The Creeping Breach of International Law

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I. INTRODUCTION

International trade continues to gain importance in U.S. foreign relations. The political and military confrontations between the Soviet Union ("U.S.S.R.") and the United States that dominated the international scene following the end of World War II have subsided. Now, however, economic confrontations between the United States, the European Community, and Asia are becoming more widespread, and the battles are in the arena of trade negotiations. As a result, more countries are entering into bilateral and multilateral negotiations to reduce international trade barriers in the sale of goods, transfer of technology, provision of services, sale of securities, and a host of other business transactions. This increase and the growing complexity of international trade provide incentives for the United States to settle trade conflicts through the use of treaties.¹

At the same time, negative attitudes in the United States toward international trade are on the rise. This may be due to dramatic increases of inward foreign direct investment,² or to general

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² "From 1980 to 1985, the FDIUS [Foreign Direct Investment in the United States] position increased from $83 billion to $185 billion, or at an average annual rate of growth of 17 percent. From 1985 to 1989, the FDIUS position grew slightly faster at an average annual rate of growth of 21 percent to $401 billion." DEP'T OF COMMERCE, FOREIGN DI-
subjective notions that the United States is losing prestige as a world economic power, that foreigners are "buying up America," or that other nations are treating the United States unfairly. In addition, the emergence of Japan and the European Community as world economic powers, the growth of Arab countries as world money centers, and the United States' loss of status in the world trading community are causing a profound shift in the way America perceives itself and how others perceive it.

The negative attitude towards international trade is aggravating the systemic conflict between international law and the U.S. domestic legal system. This Article will examine this conflict and its impact on foreign nationals. First, it will analyze the reception of treaties into the U.S. domestic legal system, focusing on treaty provisions that guarantee non-discriminatory treatment embodied in the national treatment standard. Next, the Article will analyze federal statutory law that raises doubts about whether it treats foreign nationals equally. Finally, this Article will discuss the need for reconciliation and congruent practice in the application of domestic legal rules to valid treaty obligations.

Real or perceived unfair trade practices by Japan, Germany, and other developed and developing countries have resulted in actual or proposed legislation that borders on xenophobia, especially with respect to foreign direct investment. A national compulsion with establishing a "level playing field," and the ever-present cry that "foreign companies are not paying their fair share of taxes," result in legislation that has little regard and even disdain for existing U.S. treaty obligations. This attitude is aggravating the systemic conflict between the U.S. domestic legal system and the international legal system.
The hypothetical case of Ernst, a German national, will be used to track the national treatment standard and the treatment he actually receives under U.S. domestic law. Ernst will be involved in two separate transactions: (1) the unfriendly takeover of a U.S. company engaged in the manufacture and sale of computer chips; and (2) the purchase of 10,000 acres of farmland in Texas. The computer chip company makes an appealing target because inefficient management has created shareholder displeasure.

Ernst resides in Germany and harbors no desire to live in the United States. The perceived openness of the U.S. markets and the national treatment guarantees found in the United States-Germany Friendship, Commerce and Navigation ("FCN") Treaty and tax treaties encourage him to make his investments. Ernst will soon discover, however, that the U.S. legal system does not always provide the protection that the drafters of the treaties expected their provisions to offer.

II. THE RECEPTION OF TREATIES INTO THE U.S. DOMESTIC LEGAL SYSTEM: THE SYSTEMIC CONFLICT WITH INTERNATIONAL LAW

The treaty-making process begins when the executive branch negotiates the treaty and the U.S. Senate ratifies it. Upon ratification, the treaty becomes an international obligation among the states involved. This fact may not be of much importance to Ernst, however, as his legal protection is derived from how the U.S. domestic legal system receives and applies the treaty.

The legal theory of a particular state dictates how a treaty provision will be received and treated at the domestic level (and the resulting potential conflict). In a traditional monist state, international law theorists divide states into two principal categories: Monist and Dualist. The Monists view international law as unitary, with the international and domestic legal systems being integral parts of the same system. The traditional monist view is that, in a conflict between international law and national law, international law always prevails. The Dualists, on the other hand, see international law and domestic law as independent of each other. To Dualists, international law regulates the relations of the sov-
tional and domestic law do not conflict because the state considers international law to be directly applicable and supreme. Similarly, no conflict exists in a dualist state because it treats international legal systems as independent and never directly applicable domestically.

In either a monist or a dualist state, the status of a treaty is clear. Conflicts and confusion occur in states, like the United States, that use a system of self-executing and/or non self-executing treaties. This system mixes the non-traditional monist and dualist schools of thought. The separation of powers between the executive and legislative branches of the Federal Government, the federalist system, and the relatively static nature of treaties increase the conflict.

ereign, whereas domestic law regulates the internal affairs of the state. Under this theory, international law can only be applied in a state where it has been expressly incorporated into the national legal system. See Rebecca M.M. Wallace, International Law 31-51 (1986).

