FTCs and the 'Two-State Problem': Recognizing Contested Governments for Tax Purposes

by Benjamin M. Satterthwaite

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In this article, the author considers the creditability of foreign taxes incurred by a taxpayer in a geographic area claimed by two governments, only one of which is recognized by the United States. This situation is complicated further by an active tax treaty, which is currently the case in Venezuela.

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One of the most elementary prerequisites of a foreign tax's creditability is whether a payment has been made to the foreign government acting in its capacity as tax authority. Although that requirement is easily met in most circumstances, it becomes difficult to analyze when a foreign tax liability arises in a geographic area claimed by two governments. Clearly, the United States will recognize only one of them, which should effectively void payments made to the unrecognized government for foreign tax credit purposes. However, that "two-state problem" can be further complicated by the existence of a tax treaty governing transactions with the country, particularly if the treaty was signed by the very government that is no longer recognized.

That very dynamic is playing out in Venezuela, which will serve as a model for our inquiry into this apparent defect in the law governing FTCs.

The two-state problem is not unique to Venezuela. Two governments claim the majority of Libya, and until recently, the governments of Iraq and Syria were challenged by the Islamic State, which taxed large swaths of both countries' territories. Within the borders claimed by Georgia, the republics of South Ossetia and Abkhazia have operated as de facto sovereign states for decades. Then there is Palestine, wherein the Palestinian Authority and Israel both collect tax (the United States does not recognize the state of Palestine[1]). Many vital U.S. trade partners are engaged in territorial disputes capable of providing the impetus for similar complications.

The only characteristic that makes Venezuela truly unique regarding the two-state problem is the existence of an active income tax treaty with the United States. Despite the FTC's design as a completely unilateral mechanism for affording relief from double taxation, it can be argued that tax treaties provide the partner country with the presumption that otherwise qualified taxes can be used to offset U.S. tax liabilities.[2] That principle is advanced by U.S. adherence to the Vienna Convention on the Law of Treaties, whose article 15 accession provisions obligate the United States

[1] Jacob Magid and Adam Rasgon, "US State Department Drops Palestinian Territories Listing From Website," *The Times of Israel*, Aug. 26, 2019.

[2] *See* Richard E. Andersen, *Analysis of United States Income Tax Treaties*, at para. 19.02 (2003).

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to continue honoring treaties with subsequent acceding governments of the treaty partner.

Another wrinkle with Venezuela is the article 24 treaty language on double taxation, which makes no guarantees on the creditability of Venezuelan taxes beyond what is already afforded under domestic law, stating, "Such credit shall be allowed in accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof)."

That calls into question the creditability of taxes paid in jurisdictions with two competing governments. In Venezuela, the United States no longer recognizes or retains diplomatic relations with the Maduro regime, so payment of tax to that entity should be a nullity in the FTC analysis. Even so, the FTC remains available. Assuming that outcome is valid under U.S. law, it carries with it two potentially problematic implications: (1) the United States recognizes dictatorships like those found in Venezuela for tax purposes; and (2) income tax treaties provide treaty partners protection against FTC blacklisting under IRC section 901(j).

I. Background

A. Section 901(j) Limitations and Venezuela

In analyzing whether a tax is paid to a foreign jurisdiction one must consider the FTC limitations in section 901(j)(1), which deny an otherwise valid FTC to countries specified under section 901(j)(2)(A) and apply to any country:

- whose government the United States does not recognize, unless it is otherwise eligible to purchase defense articles or services under the Arms Export Control Act;
- with which the United States has severed diplomatic relations;
- with which the United States has not severed diplomatic relations but does not conduct those relations; or
- the Secretary of State has, under section 6(j) of the Export Administration Act of 1979, as amended, designated as a foreign country that repeatedly provides support for acts of international terrorism.

The first restriction disqualifies Venezuela. Under the Arms Export and Control Act, the president has the power to regulate trade in defense articles and services to foreign jurisdictions. Since 2006, a finding has been made that Venezuela "is not cooperating fully with United States anti-terrorism efforts," and is thus ineligible for defense sales.[3] As a result of that black-letter reading of the statute, taxes paid to Venezuela should be ineligible for the FTC.

