FEDERATION BANCAIRE
DE LA COMMUNAUTE EUROPEENNE

K 15
No. 215

Paul FABRE
Secretary-General

OFFICE OF TAX POLICY
Room 3108,
U.S. Treasury Department
Washington, D.C., 20220

Brussels, 12th August 1985

941.2(103)

Dear Sirs,

Re : Proposed unitary tax legislation

The European Banking Federation represents the ten banking associations of the member states of the European Community. These associations comprise the more than two thousand full range service commercial banks established in the E.C., many of which operate in the United States. A number are established in states applying unitary taxation or are considering establishing there.

As such, the Federation has become increasingly concerned by the problem of worldwide unitary taxation and has already made representations to the Californian authorities to that effect.

It must first be stated that the very concept of unitary apportionment is alien and profoundly disturbing to all of European industry and banking as well as to every one of our governments. Although the objective of combating transfer pricing is understood, it is unanimously felt in Europe that the method, bearing little relationship as it does, to the principle of profit fundamental to accepted accounting practices, can only lead to the most artificial conclusions.

Concerning the Treasury's proposed legislation, the Federation is unable to make detailed comments, given the time of year and the extremely short deadline involved. We may request the opportunity to do so at a later date. In the meantime, we are nonetheless in a position to bring your attention to the following crucial points.

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The proposed legislation does not take into account the situation of bank branches. Section 6103(d)(4)(F) contains a definition of "worldwide unitary basis" which will effectively allow States to benefit from the Federal legislation whilst continuing to compute the taxes of branches of foreign banks by means of worldwide unitary apportionment.

Because of geographic restrictions applicable to banks in the U.S., branch or agency offices may be the only available vehicle for a foreign bank to enter a particular banking market. In addition, use of a branch or agency office in many circumstances is the only method by which a foreign bank can compete effectively against domestic banks similarly situated.

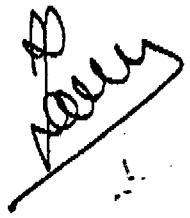
The unfavourable treatment being meted out to branches seems all the more unjustified concerning banks when it is considered that the very threat which worldwide unitary taxation was designed to meet is weakest in their case. The major deductions of a foreign bank's direct offices in the U.S., i.e., the interest expense and bad-debt deductions, are almost always computed by formulas that substantially eliminate the risk of abusive transfer pricing.

There is thus no conceivable reason why bank branches should be subject to such harmful treatment. We sincerely hope that the proposed legislation will be accordingly amended.

We are also concerned that the Federal legislation imposes new reporting requirements which, as we understand it, will be extended even to banks which previously had no connection whatsoever with the unitary issue. We fear that these requirements may be such as to cause considerable and onerous burdens which do not seem justifiable and which, indeed, are not imposed on American banks operating in our countries.

We thank you for giving us this opportunity to express our views.

Yours sincerely,



Le Président

Luxembourg, 25th February 1985

As president of the Banking Federation of the European Community, I am writing to express the unanimous concern of our members over the effect of worldwide unitary taxation on European banks.

Spurred by the considerable harm which such legislation causes us, we have drawn up the enclosed memorandum presenting our view on the problem. I hope that our remarks will receive your kind attention, for which I thank you in advance. Needless to say, our Secretariat is at your disposal for any further information or co-operation you might need; its coordinates are:

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Avenue de Tervuren, 168 (Box 5)
1150 Brussels - Belgium
Tel.02/762.83.03 - Telex 23516 fbanc.b.

Yours faithfully,

Georges ARENDT

nancy ordway, chief department director, department of finance= jeff huff, director of finance= senator david roberti, president pro tem of the california senate= senate alfred e. alquist= senator daniel e. boatwright= senator james nielsen, senate minority floor leader= assemblyman willie l. brown, jr., speaker of the california assembly= assemblyman patrick j. nolan, assembly minority floor leader= assemblyman thomas m. hannigan= assemblywoman theresa hughes= assemblyman dennis brown= david doerr, consultant to the assembly revenue and taxation committee= and martin helmke, consultant to senate committee on revenue and taxation. all the senators and assembly members will receive this correspondence if it is addressed to the assemblyperson or senator at the state capitol, sacramento, california 95814.