8. In some monist states, treaty provisions, even though directly applicable, may not be supreme because of their hierarchical status in the domestic system. If the treaty provision is given higher status than the domestic system (traditional monist view), subsequent domestic legislation will not overrule it. If, however, the treaty provision is not given higher status than the domestic system, subsequent domestic legislation will overrule it. John H. Jackson, Status of Treaties in Domestic Legal Systems: A Policy Analysis, 86 Am. J. Int'l L. 310, 320 (1992).

9. See discussion supra note 7.

10. The separation of powers between the branches is traced directly to the Constitution. “The Congress shall have Power . . . to regulate commerce with foreign Nations . . . .” U.S. Const. art. I, § 8; The President “shall have Power, by and with the Advice and Consent of the Senate, to make Treaties, provided two thirds of the Senators present concur.” U.S. Const. art. II, § 2.

11. Individual states have been active in passing legislation that affects valid treaty provisions. The U.S. Supreme Court has held, however, that a treaty provision “cannot be rendered nugatory in any part of the United States by municipal ordinances or state laws. It stands on the same footing of supremacy as do the provisions of the Constitution and laws of the United States.” Asakura v. Seattle, 265 U.S. 332, 341 (1924). Notwithstanding this rule, individual states have attempted to regulate foreign investment. For a discussion of the constitutionality of state attempts under the Dormant Commerce Clause and the Foreign Affairs Power, see generally Cheryl Tate, Note, The Constitutionality of State Attempts To Regulate Foreign Investment, 99 Yale L.J. 2023, 2033-42 (1990).

12. Treaties are static instruments, formulated with reference to circumstances existing at the time of the particular treaty's conclusion. They rarely provide a predictable mechanism for accommodating change, thus becoming vulnerable to the political pragmatism of federal lawmakers. Note, however, that the doctrine of rebus sic standibus does allow some relief:

A fundamental change of circumstances which has occurred with regard to those existing at the time of the conclusion of a treaty, and which was not foreseen by the parties, may not be invoked as a ground for terminating or withdrawing from the treaty unless: (a) the existence of those circumstances constituted an essential
III. THE SELF-EXECUTING/NON SELF-EXECUTING DICHOTOMY

A self-executing treaty generally follows the non-traditional monist view. It is thus directly applicable in the U.S. domestic system, and, upon becoming an obligation under international law, it forms a part of U.S. domestic law on an equal status with federal statutory law. A non self-executing treaty, on the other hand, follows the dualist view. It requires the adoption of implementing legislation to become part of the U.S. domestic system. In fact, the implementing legislation itself, and not the treaty, is the law that gives rise to obligations under international law.

The systemic conflict between international law and U.S. federal law can occur in several ways. First, when a self-executing treaty provision is directly applicable in the U.S. legal system but is inferior to federal statutory law, and Congress subsequently passes a clearly inconsistent statute, the treaty provision has no effect in the U.S. domestic system. This is true even though the treaty basis of the consent of the parties to be bound by the treaty; and (b) the effect of the change is to radically transform the extent of obligations still to be performed under the treaty.

Vienna Convention, supra note 1, art. 62(1).

13. For a discussion asserting that the distinction between self-executing and non self-executing treaties is a judicially-invented doctrine inconsistent with the U.S. Constitution, see generally Jordan J. Poust, Self-Executing Treaties, 82 AM. J. INT'L L. 760 (1988).

14. "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." U.S. CONST. art. VI, § 2.

15. The threshold question of whether a treaty is self-executing or non self-executing has caused conflict. The courts have held that a treaty is non self-executing when the treaty relates to a power exclusive to Congress, e.g., the appropriation of money or the raising of revenue.

Thus, the expenditure of funds by the United States cannot be accomplished by [a] self-executing treaty; implementing legislation appropriating such funds is indispensable. Similarly, the constitutional mandate that "all Bills for raising Revenue shall originate in the House of Representatives"... appears, by reason of the restrictive language used, to prohibit the use of the treaty power to impose taxes.


Other guidelines used in determining whether a treaty is self-executing or not are: (1) whether the instrument itself states that implementing legislation is required; (2) whether the Senate, in ratifying the treaty, requires implementing legislation; (3) whether Congress, by resolution, requires implementing legislation; or (4) whether the Constitution requires implementing legislation. RESTATEMENT, supra note 1, § 111.4 n.5.