The second restriction may also disqualify Venezuela. On March 12, 2019, the United States discontinued operations in its Caracas embassy, but has continued to maintain formal diplomatic relations with Venezuela, albeit through the interim Guaidó administration, not Maduro's.[4] The FTC's application to that dynamic is unclear, because the United States has effectively severed diplomatic relations with one government and continued them with another, both of which claim to reign over the same territory.

Venezuela's ineligibility for the FTC is more evident under the broader third provision. That would be a fair characterization of current U.S.-Venezuela relations, because Venezuela still maintains an embassy in Washington, and the United States has a Venezuela Chargé d'Affaires and claims to maintain formal diplomatic relations (with a competing government).

The final provision is the only one that clearly does not apply to Venezuela, which the United States has not designated as a country that repeatedly provides support for international terrorism.

Even if a jurisdiction is disqualified for the FTC under those provisions, the president may provide a waiver if that is in the U.S. national interest, will expand trade and investment opportunities for U.S. companies, and Congress is properly informed.[5] President George W. Bush exercised that power for Libya in 2005.[6] Venezuela has never received a waiver.

Despite its indisputable disqualification from the FTC under multiple provisions of section

[3] Wade Boese, "U.S. Bars Future Arms Sales to Venezuela," Arms Control Association (2006).

[4] U.S. State Department, Bureau of Western Hemispheric Affairs, "U.S. Relations With Venezuela," Bilateral Relations Fact Sheet (July 8, 2019).

[5] IRC section 901(j)(5)(A).

[6] Rev. Rul. 2005-3, 2005-3 IRB 1.

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901(j), no authority listing ineligible countries names Venezuela. Even so, the law is somewhat unsettled as to whether that even matters.[7] The Treasury Department periodically publishes revenue rulings that list countries meeting the conditions,[8] and the statute does carve out a role for Treasury in creating regulations to effectuate the FTC restrictions, but nothing directly clarifies whether a nation must be on that blacklist for the denial of credits to take effect. In fact, the statute clearly refuses to grant Treasury the power to "undesignate" a nation, instead reserving that power for the secretary of state. Moreover, all four triggers for denial of the credit concern the country's diplomatic relations, which generally fall under the purview of the State Department. That begs the question: Even if Treasury has the power to determine which nations belong on the blacklist, by what train of legal reasoning does one conclude that Venezuela doesn't belong on it?

B. The U.S.-Venezuela Tax Treaty

The United States is somewhat of an outlier in that it has a relatively generous, unilateral foreign tax relief mechanism. For that reason, the presence or absence of a tax treaty should have a trivial bearing on a taxpayer's eligibility for the FTC, which is a purely domestic remedy, and any benefits a taxpayer may obtain from a tax treaty are elective. However, U.S. treatment of Venezuela contradicts that. In fact, the paradox arising from this particular two-state problem is resolved if the treaty carries with it a policy preference favoring the granting of FTCs such that it effectively overrides domestic law.

The U.S.-Venezuela tax treaty was signed in 1999 and largely follows the 1996 U.S. model tax treaty in place at the time. It provides a direct credit against U.S. tax for amounts paid to Venezuela as income tax and an indirect credit for dividends received from a Venezuelan company that already paid income tax on it. However, the treaty says those credits are to be granted only as permitted by domestic law — that is, it appears to assert a policy preference for affording relief, but provides no explicit override of the domestic FTC framework that would apply even in the absence of the treaty.

That leads to the peculiar result of the United States possibly violating its own treaty with Venezuela by granting Venezuelan FTCs. The country does not qualify for FTCs under the domestic framework the treaty defers to. Accordingly, even if one concedes that the treaty overrides domestic law in favor of granting credits, the treaty mechanism for obtaining them leads to a contradictory result.

C. Venezuela's Descent Into a Socialist Oligarchy

To understand how the FTC applies to Venezuela, a primitive overview of the country's recent political history is necessary. When the U.S.-Venezuela treaty was signed in 1999, Venezuela had shown signs of faltering for quite a while. Beginning with a crash in oil prices in 1985, the country's petroleum-dependent government was thrown into a seemingly unending series of crises.[9] In 1989 riots broke out, resulting in thousands of deaths and forcing the government to impose martial law. In 1992 the government was weakened by back-to-back coup attempts orchestrated by Hugo Chavez. Shortly thereafter, the president was impeached for embezzlement, prompting the pardon of jailed dissident Chavez. Finally, in 1998 oil prices plunged once more and sent the country into a frenzy that led to the presidential election of Chavez.