WORLDWIDE UNITARY TAXATION, THE VIEW OF EUROPEAN BANKS

The European Banking Federation represents the ten banking associations of the Member States of the European Community. These associations comprise the more than two thousand full range service commercial banks established in the EC, several of which either have branches in California or are considering establishing there.

As such, our banks have become increasingly concerned by the problem of worldwide unitary taxation. It must first be stated that the very concept of unitary apportionment is alien and profoundly disturbing to all of European industry and banking as well as to every one of our governments. Although the objective of combating transfer pricing is understood, it is unanimously felt in Europe that the method, bearing little relationship as it does, to the principle of profit fundamental to accepted accounting practices, can only lead to the most artificial conclusions.

This said, we shall concentrate on the considerable problems inherent to unitary taxation when it is applied worldwide, and which do, in practice cause foreign banks considerable harm: the double taxation caused by formula apportionment, the inordinate compliance burden, and the lack of a clear standard to determine unitary taxation, all this resulting in the disruption of international commercial relations. These problems are analysed in part one of our paper.

We believe that the cumulative effect of these problems is such as to merit the repeal of unitary taxation. However, it is known that the report by the working group chaired by Secretary Regan favours a "water's edge" solution and that this has been the basis of several bills tabled in the California State Legislature. In the second part of our observations, we draw attention to the fact that the vocabulary used both in the Regan report and in some Californian bills is such as to exclude, perhaps inadvertently, bank branches, as opposed to subsidiaries, from the benefit of water's edge election (*). We explain why there is no possible justification for such a discrimination.

(*) Secretary Regan himself recognised this problem in a letter of 31st August 1984 to President Reagan accompanying his report. He stated that: "A particularly important question that remains unresolved in the Chairman's Report is the treatment of foreign-based banks. Because of U.S. banking regulations, foreign banks almost inevitably operate in this country through branches, rather than through separately chartered subsidiaries. Since a bank branch operating in the U.S. would easily be found to meet both the tax presence and threshold tests, the entire foreign corporation of which the domestic bank is a branch would virtually always be subject to combination with its domestic operations. This result troubles our trading partners. Means of treating domestic branches as subsidiaries under certain conditions should be explored at the state level."

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I. THE PROBLEMS INHERENT TO WORLDWIDE UNITARY TAXATION

Double taxation caused by formula apportionment

A unitary tax system applied to the worldwide income of a foreign bank creates substantial risks of multiple taxation because the system fundamentally conflicts with the tax systems of foreign countries. The formula apportionment method used by a unitary system to determine the amount of income subject to state tax does not reflect the actual income earned through the business activity in the state that provides the nexus for imposition of the unitary tax. Indeed, under accepted accounting practices used by other countries to determine taxable income, the office in the state that is the nexus for the unitary tax may have generated no taxable income at all.

Nevertheless, the formula method of apportionment often attributes to the state income that is taxed by foreign jurisdictions and thus causes double taxation because differences in salaries, profits, production costs, and other components of the formulas used for apportionment under a unitary system vary significantly among countries.

Unitary tax compliance burden

The task of complying with a unitary tax system often cannot be met by foreign taxpayers because of the extensive amounts of information that must be accumulated and analysed to determine (a) the activities of the taxpayer that constitute a unitary business and (b) the ratios necessary for apportionment under the unitary formulas. Because most financial books and records of foreign banks are kept in accordance with home country accounting principles, this information cannot be adapted for use in a unitary system without imposing an immense accounting and administrative burden on the foreign bank.