16. RESTATEMENT, supra note 1, §§ 115.1-2. Because courts are obliged to give effect to a subsequent federal statute, interpretive rules to prevent an unintentional breach of
continues to be a valid international obligation. Second, when a non self-executing treaty is negotiated by the executive branch and ratified by the Senate, it becomes an international obligation. If the implementing legislation ratified to receive the treaty into the U.S. domestic system varies from the terms of the treaty, however, the enabling legislation, and not the underlying treaty, becomes the law in the United States. Thus, the treaty provision has no effect in the United States even though it continues to be a valid international obligation. Finally, when a treaty, whether self-executing or not, provides that a foreign national will be given the same treatment as U.S. nationals, and subsequent federal legislation is passed that discriminates against the foreign national, the U.S. legal system denies relief against discrimination even though the international obligation remains in force. This Article focuses on the third scenario.

IV. THE NATIONAL TREATMENT STANDARD: THE PROMISE OF NON-DISCRIMINATORY TREATMENT

As Ernst prepares to make a substantial investment in the United States, he finds solace in the national treatment guarantees found in the FCN Treaty: “Nationals and companies of valid treaty provisions have been formulated. “[A]n act of congress ought never to be construed to violate the law of nations if any other possible construction remains.” Murray v. Schooner Charming Betsy, 6 U.S. (2 Cranch) 64, 118 (1804) (codified as amended at RESTATEMENT, supra note 1, § 114). This interpretive rule does not help in those cases where a federal statute specifically overrides a treaty provision.

17. The implementing legislation transforms the international obligation into a domestic law. The “act of transformation” itself can become a power struggle between the executive and legislative branches of the government. Jackson, supra note 8, at 325.

18. The national treatment standard is a pledge by a contracting state that the one state will not discriminate against the citizens of the other; that it will treat a national of the other treaty country the same as its own nationals. The aim of the standard is to provide non-discriminatory treatment. Herman Walker, Jr., Modern Treaties of Friendship, Commerce and Navigation, 42 MINN. L. REV. 805, 810-11 (1957-58). In a tax context, national treatment is described in the principle of horizontal equity: “Persons who are similarly situated should be treated equally.” BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS § 3.1.4 (2d ed. 1989).

The United States has accepted the national treatment standard as good policy. For example, then President Ronald Reagan stated:

With respect to foreign direct investment, U.S. policy has been to follow the national treatment standard, except in those instances involving national security. The United States opposes the use of government practices which distort, restrict or place unreasonable burdens on direct investment. . . . The United States will continue to work for the reduction or elimination of unreasonable and discriminatory barriers to the entry of investment. The United States believes that for-
either party shall be accorded, within the territories of the other party, national treatment with respect to engaging in all types of commercial, industrial, financial and other activity for gain. . . ."  

The FCN Treaty also provides:

Nationals of either Party residing within the territories of the other Party, and nationals and companies of either Party engaged in trade or other gainful pursuit . . . shall not be subject to the payment of taxes, fees or charges imposed upon or applied to income, capital, transactions, activities or any other object . . . more burdensome than those borne in like situations by nationals and companies of such other Party.  

Additionally, the guarantee in the Income Tax Treaty states:

Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith that is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected.  

For Ernst to avail himself of the national treatment guarantee, however, he has to show like circumstances with U.S. nationals. Specifically, he must show that the particular FCN or tax treaty
does not provide for a derogation from its provisions, or that the nature of the transaction does not warrant a denial of national treatment. Ernst is confident that none of these limiting factors exists and goes forward with the transactions. He is unaware that Congress, in enacting the federal statutory framework, intended to take advantage of foreign companies to raise capital.

V. SPECIFIC FEDERAL STATUTES THAT RAISE DOUBTS OF NON-DISCRIMINATORY TREATMENT

The statutes that arguably contravene the national treatment standard cover the entire breadth of international trade. In their wake, substantial questions arise regarding U.S. compliance with the fundamental precepts embodied in the doctrine of pacta sunt servanda. The hypothetical case of Ernst will be used in this Section to demonstrate the effect of these statutes on foreign persons.

23. The national treatment standard in FCN treaties can be subject to express exceptions involving certain types of vital activities; it may also be qualified by protocols that sometimes accompany the treaties. See generally Note, The Rising Tide of Reverse Flow: Would a Legislative Breakwater Violate U.S. Treaty Commitments?, 72 MICH. L. REV. 551, 567-92 (1973-74) (analyzing 11 national treatment standards in FCN treaties and their exceptions). The national treatment guarantee in the German FCN Treaty is not limited by the Protocol. See FCN Treaty, supra note 19, protocol, paras. 8-13.