Even though Venezuela was not in its prime at the turn of the millennium, its economic health was a powerhouse compared with what it would later become. Before Chavez took power, GDP stood at $15,651 per capita.[10] That made the country the 36th richest in the world, trailing only Mexico and Brazil in Latin America.[11] Despite that, 43 percent of the population found itself living below the poverty line, and a 24 percent inflation rate stifled growth.[12] Only a commodity like oil could explain a disparity like that, and it

[7] *Federal Tax Coordinator*, at para. O-4005 (1997).

[8] *See* Rev. Rul. 2005-3, *supra* note 6.

[9] Peter Millard et al., "A Timeline of Venezuela's Economic Rise and Fall," Bloomberg, Feb. 16, 2019 (last updated Apr. 30, 2019).

[10] IMF DataMapper.

[11] CIA World Factbook (1999).

[12] Max Fisher and Amanda Taub, "How Venezuela Stumbled to the Brink of Collapse," *The New York Times*, May 14, 2017.

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allowed the government to reap the benefits of the roughly 3 million barrels of it produced daily.[13]

Yet in 2019 Venezuela's inflation rate was estimated to be over 10 million percent.[14] GDP per capita has more than halved to $7,399, and the poverty rate hovers around 90 percent.[15] In 2016 alone, the economy with the largest proven oil reserves in the world shrank 10 percent — more than civil-war-ravaged Syria.[16] Before the coronavirus pandemic, Venezuela was producing around 830,000 barrels a day, nearly 75 percent less than it did when the tax treaty was signed in 1999.[17] Now, the outbreak has plunged that abysmal figure even lower to 464,000 barrels daily,[18] an output that hasn't been seen since the late 1930s.[19] Just like its island neighbor Cuba, in mere decades, Venezuela has gone from being one of the wealthiest nations in Latin America to one of the poorest.[20]

In May 2018 Nicolás Maduro claimed to be elected for another six years after receiving 68 percent of the vote in what is considered by many to be a sham election.[21] Most of the opposition candidates were barred from participating, or even imprisoned. The election itself was postponed on several occasions. Ballots were criticized for listing Maduro multiple times, and a boycott led to only 46 percent voter turnout. That prompted the National Assembly to elect 35-year-old Juan Guaidó to lead it as speaker, after all the more popular candidates had been arrested or gone into exile.[22] Once the National Assembly declared Guaidó fit to assume responsibilities as president, he took the presidential oath on January 23, 2018, and was quickly recognized by the United States, most of Latin America, Australia, Canada, Japan, and almost all of Europe.[23]

The dust has not settled, but there are now two entities claiming to be the rightful government of Venezuela. The democratically elected Venezuelan National Assembly headed by Guaidó does not accept Maduro's 2018 reelection, but despite continuing to meet regularly, it retains very little influence domestically.[24] The assembly was rendered powerless in 2017 after Maduro created the rival National Constituent Assembly and packed it with loyalists. The new body and Maduro maintain control over the police, armed forces, courts, and tax authority.

II. Reconciling the Two-State Problem

A. Explaining Away the Section 901(j) Conflict

The most common retort to the apparent conflict would highlight that Treasury has never listed Venezuela as a section 901(j) country. A clever reply would assert that the country passes the statutory test for ineligibility with flying colors. Most treatises on the matter take the first approach, insinuating acceptance of the notion that disqualified nations appear on a list published by the IRS.[25] Others are more neutral and simply list countries that have previously appeared on the blacklist, but stop short of taking a clear position on whether the listing is a prerequisite to the application of section 901(j).[26] Finally, at least one secondary source notes the apparent lack of guidance on whether section 901(j) can apply to a country that is not blacklisted.[27]

[13] U.S. Energy Information Administration, "Venezuelan Crude Production Falls to Lowest Level Since 2003" (May 20, 2019).

