not, however, a plenary one; for example, the United States may not define the term "dividend" in a manner that renders the treaty partially inoperative.[35] The Proposed DRH Regulations exceed the scope of the definitional authority granted to the United States by the treaty because, by recharacterizing a payment that falls squarely within the treaty's definition of interest as a dividend, the Proposed DRH Regulations would, in fact, render the interest article of the treaty inoperative.

If given effect, this *ultra vires* redefinition of the term "dividend" would constitute a breach of the United States' obligations under the U.S.-Poland Treaty; that the redefinition is designed to prevent what U.S. authorities view as an abuse of the treaty will not excuse or otherwise palliate the effect of the breach.[36] A breach of a treaty obligation constitutes a breach of international law, and is harmful to the United States because: (i) it damages the reputation of the United States as a member of the international community (as well as the international legal order itself); (ii) it erodes the trust of our treaty partners by undermining their expectation that the United States will remain faithful to its treaty obligations; and (iii) it ultimately works to the detriment of U.S. citizens and residents who may wish to avail themselves of the benefits of tax treaties because concern with the proclivity of the United States to override treaties has made our treaty partners increasingly unwilling to enter into reciprocal concessions and has led an increasing number of them to insist upon a right to renegotiate or retaliate in the event of an override.[37]

QUESTIONING REGULATORY OVERRIDES

The inconsistency of the Proposed DRH Regulations with existing treaty obligations raises anew the question whether an administrative agency, such as the Treasury Department, has the authority to promulgate regulations that cause the United States to breach its obligations to its treaty partners.[38] At the most basic level, it must be questioned whether Congress has the power to override treaties at all because Congress delegates the power to promulgate regulations to ad-

[27] Convention Between the Government of the United States of America and the Government of the Polish People's Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (Oct. 8, 1974), U.S.-Pol., 28 U.S.T. 891 [hereinafter U.S.-Poland Treaty].

[28] *Id.* art. 12, para. 4, 28 U.S.T. at 909.

[29] *Id.* art. 12, para. 1, 28 U.S.T. at 908.

[30] *See* text accompanying fns. 21-24, above.

[31] U.S.-Poland Treaty, art. 11, para. 2, 28 U.S.T. at 907-08.

[32] Comm. on Fiscal Affairs, Org. for Econ. Co-operation & Dev., "Tax Treaty Overrides" ¶5 (1990), *available at* LEXIS 90 *TNI* 7-13.

[33] *See* U.S.-Poland Treaty, art. 11, 28 U.S.T. at 907-08.

[34] *Id.* art. 3, para. 2, 28 U.S.T. at 898 (providing that terms used, but not defined, in the treaty will have the meaning ascribed to them under the laws of the contracting state whose tax is being determined, unless the context otherwise requires).

[35] Model Tax Convention on Income and on Capital, art. 3, para. 2, cmt. ¶13 (Comm. on Fiscal Affairs, Org. for Econ. Co-operation & Dev. 1997) ("a State should not be allowed to make a convention partially inoperative by amending afterwards in its domestic law the scope of terms not defined in the Convention"). *See also* Vienna Convention on the Law of Treaties (May 23, 1969), art. 31, para. 1, 8 I.L.M. 679, 691-92 ("A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose."); *Restatement (Third) of Foreign Relations Law* §325(1) (1987) (same); Vienna Convention on the Law of Treaties, art. 31, para. 4, 8 I.L.M. at 692 ("A special meaning shall be given to a term if it is established that the parties so intended.").

[36] *See* Comm. on Fiscal Affairs, Org. for Econ. Co-operation & Dev., "Tax Treaty Overrides," ¶¶4 & 31-33 (1990), *available at* LEXIS 90 *TNI* 7-13.

[37] Infanti, fn. 1 above, at ____-____.

[38] *See* fn. 6 above.

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ministrative agencies, and Congress, of course, cannot delegate a power that it does not itself have. As mentioned above, I have argued elsewhere that Congress lacks the constitutional authority to enact legislative overrides of tax treaties.[39] However, even assuming that Congress does have the constitutional authority to enact such overrides, two further issues must be resolved before it can be found that Congress has delegated the power to override treaties to the Treasury Department: (i) whether Congress can ever delegate the power to override treaties to an administrative agency, and (ii) whether Congress has in fact delegated the power to override treaties to the Treasury Department in this instance.