The provisions in tax treaties allowing for derogation from treaty terms are those that impose a limitation on benefits under the treaties. E.g., U.S.-F.R.G. Tax Treaty, supra note 21, art. 28. The objective of these provisions is to prevent non-contracting state nationals (Third Country nationals) from enjoying the tax benefits under the treaties. Except in those instances where "treaty shopping" is prohibited, tax treaties do not contemplate derogation. The treaties do provide for notification to the other contracting state of any significant changes that have been made in the respective state's tax laws. See, e.g., id. art. 2(2). There is, however, no provision in the treaties that allows a specific derogation from the treaties by subsequent federal legislation. The relevant provisions in the Model Income Tax Treaty use substantially the same language. See Model Income Tax Treaty, supra note 21, arts. 2(2), 16.


25. "Levying higher taxes on foreign companies is seen as a painless—indeed popular way of augmenting budget revenues." Foreigners as Scapegoats, FIN. TIMES, July 24, 1990, at 18.
A. The Unfriendly Takeover of the Computer Chip Company

1. The Initial Investment: Restrictions on Foreign Investment

Ernst faces an array of statutes that either restrict inward foreign direct investment, based on the protection of vital national interests, or at least require him to report the investment. The statutory restrictions are found mostly in federal law and are aimed at certain industries. These statutes are generally accepted as a proper exercise of the power of a sovereign nation in the protection of its vital national interests. Some question, however, the fairness to foreign persons of the newest addition to the federal statutory framework in this area.

The Exon-Florio Amendment to the Omnibus Trade and Competitiveness Act of 198828 ("Exon-Florio") authorizes the President (or designee) to suspend or halt a merger, acquisition, or takeover of a U.S. firm by a foreigner if it would threaten U.S. national security interests.30 Because "national security" is not de-
fined in the statute or the regulations and only foreign persons are affected, Exon-Florio has the potential of being applied in a discriminatory manner. This would violate the national treatment standard provided by treaty, as there is no comparable federal legislation that similarly affects U.S. nationals.

In the hypothetical case, Ernst commences the hostile takeover. The management group, fearing the loss of jobs, resists the takeover, alleging national security implications. A broad reading of "national security" could stop the takeover. Thus, Exon-Florio acts as an investment screening mechanism which inefficient management can use to stay in power, even where there is no real threat to national security. The management group could not use Exon-Florio if the same takeover was being attempted by a U.S. national. Hence, Ernst is being treated differently on the basis of his nationality.

Even if Ernst is able to overcome Exon-Florio, other restrictions await him.

2. Choice of Entity

Legal, control, and tax considerations dictate what form of business organization an entity may choose. The litigious nature of the U.S. society favors the use of an entity that limits the liability of its shareholders. Ernst decides to operate as a domestic corporation.

All income will be subject to U.S. taxes even if earned abroad. Yet, if Ernst is expecting losses in the early years, he

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or after the date of enactment of this section by or with foreign persons so that such control will not threaten to impair the national security.


31. Instead of defining national security, the statute directs the President or his designee to consider certain national defense factors. Id.


cannot deduct those losses personally because U.S. law does not make subchapter S election\textsuperscript{34} available to the corporation.\textsuperscript{35} In contrast, a U.S. shareholder would be able to deduct these losses personally. Therefore, U.S. law does not provide the horizontal equity promised Ernst under the treaties.

**B. Operating the Business and Extracting Profits**

1. The Transfer Pricing Issue: The Scourge of Section 482

   \textit{a. The Politics of Inter-Company Pricing}

   Now that Ernst has decided to operate as a domestic corporation, he must conduct the business. Politicians often complain that foreign-owned corporations are not paying their "fair share" of taxes on U.S. operations,\textsuperscript{36} focusing on alleged price manipulations. They claim that foreign corporations come into the United States, make obscene profits, and remove those profits without paying taxes.\textsuperscript{37} This is a curious complaint, as it is very similar to complaints leveled by developing countries against U.S.-based multinational corporations.\textsuperscript{38} Nonetheless, there is keen interest in reviewing the operations of foreign-owned corporations in the