[14] Sarah Kinosian, "Venezuela Inflation Tumbles to 9,586% in 2019: Central Bank," Reuters, Feb. 4, 2020.

[15] Vivian Sequera, "Venezuelans Report Big Weight Losses in 2017 as Hunger Hits," Reuters, Feb. 21, 2018.

[16] David Biller, "IMF Sees Venezuela With Double Digit GDP Contraction in 2016," Bloomberg, July 21, 2016.

[17] Fisher and Taub, *supra* note 12.

[18] Tsvetana Paraskova, "COVID-19 Upends Venezuela's Already-Struggling Oil Sector," Oilprice.com, Mar. 26, 2020.

[19] Brian S. McBeth, "Venezuela's Nascent Oil Industry and the 1932 US Tariff on Crude Oil Imports, 1927-1935," XXVII(3) *Revista de Historia Económica* 427, 432 (2009).

[20] Fisher and Taub, *supra* note 12.

[21] Flora Charner, Paula Newton, and Natalie Gallón, "Opponents Slam Venezuelan President Nicolas Maduro's Election Victory as a Sham," CNN, May 21, 2018.

[22] "Juan Guaidó: The Man Who Wants to Oust Maduro," BBC, Jan. 23, 2020.

[23] Dave Merrill and Carolina Millan, "Map: All the Countries Recognizing Guaidó as Venezuela's New President," Bloomberg, Jan. 24, 2019.

[24] "Venezuela Crisis: How the Political Situation Escalated," BBC, Jan. 13, 2020.

[25] Andersen, *Foreign Tax Credits* at para. 11.05 (1996). *See also* Carolyn Dupuy and D. Kevin Dolan, "Portfolio 6020-1st: The Creditability of Foreign Taxes — General Issues," Bloomberg, Chap. VII.

[26] Joel D. Kuntz and Robert J. Peroni, *U.S. International Taxation* at para. B4.06 (2000).

[27] *Supra* note 7.

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Treasury could have shed light on that ambiguity when it published Rev. Rul. 92-62, 1992-2 C.B. 193, which was directed primarily toward timing questions that arise when a country ceases to be blacklisted. It provides that the FTC is not available for the taxes paid or accrued while the country was still blacklisted. Confusingly, it takes no position on the exact point when a country is or isn't denied the FTC as a result of meeting a requirement in section 901(j).

The revenue ruling does, however, provide some direction on when the FTC denial period ends. Question 1 asks: "When a country ceases to be described in section 901(j) of the Code during a person's taxable year, what taxes paid or accrued for that year are creditable?" It explains that the end date is the day when the secretary of state informs the Treasury secretary that section 901(j)(2) no longer describes the country, but takes no position on when a nation starts becoming subject to the section 901(j) limitation.

The authorities that add or remove countries from the blacklist do not indicate that their lists are comprehensive, and they take positions only on the specific nations noted. That should not be terribly surprising: The statute defers to regulations to be written by Treasury, but that in isolation does not mean the countries classified are the only section 901(j) offenders. Nor does it mean that those are the only countries where tax liabilities will not be considered paid to a foreign government for FTC eligibility.

Perhaps the most persuasive argument for interpreting the application of section 901(j) to countries that have not been blacklisted is the presidential waiver provision. Under current practice, with section 901(j) applied only to blacklisted countries, that provision is rendered superfluous. It serves no use as a presidential override of Treasury, which already falls under the executive branch, so it must be a bulwark against the blanket statutory application of section 901(j) to specific countries.

Suffice it to say that the applicability of section 901(j) to Venezuela is murky. Despite the country's indisputably triggering multiple statutory provisions that deny the FTC, Treasury has given no indication that Venezuelan income taxes are not creditable. It's unclear whether that matters for applying section 901(j), but the prevailing practice has been to defer to specific Treasury pronouncements.