The first issue was raised by Justice Thomas in his recent concurring opinion in *Whitman v. American Trucking Ass'ns, Inc.*,[40] which concerned, among other things, a nondelegation challenge to the Environmental Protection Agency's rulemaking authority under the Clean Air Act. As articulated by the majority in *American Trucking*, the constitutional question in the context of a nondelegation challenge is "whether the statute has delegated legislative power to the agency." [41] To survive a nondelegation challenge, the Court has required only that Congress provide an " 'intelligible principle to which the person or body authorized to [act] is directed to conform.' " [42] As explained in *American Trucking*, "[i]n the history of the Court, . . . the requisite 'intelligible principle' [has been found] lacking in only two statutes, one of which provided literally no guidance for the exercise of discretion, and the other of which conferred authority to regulate the entire economy on the basis of no more precise a standard than stimulating the economy by assuring 'fair competition.' " [43]

In his concurring opinion, Justice Thomas indicated his agreement that Congress had provided an "intelligible principle" in the relevant section of the Clean Air Act, but expressed his concern that this standard does not serve "to prevent all cessions of legislative power." [44] Rather, Justice Thomas was of the opinion "that there are cases in which the principle is intelligible and yet the significance of the delegated decision is simply too great for the decision to be called anything other than 'legislative.' " [45] Justice Thomas concluded his concurring opinion by stating that:

> As it is, none of the parties to this case has examined the text of the Constitution or asked us to reconsider our precedents on cessions of legislative power. On a future day, however, I would be willing to address the question whether our delegation jurisprudence has strayed too far from our Founders' understanding of separation of powers.[46]

Assuming that Congress is empowered to enact legislative overrides of tax treaties, an aggrieved foreign interest holder in a DRH might take Justice Thomas up on his invitation and argue that Congress cannot delegate the power to override treaties to the Treasury Department because the decision to override treaty obligations "is simply too great for the decision to be called anything other than 'legislative.' " [47] As the Supreme Court indicated in *Field v. Clark*,

> 'The true distinction . . . is between the delegation of power to make the law, which necessarily involves a discretion as to what it shall be, and conferring authority or discretion as to its execution, to be exercised under and in pursuance of the law. The first cannot be done; to the latter no valid objection can be made.' [48]

In its earlier opinion in *Wayman v. Southard*, the Court had, however, acknowledged that:

> The line has not been exactly drawn which separates those important subjects, which must be entirely regulated by the legislature itself, from those of less interest, in which a general provision may be made, and power given to those who are to act under such general provisions to fill up the details.[49]

The absence of a bright line between delegable and nondelegable powers notwithstanding, an argument might be made that the gravity of the power to override tax treaties militates in favor of its inclusion under the rubric of those "important subjects" [50] that must be handled exclusively by Congress.

The "importance" of the power to override treaties is several fold. First, under the Supremacy Clause of the Constitution, "all Treaties made, or which shall be made, under the Authority of the United States, shall

[39] Infanti, fn. 1 above, at ____-____.

[40] 121 S. Ct. 903, 919-20 (2001).

[41] *Id.* at 912.

[42] *Id.* (quoting *J.W. Hampton, Jr., & Co. v. U.S.*, 276 U.S. 394, 409 (1928)).

[43] *Id.* at 913.

[44] *Id.* at 920.

[45] *Id.*

[46] *Id.*

[47] *Id.*

[48] 143 U.S. 649, 693-94 (1892) (quoting *Cincinnati, Wilmington & Zanesville R.R. Co. v. Comrs.*, 1 Ohio St. 77, 88-89 (1852)).

[49] 23 U.S. (10 Wheat.) 1, 43 (1825).

[50] *Id.*

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be the supreme Law of the Land." [51] The power to override tax treaties is thus, in substance, the power to decide the extent to which they will remain the supreme law of the land and continue to govern the interactions between two distinct societies. Viewed in this light, the power to override tax treaties bears a strikingly close resemblance to what has been described by Alexander Hamilton as the "essence" of legislative power: "The essence of legislative authority is to enact laws, or in other words to prescribe rules for the regulation of society." [52] Second, while the broad authority of the executive branch with respect to matters of foreign relations is well-settled,[53] the Constitution expressly requires the participation of the legislative branch in the making of treaties.[54] Delegation to the executive branch of the judicially sanctioned legislative role in "unmaking" selected portions of treaties would appear to upset this balance of power.[55] Finally, the effects of delegating the power to override tax treaties are not confined to the domestic arena because the power to override tax treaties is, at its crux, the power to displace the joint determination of the United States and another sovereign nation concerning the tax treatment to be accorded an item of income or a given transaction. For these reasons, an aggrieved foreign interest holder might argue that, if a power to change the terms of existing tax treaties is to be exercised unilaterally by the United States at all, its importance dictates that it should be exercised only by the duly elected branches of government through the legislative process established in Article I of the Constitution.[56]