\begin{itemize}
\item \textsuperscript{34} Under Subchapter S of the Internal Revenue Code, as amended, certain closely-held corporations can elect to be treated as a pass-through entity. I.R.C. §§ 1361-1379 (1984). Once a valid election has been made, items of income, loss, deductions, and credits will be passed through the corporation to the shareholders.
\item \textsuperscript{35} 26 U.S.C. § 1361(b)(1)(c) (1988).
\item \textsuperscript{37} There are studies which do not attribute the low profits of foreign-owned companies to aggressive transfer pricing policy, but rather to start-up expenses, acquisition indebtedness, or other factors completely unrelated to any scheme of price manipulation. \textit{See International Taxes, Gideon Urges 'Balanced' Approach on Foreign-Controlled Corporation Taxes, DAILY REP. Exec. No. 135, July 13, 1990, at G-6.}
\item \textsuperscript{38} The dispute centers on the proper value of the expropriated property. Developing states argue that the value of the plant owned by citizens of developed states, such as the United States, should be adjusted to reflect the fact that the company has not contributed fairly to the country where it was doing business. They allege that profits and natural resources are removed from the country and that nothing is left behind. The argument was tacitly accepted by the United Nations when it adopted the "appropriate" standard of compensation. The "appropriate" standard suggests that adjustments should be allowed for unfair treatment to the developing state. \textit{See generally Richard Lillich, The Valuation of Nationalized Property in International Law: Toward a Consensus or More Rich Chaos, reprinted in International Business Transactions: A Problem-Oriented Coursebook 893 (Ralph H. Folsom et al. eds., 2d ed. 1991) (1975).}
\end{itemize}
United States. Ernst will likely become painfully aware of this interest.

b. The Mechanics of Inter-Company Pricing

Companies are able to manipulate prices between controlled corporations on inter-corporate sales. In particular, foreign corporations are able to manipulate prices by charging an inflated price to the U.S. domestic corporation, typically a subsidiary, for goods and services provided by the parent corporation. The inflated price causes the net income of the U.S. domestic corporation to decrease, which, in turn, decreases the U.S. tax bill.

The Tax Reform Act of 1986 partially addressed this problem. The biggest weapon in the U.S. arsenal against manipulative transfer pricing, however, is Section 482 of the Internal Revenue Code ("IRC"). It reads in pertinent part:

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of such organizations, trades, or businesses.

The Section is phrased broadly. Moreover, the actual wording of the Section does not limit its application to areas involving international trade. Nevertheless, international Internal Revenue Service ("IRS") agents have used it extensively in conducting investigations.

Adjustments made under Section 482 are fact-intensive and burdensome to refute. As a result, Section 482 adjustments involve

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39. The Tax Reform Act of 1986 provides that, in inter-corporate transactions involving inventory sale and purchase between related persons, the amount of any costs that (1) are taken into account in computing the basis or inventory cost of such property by the purchaser and (2) are taken into account in computing the customs value of such property, shall not, for purposes of computing such basis or inventory costs, be greater than the amount of such costs taken into account in computing such customs value. 26 U.S.C. § 1059A(a) (1988).

40. 26 U.S.C. § 482 (1954). To explain this deceptively brief Code Section, the IRS has issued about 200 pages of legislatively-mandated regulations to explain it. Temp. Treas. Regs. 1.482-OT, 1.482-1T, 1.482-2T-7T.
substantial costs. Economists, accountants, engineers, and lawyers must be hired to defend against Section 482 actions. Thus, Section 482 is an example of a statute that, although arguably usable against all taxpayers, is applied more frequently against foreign persons. Therefore, Ernst can never truly be secure in thinking that the IRS will respect the inter-company pricing arrangement that he sets up.

2. The Branch Profits Tax

If Ernst selects a German corporation to avoid the problems posed by Exon-Florio, the branch profits tax ("BPT") will adversely affect his business operations. The BPT imposes a tax on the dividend equivalent amount of a foreign corporation's U.S. branch, in addition to the tax on its normal business operations. Distributions from a U.S. branch to a domestic corporation home office are not taxed.

Congress passed the BPT because it believed that prior law discriminated in favor of foreign persons. The discrimination (in tax parlance, the lack of horizontal equity) operates in this way: A

41. The use of Section 482 of the IRC as a direct weapon against foreign companies surfaced in a proposed law that was not enacted. See 138 CONG. REC. 3819 (1992). The Act would have made discriminatory treatment a part of the statute by imposing a minimum tax on foreign corporations doing business in the United States whether or not any actual income was generated, if their U.S. industry group as a whole generated income. In a prepared statement about the proposed bill, the Treasury Department under then President Bush declared that the bill would breach notions of horizontal equity and the national treatment standard provided by the Treaty. The Treasury Department was opposed to the new Act because it would have discriminated against foreign-owned businesses in violation of tax treaties and long-standing tax policy. The Treasury went on to say that non-discrimination articles in U.S. treaties require foreign-controlled taxpayers to be treated in the same manner as similarly situated U.S.-controlled taxpayers. Further, the Treasury declared that the bill would violate arms-length standards in treaties used by treaty partners and the Organization for Economic Cooperation and Development. Prepared Statement of Assistant Secretary for Tax Policy Fred Goldberg Before House Ways and Means Committee at hearing on H.R. 5270, The Foreign Tax Rationalization and Simplification Act of 1992, July 21, 1992, DAILY REP. EXEC. NO. 141, July 22, 1992, at D-67.