B. Venezuelan Taxes Are Ineligible for the FTC

If section 901(j) is ignored, Venezuela is still ineligible for FTCs under a black-and-white reading of domestic U.S. law. One of the first inquiries in determining the creditability of a foreign tax liability is whether the foreign levy is indeed a tax. The regulations clarify that by providing that the foreign tax must be imposed under the foreign country's authority to levy taxes.[28] More specifically, the levy must be imposed by the government in its role as a revenue raiser, and not in its role as a governmental regulator or as a property owner requiring compensation for the use or acquisition of property.[29]

The United States does not recognize the Maduro government, so it follows that its authority to tax would also not be respected. Accordingly, any amount paid to that unrecognized government should be treated like any other non-creditable tax. As the case law clarifies, the foreign government's characterization of the payment as a type of tax has no bearing on its creditability.[30] Rather, a taxpayer's entitlement to FTCs is determined by applying principles of domestic U.S. law.[31] If the Maduro regime is not even a government under U.S. law, it would be illogical to designate any payments to it as taxes. The Maduro government's financial legitimacy has already been called into question on those very grounds. The recent economic turmoil sparked by the coronavirus led Venezuela to petition the IMF for $5 billion in aid, which the IMF denied, citing a lack of clarity on what the official government is in the country.[32]

Even so, that conclusion is far from ironclad. It could be voided if there is a presumption read into the statute that a tax is deemed imposed

[28] Reg. section 1.901-2(a)(2)(i).

[29] Dupuy and Dolan, *supra* note 25, at Chap. II, citing Elizabeth A. Owens, *The Foreign Tax Credit* (1961).

[30] *See Amoco Corp. v. C.I.R.*, 138 F.3d 1139 (7th Cir. 1998); and *Waterman S.S. Corp. v. United States*, 381 U.S. 252 (1965), *reh. denied*, 382 U.S. 873 (1965).

[31] *Waterman S.S. Corp.*, 203 F.Supp. 915 (S.D. Ala. 1962).

[32] Patricia Laya and Alex Vazquez, "IMF Won't Lend to Venezuela Because Maduro Lacks Recognition," Bloomberg, Mar. 17, 2020.

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under normal conditions unless it is designated under section 901(j). The primary issue with that interpretation is that nothing explicitly confirms it. The statute contains no indication that it is to act as an exclusive mechanism for disqualification. Nor does the legislative history support that reading.[33] In fact, that interpretation is inconsistent with the summary in the committee report for the Trade and Development Act of 2000, which added the presidential waiver to section 901(j).[34]

One might also argue that the objections raised in this article run afoul of the "revenue rule," as it is known in international law, which forbids the United States from intervening in how foreign tax revenue is used.[35] Although that principle is most certainly a concern in foreign tax policy, the objections made here have nothing to do with how a foreign government is using tax revenue. Rather, the issue concerns the authority of a delegitimized government to collect the tax revenue in the first place.

III. Implications of Current Treatment

As a result of the inconsistencies discussed, we are left at an impasse that can be broken down into two broad concepts. First, under a black-letter reading of the FTC statute, Venezuela's eligibility is called into question on two grounds:

- A prerequisite to FTC eligibility requires a payment be made to a foreign government in its capacity as a tax authority. With the U.S. government no longer recognizing Venezuela's Maduro regime, it follows that any payment thereto would also not be recognized as a tax for FTC purposes.
- Venezuela triggers multiple section 901(j) provisions providing for FTC ineligibility. It might be considered a formally unrecognized country, but is most certainly an informally unrecognized country, and is forbidden from purchasing defense articles under the Export Control Act.

Second, the statute carves out a role for Treasury in writing regulations to carry out the rules in section 901. For disqualified countries, that has been exercised largely in the form of revenue rulings that in aggregate make up a blacklist of countries deemed ineligible for the FTC. There is very little authority on whether that blacklist is a complete list of countries not qualifying for the FTC, but most have treated it as such. As a result of that practice, Venezuela's absence from the list has allowed its taxes to be eligible for the FTC. Further, the double taxation article in the U.S.-Venezuela tax treaty promotes a general policy of mitigation but makes no commitment beyond the remedies already available under domestic law. How that affects FTC eligibility is unclear because the eligibility under domestic law is highly questionable, yet no active income tax treaty partner has been blacklisted.

As a result of those findings, one or both of the following conclusions must be true to adequately account for the inconsistencies:

- If the blacklist is an exhaustive list of countries ineligible for the FTC, then the United States recognizes Venezuela for tax purposes, despite not recognizing it diplomatically.
- If the blacklist isn't exhaustive, Venezuela is ineligible for FTCs under domestic law, but remains eligible, presumably as a result of the tax treaty.