No clear standard to determine unitary taxation

The above mentioned difficulties are compounded by the fact that there is no clear, predictable standard that can be used to determine which activities of a foreign taxpayer constitute a "unitary business" subject to apportionment under a unitary tax system. As a result, all activities carried on by a taxpayer outside the U.S. are potentially subject to characterization as "unitary" by State tax authorities, even though the activities may not be related to, or even legally permissible in, the U.S. State asserting its unitary tax, and are consequently quite useless for any attempt at transfer pricing or other manipulation.

This point is particularly true for foreign banks. Because of differences between banking powers in the U.S. and in foreign countries, many foreign banks and their foreign subsidiaries conduct a far broader range of activities outside the U.S. than are legally permissible inside the U.S. For example, foreign banks often engage in

securities and general industrial activities in their home country that are not permitted to banks in the United States and therefore could not legally be carried on in the State imposing its unitary tax. It would be unreasonable and unfair for States to attempt to apply their unitary tax system to business activities of a foreign taxpayer carried on outside the U.S. that are not conducted, and cannot legally be conducted, in the State applying the unitary tax system.

The disruption of international commercial relations

As a result of the problems noted above, several of our governments as well as the Commission of the European Communities and the European Parliament have sharply criticised the unitary tax system as applied to worldwide income of foreign corporations and have stated officially that unitary tax systems applied in this manner are an impediment to sound commercial relations with the U.S. These criticisms create a significant risk of retaliatory taxation or other retaliatory action by our governments.

In addition, tax treaty negotiations between the United States and its trading and investment partners, for example Germany, the Netherlands and the United Kingdom, have been unnecessarily strained as a result of unitary apportionment of worldwide income by the States. From the perspective of our governments, State apportionment of a European corporation's worldwide income under a unitary system frustrates the essential objective of bilateral tax treaties, i.e., the avoidance of double taxation. As a result, we are finding that we cannot rely on U.S. tax treaties to reflect accurately the tax system under which our subsidiaries or branches in the U.S. will be taxed. This problem is particularly sensitive because our governments typically bind their political subdivisions to the terms of their tax treaties while the U.S. does not. Thus, attempts by States to impose unitary tax systems on the worldwide income of foreign corporations have adversely affected international commercial relations.

II. THE STATUS OF BANK BRANCHES

The wording of several bills tabled in the Californian State Legislature can be interpreted as implying that bank branches, as opposed to subsidiaries, would be prohibited from electing a water's edge solution. Were this to be the case, it would be of the greatest detriment to European banks, erasing most of the effect of the water's edge provisions.

Because of geographic restrictions applicable to banks in the U.S., branch or agency offices may be the only available vehicle for a foreign bank to enter a particular banking market. In addition, use of a branch or agency office in many circumstances is the only method by which a foreign bank can compete effectively against domestic banks similarly situated because of lower lending limits and other bank regulatory requirements imposed by bank regulators on subsidiary operations. For these and other reasons, foreign banks often must use a branch or agency office to achieve their business objectives in the U.S.

We consider this negative exception for bank branches to be particularly incongruous since the problems raised by unitary tax systems, i.e., defining a unitary business, creating double taxation through arbitrary formula apportionment, and complying with unitary systems, are equally great when a worldwide unitary tax is imposed on a foreign corporation with a U.S. branch office as when imposed on a foreign corporation with a U.S. subsidiary operation.

Finally, the unfavourable treatment being meted out to branches seems all the more unjustified concerning banks when it is considered that the very threat which worldwide unitary taxation was designed to meet is weakest in their case. The major deductions of a foreign bank's direct offices in the U.S., i.e., the interest expense and bad-debt deductions, are almost always computed by formulas that substantially eliminate the risk of abusive transfer pricing.

Consequently, limiting application of any unitary system to effectively connected income does not create a significant risk of manipulation to reduce the income subject to unitary apportionment.

To conclude, we consider that the extra-territorial effects of worldwide unitary taxation are such that the only solution would be outright abolition of the tax or, at the very least, the possibility for foreign banks, be they subsidiaries or branches, to benefit from a fair, viable and comprehensive water's edge election.