42. See FCN Treaty, supra note 19, arts. 6-7.


branch of a U.S. domestic corporation transfers cash to its home office; the home office (domestic corporation) then distributes the cash to its shareholders. The cash distribution is then a dividend subject to U.S. taxation.\(^4\) The converse situation is as follows: A U.S. branch of a foreign corporation transfers cash to its home office; the home office (foreign corporation) then distributes the cash to its foreign shareholders. The cash distribution to the foreign shareholder is not subject to U.S. tax.\(^4\) Hence, under prior law, U.S. taxpayers were taxed twice on the same income while foreign taxpayers were taxed only once. To remedy this situation, the BPT imposes a double tax on the foreign shareholder. Although this seems fair at first, Ernst resides in Germany and has no desire to live in the United States. Are Ernst and a domestic shareholder situated so similarly as to warrant horizontal equity? Unfortunately for Ernst, they are not.\(^4\)

Even if similar circumstances exist, which would support the idea that foreigners should be taxed twice, the BPT overshoots the mark. The BPT does not provide horizontal equity. In fact, it treats foreign persons differently in two ways.

One difference is found in the timing of the tax. BPTs are computed annually, when the tax return is filed.\(^4\) The tax is therefore forced each year. In the case of a domestic person, however, the decision to pay dividends triggers the tax computation. Because the timing of dividend payments is within the discretion of the board of directors of the corporation, the dividend is generally controlled by the corporation. The timing of the payment is therefore more favorable to the U.S. citizen.

Even more significant is the dividend exclusion available to certain domestic corporate shareholders, which can be as high as one-hundred percent.\(^4\) The exclusion is allowed when the recipi-

\(^{45}\) There are several differences. For example, a U.S. person can avail himself of all the benefits of living in the United States, while Ernst cannot; a U.S. person can deduct expenses against dividend income, yet Ernst cannot. See U.S.-F.R.G. Tax Treaty, supra note 21, art. 10; I.R.C. § 212 (1986). For further reference, see generally Richard L. Kaplan, *Creeping Xenophobia and the Taxation of Foreign-Owned Real Estate*, 71 GEO. L.J. 1091, 1121-23 (1983) (discussing, in the setting of the Foreign Investments in Real Property Tax Act, that foreign persons are not in like circumstances with U.S. persons).
ent of a qualifying dividend is an includible corporate member of an affiliated group. The effect is that tax-free distributions are available at the corporate level to certain domestic corporate persons. By contrast, the dividend exclusion is not available to a comparable corporate arrangement involving a foreign corporation because a foreign corporation cannot be a member of an affiliated group.

Disheartened by these problems, Ernst now considers the acquisition of a Texas farmland.

C. The Investment in Texas Farmland

1. The Initial Investment

Congress is particularly wary about direct foreign investment in real estate, especially agricultural land. When Ernst purchases the agricultural land, he must comply with the reporting requirements imposed by the Agricultural Foreign Investment Disclosure Act (“AFIDA”). AFIDA, enacted on October 14, 1978, is a federal reporting statute designed to safeguard agricultural land acquired by foreigners.

AFIDA requires a foreign person who acquires or disposes of an interest in agricultural land to report the transaction to the U.S. Department of Agriculture within ninety days of the transaction’s

48. The term qualifying dividends “means dividends received by a corporation, which at the close of the day the dividends are received, is a member of the same affiliated group of corporations . . . distributing the dividend.” 26 U.S.C. § 243(b) (1988).
50. An “affiliated group” means, among other things, one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation. 26 U.S.C. § 1504(a)(1) (1988). A foreign corporation can never be a part of an affiliated group since it cannot be an includible corporation under the Statute. See definition of “includible corporation,” supra note 49.
51. See discussion supra note 50.
54. “Agricultural land” is defined as land in the United States used currently or within the last five years for farming, ranching, forestry, or timber production if the revenue exceeded $1,000 per year. 7 U.S.C. § 3508(1) (1988).
55. A “foreign person” is defined as: any foreign corporation; any person who is not a citizen or resident alien of the United States; or a domestic corporation with a foreign owner of a 10% interest. A “foreign corporation” is a corporation not organized under the laws of any state in the United States. 7 U.S.C. § 3508(3)-(4) (1988).
consummation.\textsuperscript{56} The Secretary of Agriculture can assess a civil penalty where it is deemed appropriate for carrying out the purposes of AFIDA.\textsuperscript{57} As this statute only applies to foreigners, it clearly imposes obligations on them that are not forced upon U.S. citizens.