A. U.S. Recognition of the Maduro Regime

At first glance, recognizing a government only for tax purposes may seem an untenable legal conclusion, but there is a surprising amount of evidence supporting it. At the very least, Treas. reg. section 1.901-2(a)(2)(i) is written vaguely enough to permit that interpretation, which describes foreign levies as requiring a "compulsory payment pursuant to the authority of a foreign country to levy taxes." It is axiomatic that the term "legal authority" is more limited in scope than "authority" by itself. That maxim comports with the U.S. stance toward the Maduro regime, which is more akin to a nonrecognition of its legal authority as opposed to its authority in general, which could be established by the military or another enforcement institution.

[33] *See* Tax Reform Act of 1986.

[34] *See* H. Rept. 106-606 (2000).

[35] Brenda Mallinak, "The Revenue Rule: A Common Law Doctrine for the Twenty-First Century," 16(79) *Duke J. Comp. & Int'l L.* 79 (2006).

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Whatever the case, that is completely speculative. The regulations fail to distinguish the type of authority, so we are left with the potential interpretation that the source of authority is irrelevant for obtaining a credit for taxes paid to a foreign government.

The stronger argument for that implication stems from reviewing the historical U.S. treatment of countries in political turmoil. For example, from 1979 to 1983, the communist "New Jewel Movement" controlled the Caribbean island of Grenada. Despite U.S. condemnation of the coup that resulted in that group taking power and continued resistance from President Reagan, who challenged the group's right to continue governing, the IRS did not publish anything regarding Grenada's ineligibility for the FTC. That said, those events predated section 901(j), which wasn't enacted until 1986. Even so, nothing suggests that credits were denied because the taxes were paid to a government whose sovereignty was questioned.

However, a similar sequence of sovereignty-challenging events occurred between Reagan and the Nicaraguan Sandinista government from 1980 to 1988. Nicaragua even went so far as expelling the U.S. ambassador, which prompted the U.S. to follow suit. Ambassadorial relations would not be resumed for another two years. Despite this, like Grenada, Nicaragua never found itself on the blacklist. Moreover, there is no evidence suggesting credits were denied on the basis of being paid to a government whose sovereignty was being openly challenged.

Confusingly, despite cases like Grenada and Nicaragua where inaction was sufficient to override what might otherwise result in FTC ineligibility, there are other instances where action was needed to preserve FTC eligibility for an ineligible country. Libya is a prime example of this. The country was blacklisted as a result of numerous skirmishes with western powers, spurred by dictator Muammar Gaddafi openly condoning terrorism and stockpiling chemical weapons. The 2003 invasion of Iraq prompted Gaddafi to have a change of heart. He renounced the country's weapons programs and welcomed international inspectors to verify their disposal. Following through on that commitment led President George W. Bush to reward the regime by lifting most sanctions by September 2004, including removing Libya from the section 901(j) blacklist.[36] By that time, formal diplomatic relations had been restored for several months, so the presidential waiver served only to negate the application of section 901(j)(2)(A)(iv),[37] which deemed Libya ineligible as a result of its designation on the list of countries that repeatedly support acts of international terrorism. Because of that other reason for being blacklisted, it's unclear whether the previous resumption of diplomatic relations would have triggered full FTC eligibility.

If we accept the notion that the only countries ineligible for the FTC are those listed on the section 901(j) blacklist, a potentially troublesome legal and foreign policy position arises: Non-blacklisted countries with whom the United States has formally or informally ceased diplomatic relations are still recognized for tax purposes. Obviously, the U.S. diplomatic arm would take issue with that statement, but regardless of how it's characterized, the effect remains unchanged. Despite cutting ties completely with Venezuela's Maduro government, the United States still appears to recognize the authoritarian regime for tax purposes and has exhibited that same policy toward troubled nations throughout history.

B. Treaty Application

The effect an income tax treaty has on application of section 901(j) is exceptionally difficult to pinpoint. No blacklisted country has ever had an active income tax treaty with the United States when it was designated. South Africa came close, so it is really the only precedent capable of providing any clarity.