Assuming *arguendo* that Congress has the power to override treaties and that it can validly delegate that power to administrative agencies, the next issue to consider is whether Congress has delegated the power to override treaties to the Treasury Department in this instance. The Treasury Department has indicated that the Proposed DRH Regulations are being promulgated under the authority of §7805, §894, and §7701(*l*).[57] Section 7805 merely operates as a blanket grant of authority to the Treasury Department to "prescribe all needful rules and regulations" for the enforcement of the Internal Revenue Code.[58] One commentator has already argued that the grant of authority in §7805, when read in light of the general provisions of §894, is insufficient to support the promulgation of the Proposed DRH Regulations (even aside from the treaty override issue).[59] This same commentator has also argued that the specific grant of regulatory authority in §894(c)(2) is, by its terms, insufficient to support the promulgation of the Proposed DRH Regulations (once again, even aside from the treaty override issue).[60]

Having ruled out §894 and §7805 as containing insufficient support for the promulgation of the Proposed DRH Regulations, that leaves only §7701(*l*) as a potential basis for promulgating these regulations. Section 7701(*l*) permits the Treasury Department to "prescribe regulations recharacterizing any multiple-party financing transaction as a transaction directly among any 2 or more of such parties where [it] determines that such recharacterization is appropriate to prevent avoidance of any tax imposed by this title." [61] As the legislative history of the enactment of §7701(*l*) indicates, this grant of authority was meant to be rather broad; however, nowhere in the legislative history or in the text of §7701(*l*) did Congress explicitly delegate to the Treasury Department the power to override tax treaties.[62]

In view of the absence of an explicit delegation of the power to override treaties, the existence of an implicit delegation must be considered.[63] In applying the later-in-time rule, however, the Supreme Court has held that "[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 ex-

[51] U.S. Const. art. VI, cl. 2. Income tax conventions are "treaties" in the constitutional sense. *Samann v. Comr.*, 313 F.2d 461, 463 (4th Cir. 1963); *Am. Trust Co. v. Smyth*, 247 F.2d 149, 153 (9th Cir. 1957), *overruled on other grounds by Maximov v. U.S.*, 373 U.S. 49 (1963).

[52] The Federalist No. 75, at 504 (Alexander Hamilton) (Jacob E. Cooke ed., 1961). *See also* text accompanying fn. 48, above.

[53] *See U.S. v. Curtiss-Wright Export Corp.*, 299 U.S. 304, 319 (1936) ("the President alone has the power to speak or listen as a representative of the nation").

[54] U.S. Const. art. II, §2, cl. 2.

[55] *See* Infanti, fn. 1 above, at ____-____.

[56] *Cf. Clinton v. City of New York*, 524 U.S. 417 (1998) (invalidating the Line Item Veto Act, which permitted the President, pursuant to a procedure established by Congress, to render inoperative certain items in bills that had been enacted into law in accordance with the legislative process set forth in Article I of the Constitution and, in effect, to substitute his own policy judgment for that of Congress).

[57] Treaty Guidance Regarding Payments with Respect to Domestic Reverse Hybrid Entities; Correction, 66 Fed. Reg. 14,352 (3/12/01).

[58] §7805(a).

[59] May, "U.S. Treasury Attacks Domestic Reverse Hybrid Planning," 22 *Tax Notes Int'l* 1945 (2001).

[60] *Id.*

[61] §7701(*l*).

[62] *See* H.R. Rep. No. 103-111, at 727-29 (1993), *reprinted in* 1993 U.S.C.C.A.N. 958-60; H.R. Conf. Rep. No. 103-213, at 654-55 (1993), *reprinted in* 1993 U.S.C.C.A.N. 1343-44; Doernberg, "Override by Administrative Regulation," fn. 6 above, at 533.

[63] *See Chevron U.S.A. Inc. v. Natural Res. Def. Council*, 467 U.S. 837, 844 (1984) ("Sometimes the legislative delegation to an agency on a particular question is implicit rather than explicit.").

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pressed."[64] This canon of construction would appear to foreclose the possibility of an implicit delegation of the power to override treaties. Nevertheless, when Congress codified the later-in-time rule in 1988,[65] it disavowed any requirement that treaties be specifically adverted to either in the text of legislation or in accompanying legislative history as a prerequisite to the application of later-in-tme rule.[66] Yet, Congress at the same time indicated that the "initial presumption of harmony between . . . earlier treaties and later statutes"[67] was not altered by its codification of the later-in-time rule. In an early articulation of this presumption of harmony, Chief Justice Marshall stated that "an act of Congress ought never to be construed to violate the law of nations if any other possible construction remains."[68] Section 7701(*l*) is clearly susceptible of being construed so as not to violate the "law of nations" (what we now refer to as international law); all that is necessary is to confine the application of §7701(*l*) to situations where it will not conflict with existing treaty obligations — which still leaves §7701(*l*) a rather wide berth of application.[69]