Thus, upon his purchase of the farmland, Ernst must report the purchase, the location of the property, and the amount paid. In addition, he must post this information in the courthouse of the county where the land is situated. This clearly imposes upon Ernst an obligation that is obviously more burdensome than that imposed upon U.S. persons.

2. The Operation and Sale of the Property

Ernst, like any rational business person, is concerned with limiting expenses in the business operation. One of the costs associated with a business is the state ad valorem tax. In Texas, when property is used for agricultural purposes by U.S. citizens, a special lower tax rate is allowed.\textsuperscript{58} The lower tax is not available to foreigners, however.\textsuperscript{59} Thus, from a cost/operational perspective, Ernst will be treated unfavorably as compared to a U.S. citizen in the amount of ad valorem taxes he must pay.

Eventually, Ernst will sell his property. In that event, the Foreign Investments in Real Property Tax Act ("FIRPTA"),\textsuperscript{60} passed in 1980, will tax the capital gain realized on the sale of the prop-

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\textsuperscript{56} Any foreign person who acquires or transfers any interest other than a security interest in agricultural land must submit a report to the Secretary of Agriculture not later than 90 days after the date of such acquisition or transfer of the agricultural interest. 7 U.S.C. § 3501(a) (1988).

\textsuperscript{57} This report requires specific information on the person who purchases the land. In addition, the information required is very detailed and of the type that most people would prefer to maintain confidential; it includes the legal name and address of the foreign owner, the legal description of the property, and the amount paid. Also, the information must be posted in the courthouse of the county where the land is located. \textit{Id.}

\textsuperscript{58} The amount cannot exceed 25\% of the fair market value of the property at the time of the assessment on the basis of .1\% per week from the due date of the report. 7 U.S.C. § 3502 (1988).

\textsuperscript{59} The Texas ad valorem tax is generally based on the fair market value of the property. A special capitalization rate, which greatly reduces the tax, is allowed for agricultural property. \textit{Tex. Tax Code Ann.} §§ 23.01(a), 23.52-.53 (West 1992).

\textsuperscript{60} The Statute reaches this result by making the land ineligible for the special agricultural appraisal if the land is owned by a non-resident alien individual or by a corporation when the majority of the shareholders are non-resident aliens. \textit{Tex. Tax Code Ann.} § 23.56(2)-(3) (West 1992).
Congress enacted FIRPTA to correct a perceived violation of the principle of horizontal equity. Prior to the passage of the law, Ernst could have structured the sale in such a way that he would not have to pay federal income tax on the capital gain realized. This violated the principle of horizontal equity because a U.S. person, on the same transaction, could not avoid the tax.

In addition to substantive provisions, FIRPTA contains a withholding mechanism on the sale of the property. In addition, FIRPTA requires that Ernst report the purchase of the property. Typically, federal income tax law does not require information on purchases. On sales or results of operations, however, even a purchase of residential real estate held exclusively for personal use and not for profit is subject to reporting requirements under FIRPTA. There is no comparable reporting or withholding legislation for U.S. persons. The effect of this disparity is that non-resident aliens or foreign corporations are burdened more heavily than U.S. nationals.

As in the BPT analysis, the question is whether the foreign person should be taxed as a U.S. citizen. Is the foreign person truly

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61. FIRPTA imposes a tax on the gain in the disposition of a U.S. real property interest. A U.S. real property interest includes any interest in real property, except an interest solely as a creditor held by an individual or through a U.S. Real Property Holding Corporation ("USRPHC"). 26 U.S.C. § 897(c) (1988). The Act also imposes a tax on gains in the sale of stock of a USRPHC. A USRPHC is any domestic corporation where the fair market value of its U.S. real property interest equals or exceeds 50% of the fair market value of its U.S. real property interests, its interests in real property located outside the United States, plus any other of its assets that are used or held for use in a trade or business. 26 U.S.C. § 897(c)(2) (1988). Those corporations regularly traded in established securities markets are specifically excluded from the laws regulating a USRPHC.

62. See generally Kaplan, supra note 45, at 1121 (reviewing the statute challenging the idea of "like circumstances" existing between foreign and U.S. persons).

63. The purchaser in such case shall be required to deduct and withhold a tax equal to 10% of the amount realized on the disposition. 26 U.S.C. § 1445(a) (1988).

64. Section 6039C(a) requires any foreign person holding a direct investment in a U.S. real property interest for the calendar year to make a return setting forth: the name and address of such person; a description of all U.S. real property interests held by such person at any time during the calendar year; and such other information as the Secretary may by regulation prescribe. For purposes of this Section, a foreign person shall be treated as holding a direct investment in a U.S. real property interest during any calendar year if: such person did not engage in a trade or business in the United States at any time during the calendar year; and the fair market value of the U.S. real property interests held directly by such person at any time during the year equals or exceeds $50,000. 26 U.S.C. § 6039C(a)-(b) (1988).