The United States terminated its tax treaty with South Africa on October 15, 1986 (effective July 1, 1987), in protest of the apartheid regime,[38]

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[36] Kelsey Davenport, "Chronology of Libya's Disarmament and Relations With the United States," Arms Control Association (last updated Jan. 2018).

[37] Washington resumed diplomatic relations with Libya June 28, 2004, so the absence of diplomatic relations detailed in section 901(j)(2)(ii) would no longer have been a trigger for FTC ineligibility.

[38] Jason R. Connery, Seth Green, and Kimberly Tan Majure, "Current Status of U.S. Tax Treaties and International Tax Agreements," 48(12) *Tax Mgm't Int'l J.* 6 (2020). A new income tax treaty was ratified after the fall of apartheid.

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and blacklisted it on January 1, 1988.[39] It was probably no coincidence that the treaty termination occurred before the blacklisting. More importantly, that sequence of events provides evidence for the supposition that an income tax treaty provides protection for countries that would otherwise be ineligible for FTCs under section 901(j).

Unfortunately, the old South Africa-U.S. treaty is difficult to align with its more modern counterparts. Signed in 1946, it contained many of the vestiges of treaties developed under the League of Nations and predated the dawn of the OECD model by 17 years. It was similar to the U.S.-Venezuela treaty in the sense that it provided double taxation relief by deferring to the domestic crediting system, but that is really the only relevant point of comparison.

The FTC lacked many of the limiting provisions that are now in place, so the South Africa-U.S. treaty had stronger implications than now. It was also far more explicit in its override of domestic FTC provisions. For example, Article IV(1) said, "It is agreed that by virtue of the provisions of paragraph (2) [regarding South Africa's allowance of credits] of this Article the Union of South Africa satisfies the 'similar credit' requirement."

The reference to the similar credit requirement effectively declared that South Africa met that particular domestic requisite for the FTC; those kinds of direct overrides of the FTC are rarely seen in modern treaties. The old treaty also froze the domestic FTC law by providing that FTC benefits and limitations be those in place on the day the treaty entered into force, so it was protected from adverse changes in domestic law. Again, specific overrides of domestic law like that are infrequent in more modern treaties.

Because of those more blatant and direct provisions in the old South Africa treaty, its precedential value as it relates to the more ambiguous Venezuela treaty is tenuous. Even so, the treaty was terminated before the nation was officially denied FTCs under section 901(j), suggesting that the treaty itself provided protection against blacklisting.

Lastly, one of the strongest indications that tax treaties disinhibit section 901(j) stems from U.S. obligations under the Vienna Convention on the Law of Treaties. The United States is not a party to the treaty but considers many of its principles to constitute customary international law[40] (in fact, the technical explanation to the U.S.-Venezuela treaty invokes the convention).

The Vienna Convention contains a provision in article 15 known as the "accession clause." In short, it serves to promote the longevity of bilateral agreements by defaulting to a policy that commits governments to the obligations negotiated by preceding administrations. For that reason, several former Soviet satellite states still retain the benefits of a U.S.-U.S.S.R. tax treaty signed in 1973.[41]

Given that pattern of adherence to the accession clause of the Vienna Convention, it is worth exploring whether it could justify the United States' tax behavior toward Venezuela. A plain application of the principle might prohibit termination of the treaty merely because of a socialist government change. One could argue that that is all that has occurred. Economic turmoil, mass exodus of refugees, and crippling sanctions do not, without more, nullify treaty obligations.

On the other hand, the effort required to terminate the treaty is relatively minimal. Either party can terminate if six months' notice is given through the proper diplomatic channel. Even if a material breach requirement is read into the treaty from the Vienna Convention, Venezuela's shoddy adherence to the treaty is likely to exceed that threshold.[42] Further, far less dramatic disagreements have prompted the United States to terminate treaties without running afoul of that obligation.[43]

[39] Rev. Rul. 2005-3, *supra* note 6.

[40] U.S. State Department, "Frequently Asked Questions: Is the United States a Party to the Vienna Convention on the Law of Treaties?" (last accessed Mar. 24, 2020).