Such a reading of §7701(*l*) is also consistent with the Senate's recent actions with respect to the income tax treaties concluded by the United States with Italy and Slovenia.[70] As sent to the Senate, each of these treaties contained broad anti-abuse provisions in their dividends, interest, royalties, and "other income" articles, which operated to deny the benefits of these articles "if the main purpose or one of the main purposes of a person is to take advantage of the benefits of the respective article through a creation or assignment of shares, debt claims, or rights that would give rise to income to which the respective article would apply."[71] While such broad anti-abuse provisions have appeared in tax treaties concluded by other countries, these were the first U.S. treaties to contain such provisions.[72] Congress was chary of approving these anti-abuse provisions because they represented a "policy shift," their potential implications had not been adequately explained by the Treasury Department, and the Treasury Department had not fully justified the need for rules that "go beyond present U.S. domestic law" (e.g., the substance-over-form and business purpose doctrines) in addressing the concerns raised by abusive transactions.[73] For these reasons, the Senate consented to these treaties subject to a reservation requiring that the anti-abuse provisions be stricken from the treaties.[74] In light of the Senate's recent unwillingness to grant the Treasury Department explicit, broad anti-abuse authority in the treaty context absent full, careful, and thoughtful consideration, it should not lightly be concluded that Congress granted similarly broad anti-abuse authority when it enacted §7701(*l*), especially given that such authority was mentioned neither in the text of the statute nor in the legislative history of its enactment.[75]

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[64] *Cook v. U.S.*, 288 U.S. 102, 120 (1933); *accord Trans World Airlines v. Franklin Mint Corp.*, 466 U.S. 243, 252 (1984); *McCulloch v. Sociedad Nacional de Marineros de Honduras*, 372 U.S. 10, 21-22 (1963); *Blanco v. U.S.*, 775 F.2d 53, 61 (2d Cir. 1985); *Torres v. Immigration & Naturalization Serv.*, 602 F.2d 190, 195 (7th Cir. 1979); *U.S. v. White*, 508 F.2d 453, 456 (8th Cir. 1974); *Ungo v. Beachie*, 311 F.2d 905, 907 (9th Cir. 1963).

[65] §7852(d).

[66] S. Rep. No. 100-445, at 326 (1988), *reprinted in* 1988 U.S.C.C.A.N. 4515, 4837. *See* fn. 2 above, for a description of the later-in-time rule.

[67] S. Rep. No. 100-445, at 321, *reprinted in* 1988 U.S.C.C.A.N. 4515, 4833.

[68] *Murray v. Schooner Charming Betsy*, 6 U.S. (2 Cranch) 64, 118 (1804). *See also Restatement (Third) of Foreign Relations Law* §114 (1987).

[69] *See* Doernberg, "Override by Administrative Regulation," fn. 6 above, at 528-30.

[70] Neither of these treaties has yet entered into force.

[71] S. Exec. Rep. No. 106-7, at 3 (1999) (concerning the tax treaty with Slovenia). *See also* S. Exec. Rep. No. 106-8, at 3 (1999) (concerning the tax treaty with Italy).

[72] *See* Joint Comm. on Taxation, Explanation of Proposed Income Tax Treaty Between the United States and the Republic of Slovenia (1999), *reprinted in* 3 *Tax Treaties* ¶8161, at 40,199-49 (1999); Joint Comm. on Taxation, Explanation of Proposed Income Tax Treaty and Proposed Protocol Between the United States and the Italian Republic (1999), *reprinted in* 2 *Tax Treaties* ¶4801F, at 33,080-81 (1999).

[73] S. Exec. Rep. No. 106-7, at 5 (1999) (concerning the tax treaty with Slovenia). *See also* S. Exec. Rep. No. 106-8, at 5 (1999) (concerning the tax treaty with Italy).

[74] *See* Fogarasi et al., "Current Status of U.S. Tax Treaties," 30 *Tax Mgmt. Int'l J.* 252 (2001).

[75] *See* Guenther, fn. 4 above, at 670-75; Doernberg, "Overriding Tax Treaties," fn. 6 above, at 114; Doernberg, "Override by Administrative Regulation," fn. 6 above, at 541-44.

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CONCLUSION

The underlying purpose of the Proposed DRH Regulations is to fill a lacuna in the final §894 regulations that could have resulted in a hardship to the foreign interest holders of DRHs. Unfortunately, the salutary effect of these regulations is all but negated by the inclusion of an exception that is aimed at preventing tax arbitrage and the perceived abuse of treaties. As described above, this anti-abuse exception is inconsistent with the provisions of at least one existing tax treaty and, therefore, raises the specter of a treaty override; however, the power of the Treasury Department to override treaties through the promulgation of inconsistent regulations (and, in particular, through the promulgation of the Proposed DRH Regulations) is open to serious question. Given the uncertain authority of the Treasury Department to promulgate a regulatory override, taxpayers and their counsel should vigorously oppose the application of the anti-abuse exception in the Proposed DRH Regulations to the extent that its effect is in clear contradiction to a treaty obligation of the United States.

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