65. The purchaser or a transferee in such a case shall be required to deduct and withhold a tax equal to 10% of the amount realized on the disposition. 26 U.S.C. § 1445(2) (1988).
situated similarly to the U.S. citizen? Even assuming that horizontal equity principles require substantive tax law changes and that the withholding rules are justifiable, the reporting obligations seem to go beyond placing the parties in like circumstances and to unduly burden the foreigners.

VI. THE NEED FOR RECONCILIATION AND CONGRUENT PRACTICE

A. The Case for Finding a Breach of International Law

The national treatment standard proscribes discriminatory treatment of foreign persons as compared to domestic persons in like circumstances. The United States includes the provision in treaties to protect U.S. companies doing business abroad from discrimination. The provision is essentially a part of the bargain negotiated in the treaty. Although there are benefits, the statutes also raise doubts about equal treatment. Ernst, for example, faces investment and tax statutes whose operative provisions are clearly more burdensome on foreign persons.

The initial question is whether there has been a breach of international law. In order to find a breach of international law, there must be a finding of a "significant violation of a provision essential to the agreement."\(^6\) Can the cumulative effect of the statutes constitute a creeping breach of international law? Even in the absence of such a finding, the United States must take steps to modify its system or the procedures by which it enters into treaties because there are other problems that can arise due to the failure to live up to treaty provisions.


The macroeconomic factors noted above create an environment of disdain towards treaty provisions. The Tax Reform Act of 1986 changed many substantive areas of both domestic and international tax law. It also specifically overrode many prior treaty provisions.

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66. Vienna Convention, supra note 1, art. 60(1)-(2). The President has the authority to make the determination for finding a breach. United States v. Curtiss-Wright Export Corp., 299 U.S. 304, 320 (1936); Restatement, supra note 1, § 335 cmt. b.
provisions. Although Congress partially retreated from this position in subsequent legislation, the intent of Congress on treaty provisions was clear: "If, in any of the cases above where Congress does not believe that a conflict exists, there is in fact a conflict, Congress intends that the 1986 Reform Act will apply notwithstanding the Treaty."69

The above statement by Congress leaves no doubt about what it thinks of treaty obligations, regardless of the effect that a unilateral overriding of treaty provisions could have on international law. In addition, certain trade statutes allow the United States to take unilateral retaliatory action against real or perceived unfair trade practices. The General Agreement on Tariffs and Trade ("GATT") signatory countries have attacked this unilateral action as violating the national treatment guarantee of that important multilateral treaty. The disdain towards treaty provisions has spread from the IRS to the U.S. Customs Service.71

VII. CONCLUSION

The United States is reaching a point in its existence where it no longer dominates international trade. Japan and the European Community have emerged as world powers, and the Arab countries continue to expand as money centers. This shift in power has changed the landscape of international trade. The present genera-


69. Technical Act, supra note 68, at 3535-36.


71. The Omnibus Trade and Competitiveness Act of 1988 was the implementing legislation for the International Convention on the Harmonized Commodity Description and Coding System, a multilateral treaty intended to streamline tariff rates among contracting states. See Omnibus Act, supra note 28, § 1201. The U.S. Customs Service's interpretations, however, in effect eschew the international character of its obligations. In its interpretive note, the U.S. Customs Service states: "Uniformity in the interpretation of the international system, the harmonized system (HS), is not a function of Customs. Customs is charged with the administration and interpretation of the HS, the tariff enacted by Congress." U.S. Customs Service, Guidance for Interpretation of Harmonized System, 54 Fed. Reg. 35, 127 (1989). In effect, Customs is saying that their only responsibility is the interpretation of the enabling legislation, not the treaty obligations that spawned it. See id.
tion is witnessing this change. Unfortunately, U.S. citizens are getting caught up in the idea that this foreign progress is attributable to some unfair treatment.

In light of the environment of distrust that exists among the trading nations, the United States must resist reacting like a Third World country. The idea that laws can be changed and that contractual negotiations can unilaterally be modified simply because the dynamics of trade are changing can do more harm than good. Developed countries have long criticized developing countries for formulating protectionist policies as a reaction to real or imaginary threats posed by the developed countries. The United States, as a capital and technology exporting country, must be careful about passing legislation that adversely affects foreign nationals or foreign corporations. The threat of retaliation is very real, particularly because the United States has more multinational corporations than any other country. To find its place in the new economic world order, the United States must resort to its strengths—technological leadership, entrepreneurial spirit, and ingenuity—not protectionist legislation.