[41] That treaty is still in effect for Armenia, Azerbaijan, Belarus, Georgia, Kyrgyzstan, Moldova, Tajikistan, Turkmenistan, and Uzbekistan.

[42] Specifically, Venezuela has expropriated many properties owned by U.S. businesses, including General Motors Co., Hilton Worldwide Holdings Inc., and ConocoPhillips.

[43] For example, the United States cited the lack of a limitation of benefits provision in terminating its treaty with Malta in 1995.

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Once again, we are not left with any straightforward rule regarding the effect treaties have on FTC creditability. The inquiry is complicated by the heterogeneity of the treaties themselves, which contain obligations that vary according to both age and partner countries. Yet there are historical sequences of events consistent with the conclusion that the existence of an income tax treaty prevents FTC disqualification for otherwise creditable taxes. Accordingly, the conflicts in applying section 901 to Venezuela could be explained by assigning a more active role to its income tax treaty with the United States.

IV. Conclusion

The problem illustrated here has significance far beyond U.S.-Venezuela relations. The heart of the concern lies with the tension created by mismatches between tax and diplomatic policy. Although Venezuela is the most extreme example, many countries receive tax treatment inconsistent with U.S. foreign policy. In some instances, international tax treatment is relatively unaffected despite numerous punitive measures in place in other areas. Conversely, there are countries that receive punitive international tax treatment but otherwise retain relatively normal relations with the United States.

Russia is a terrific example of a country where U.S. income tax law provides few barriers to investment, but several difficulties are imposed in other areas of the law. The majority of foreign capital investment in Russia is American,[44] and an active tax treaty further facilitates financial outflows. Yet possession of Russian assets is heavily penalized under an array of sanctions affecting large swaths of the Russian economy.[45] Even permitted transactions can subject the taxpayer to cumbersome licensing requirements overseen by the Office of Foreign Assets Control.

On the other hand, investment in highly developed countries with low corporate rates is discouraged under the new global intangible low-taxed income regime, under which income earned by controlled foreign corporations subject to a tax rate of at least 18.9 percent is exempt from net tested income.[46] That diminishes the merits of transacting with trade partners that have rates below that amount, like Ireland, with whom the United States has a cordial diplomatic relationship.

The two-state problem, if ignored, could result in more legal conundrums that harm taxpayers. A modicum of guidance on it could prevent surprises the next time a trading partner experiences political uncertainty. Venezuela is not the first country to have its eligibility for the FTC put in question by two governments competing for power over it, and it won't be the last. In the end, it's possible that recognition of some authoritarian governments for FTC purposes is indeed the intended U.S. position.[47]

Finally, this article highlights a need for clarifications on how income tax treaties affect the FTC. Treaty language deferring to the domestic crediting system is meaningless if laws are not applied as written. That exact issue has been flagged as it pertains to amendments that disallow FTCs when the United States may have committed to their allowance through tax treaties. Rosenbloom and Shaheen correctly point out that those inconsistencies can still be reconciled by tweaking the legal understanding of FTCs, but that could trigger several implications that may not be intended.[48] Similarly, the continued granting of Venezuelan FTCs does not conflict with U.S. law so long as some principles are adjusted. Specifically, the United States can confront the two-state problem by recognizing a foreign government for tax purposes but ignoring it for all others. The inconsistency could also be remedied by reading into income tax treaties a looser application of the FTC's fundamental "payment to the government" requirement. Regardless, it's clear that foreign policy objectives are more difficult to achieve when tax laws are acting as a counterbalance, and vice versa. ■

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[44] Kenneth Rapoza, "Most Foreign Capital Flowing Into Russia Stock Market Is American," Forbes, Oct. 22, 2019.

[45] Treasury Office of Foreign Assets Control, "Ukraine/Russia Related Sanctions Program" (last updated June 2016).

[46] IRC section 951A(c)(2)(A)(III).

[47] This article does not weigh the merits of diplomatic recognition of Venezuela or any other country and limits the analysis to recognition only as it regards the FTC.

[48] H. David Rosenbloom and Fadi Shaheen, "The TCJA and the Treaties," *Tax Notes Int'l*, Sept. 9, 2019, p. 1057.

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