November 22, 1983

PRESENTATION TO US WORKING GROUP ON UNITARY TAXATION.

INTRODUCTION

1. The application of the Unitary system of taxation by a number of US states has become a matter of great urgency since the supreme Court decision in the Container Corporation of America v Franchise Tax Board case.

Under the unitary system of taxation subsidiaries of multi-national enterprises are taxed, in the US states concerned, not on their profits in the state as ascertained by separate or arms length accounting but rather on a proportion of world profits earned by the group of which it forms a part. That proportion is determined using a three factor formula which applies sales, payroll and fixed asset figures in the taxing jurisdiction to the corresponding world wide figures.

There is a real danger that other US-states not at present applying the unitary system will feel encouraged to do so following the court decision which upheld the Californian System as applied to US based multi-national companies.

2. The President of the United States has now established a high level Working group under the Chairmanship of Treasury Secretary Regan to explore and attempt to resolve the issues involved in the application of the Unitary method. These include the application of unitary tax in an international context including its impact on international investment flows and an equitable resolution to the problems of foreign governments and foreign based multinationals. The purpose of this paper is to establish the considerations we deem relevant for the trading partners of the U.S. and in particular for the EC.

EEC-POSITION

International Taxation

3. It is an accepted principle of international taxation that an enterprise of a state which carries on business in another state through a permanent establishment or a subsidiary may only be taxed in that other State on profits of activities carried on in that other state.

4. The OECD Model Double Taxation Convention of 1977, to which the United States subscribed makes it plain at Article 7(2) that a permanent establishment of a foreign enterprise shall be attributed the profits it might be expected to make if it were a distinct and separate enterprise and may be taxed on those profits.

5. The Commentary to Article 7 paragraph 4 of the OECD Convention states: "It has in some cases been the practice to determine the profits to be attributed to a permanent establishment not on the basis of separate accounts or by making an estimate of arm's length profit, but simply by apportioning the total profits of the enterprise by reference to various formulae. Such a method differs from those envisaged in paragraph 2, since it contemplates not an attribution of profits on a separate enterprise footing, but an apportionment of total profits; and indeed it might produce a result in figures which would differ from that which would be arrived at by a computation based on separate accounts".

It follows from the above that only directly determined profits resulting from activity carried out in the state, are the ultimate yardstick of the taxation rights of that state.

6. With regard to profit determination on an indirect basis using an allocation method based on an apportionment of total profits, this method is not regarded as appropriate and should be used

exceptionally and only if it is accepted both by the taxation authorities and taxpayers generally as being satisfactory.

7. The United States went even a step further when they expressed with reference to Article 7(2) of the treaty the belief that it would be appropriate "to provide for arm's length treatment not only with the head office of the enterprise, but also with any person controlling, controlled by, or subject to the same common control as the enterprise". They also expressed the more definite view that profits should be determined on an independent enterprise basis rather than a separate enterprise basis. (OECD Model Commentary on Article 7 Paragraph 24 and 40).

8. This attribution of taxation rights exists for permanent establishments which means integral parts of an enterprise and it goes without saying that this attribution must apply with even greater force if an enterprise carries out its activities in a state by means of separate legal entity, that is a subsidiary.

9. The OECD Model Convention including its commentary has been adopted by the Council of the OECD which means that this is the basis for the worldwide system of double tax convention including those to which the USA is a party. Since it is a model convention and despite the fact that it does not directly create written tax law, it nevertheless follows that its guidelines form an integral part of long established international taxation practice. It cannot be unilaterally ignored for internal political reasons by one party without serious consequences to the whole equilibrium of international tax principles as a basis for international trade and commerce.

10. Furthermore, the report of the OECD Committee on Fiscal Matters, on Transfer Pricing and Multinational Enterprises (1979), firmly endorses the arms-length principle, and rejects alternative principles as being incompatible with articles 7 and 9 of the OECD Model Taxation Convention as being unnecessarily arbitrary.

11. The U.S. has contributed to this international tax consensus; a further extension of global methods threatens to disrupt this emerging order or consensus.

Consequences of Indirect Taxation of worldwide Profits

12. The attribution of taxation rights described above exist for good reasons and specific criticism of the unitary system by the international business and trading community centres on the inequitable and unfair consequences of the application of this particular system.

There is, necessarily inherent in the system, a strong risk of double taxation.

13. It is obvious that the results of the indirect method applied to worldwide profits may lead to an excessive attribution of profits to a US state.

14. This might in particular be the case where the indirect formula itself, by reason of its composition causes an imbalance in the attribution in favour of the state concerned.

15. Payroll and property values in the US are high compared to other countries and it is most unlikely that corresponding values elsewhere in the world would reach the level of, for example, Californian values and the result must be that formula apportionment has an inbuilt tendency to allocate higher profits to the US jurisdiction that could be justified as reasonably allocable under the direct method.

16. Formula apportionment makes no allowance for differing circumstances likely to be found throughout the world in the operations of a large multinational company.

17. For example, in a high cost jurisdiction such as California payroll costs will be high and state personal income tax receipts will be correspondingly high but profit on an arms' length basis may well be lower than in low cost countries.

18. In a low cost country on the other hand profits may be higher both in relation to sales and costs. Personal income tax receipts by the government will be lower but tax on profits will be correspondingly higher.

19. Under formula apportionment a Californian subsidiary of a worldwide enterprise will be allocated much higher profits than it would have returned on an arms' length basis. This apportionment ignores the fact that California will already have received substantial revenue in the form of personal income tax while a high proportion of the profits calculated on worldwide apportionment basis will already have been taxed elsewhere.

20. Profits in developing countries may well be much higher in relation to costs than in more highly developed countries, with the higher return compensating in some measure for the higher risks of expropriation, currency exchange limitation and similar factors. It is unfair that a state operating a worldwide reporting system should wish to deprive a parent company outside the US of a fair return on what is a high risk capital investment.

21. Treasury Assistant Secretary Lubiok who appeared before the House of Representatives Ways and Means Committee on 31 March 1980 was reported as pointing out that the unitary system appears, in comparison to an arms' length or separate accounting method, to generate substantially more taxation for the states.

22. At the same hearing a striking example of the distortive effect of the system was given regarding the Hongkong Bank of California which had its net income before tax in 1977 adjusted from $707,000 to $4,832,000 and assessed a 79% effective rate of tax instead of

the (then) statutory rate of 11.6%.

23. It follows that in those situations described enterprises will have sometimes to suffer serious double taxation to the extent that the indirect formula in comparison with the direct leads to higher taxation in the US. In such a situation what is effectively happening is that part of the non-American portion of worldwide profits is being taxed in the US - the full amount of these non-American profits are of course already taxed in the home country of the enterprise (or in whatever other country the profits are earned). This double taxation is due to the fact that, the US tax claim is unilaterally extended to profits attributable to a foreign tax jurisdiction.

Loss Case

24. The consequences of the application of the unitary system described above would be even more anomalous in a situation where in accordance with the direct method there would be no profit at all attributable to the US activity whereas the worldwide activities of the enterprise have made a profit.

This situation might in particular arise where an enterprise has start up losses in the US. In this respect what should be borne in mind is that whereas US firms have been firmly established in Europe for many years, many European enterprises have only recently, been entering the US markets.

25. An example of this situation was also given to the House Ways and Means Committee at the hearing in 1980:

Scallop Nuclear Inc a subsidiary of Shell Petroleum NV had reported losses for federal income tax purposes of $390 million in the years 1973-76. The California Franchise Tax Board was reported as having announced that Scallop Nuclear's proportion of worldwide combined income of the Shell group for those years was $40 million a complete turnaround from the federal position.

The cost of compliance with state regulations in reporting worldwide combined income places a heavy administrative burden on non domestic corporations trading inside the US.

26. Foreign enterprises trading in US States not imposing unitary taxation incur in common with US enterprises in a similar situation certain costs in complying with federal and state requirements. If the US enterprise has subsidiaries operating outside the US financial returns will be required for company accounting purposes in US currency. The non-domestic corporation will have no requirement to produce any returns, other than those concerning its US operations, in US currency.

27. If the foreign enterprise however operates in a state jurisdiction where worldwide combined reporting requirements exist it will have the additional burden of reporting on its income and on the details of its operations throughout the world. This can be a massive task as can be seen when one considers the ramifications of a multinational company such as Shell Petroleum NV, a Dutch company, which has some 900 non-US subsidiaries and affiliates operating in over 100 countries.

28. In addition, all financial returns which will have been expressed in foreign currencies and foreign languages will have to be translated into US currency and English and the income figures adjusted to agree with the rules in operation in the state to which the return is being made. State rules are by no means uniform and a series of adjustments might well be required if operations are carried on throughout the US. There is no doubt that an exceedingly laborious and costly task is imposed on foreign corporations.

29. Large quantities of non-financial date concerning the operation and organisation of foreign businesses may also be required in connection with the determination of whether or not a business is unitary. This can also be an extremely onerous task for a large corporation.

International Trade and Commerce

30. The unilateral extension by the States using the unitary tax system to the detriment of foreign jurisdictions and its grave consequences for non-American enterprises active in the US is a serious impediment to the operation of a coherent and consistent framework for the carrying out of international trade and investment as has been underlined by Member States of the European Community on a number of occasions.

31. Such a framework has been provided by the network of Friendship, Commerce and Navigation (FCN) Treaties and nine of the ten Member States of the European Community have entered into post-war treaties with the United States to establish reciprocal protection for commercial relationships.

Each of these treaties contains a specific provision similar to that in the Netherlands/US Treaty of Article XI(4) which prohibits the imposition or application of "any tax fee or charge upon any income capital or other basis in excess of that reasonably allocable or apportionable to its territories".

The extension of unitary tax and the grave consequences resulting from it for non American enterprises carries the risk of seriously disturbing international trade and investment relationships. It will undermine the legal basis on which such international relationships are built. It will replace the current well-understood tax arrangements by a regime which will be uncertain in its effect, and distort and inhibit investment decisions. This could have consequences for foreign investment of US enterprises in other industrialized countries, as well as for foreign internal investment in the USA.

32. What is even more potentially harmful is the adverse effects on world wide trade and investment if foreign governments responded by taking countermeasures or by introducing unitary systems of their own.

In particular the use of unitary tax by some US states may provide for some developing countries a welcome argument for them to follow the American example and to increase by it their government's take from foreign firms. In the long run this might create not only for non-American industrialised countries but in particular for the US even greater disadvantages than the short-term advantages of the unitary tax systems may have for some of the US states.

Special Aspects

33. Nine Member States of the EEC have concluded Treaties on Friendship, Commerce and Navigation with the USA after 1945 (so-called FCN treaties). All these treaties contain clauses which specifically protect the companies of one treaty party with respect to their investments in the territories of the other treaty party. The unitary method of taxation seriously abridges such protection with respect to the investments which companies incorporated in the nine Member States concerned made within the USA. The Member States are therefore, of the opinion that the unitary method of taxation violates the terms of the FCN treaties in force between nine Member States and the USA.

Conclusion

34. The trading partners of the US look to the working group now in session to take full account of the arguments deployed in this note concerning the damage that unitary taxation would cause to the international trading community, in whatever recommendations it may make.