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BY TELECOPIER
FROM BRUSSELS (K. EWIG I B 1)
TO WASHINGTON DELEGATION (SIR ROY DENMAN)

SUBJECT : SPECIALTY STEEL, UNITARY TAXATION

PLEASE FIND ATTACHED THE STATEMENT MADE BY MR. LUYTEN AT THE OECD STEEL COMMITTEE ON 9 AND 10 NOVEMBER. ALSO FIND ATTACHED THE DRAFT PAPER FOR SUBMISSION TO THE REGAN WORKING GROUP ON UNITARY TAXATION; PLEASE MAKE ANY COMMENTS YOU HAVE AS QUICKLY AS YOU CAN. WE ARE STILL HOPING TO HAVE OUR MEETING OF EXPERTS ON 21 OF THIS MONTH. WE WILL LET YOU KNOW IF THERE IS ANY CHANGE OF PLAN.

K. EWIG

XV/B/1

14.11.1983

HM/mg

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 multinational 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 multinational 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. This group will, amongst others, consider the views of the trading partners of the US and in particular those of the European Community. The purpose of this paper is to establish the arguments and answers to possible questions which might be raised in that hearing.

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EEC-POSITION

International Tax Law

3. It is an accepted principle of international tax law 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 consented, 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.

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 can be taxed.

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 a separate enterprise basis. (OECD Model Commentary on Article 7 Paragraph 24)

8. This ruling exists for permanent establishments which means integral parts of an enterprise and it goes without saying that the ruling 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 it has been adopted by the United States. 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 the long accepted body of customary international tax law. It can not be unilaterally ignored for internal political reasons by one party without serious consequences to the whole equilibrum of international tax law as a basis for international trade and commerce.

Consequences of Indirect Taxation of worldwide Profits

10. The rulings 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.

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

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

12. 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.

13. Payroll and property values in the US are high 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 than could be justified as reasonably allocable under the direct method.

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

15. 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.

16. 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.

17. 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.

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18.. 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 world-wide reporting system should wish to deprive a parent company outside the US of a fair return on what is a high risk capital investment.

19. Treasury Assistant Secretary Lubiek 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".

20. 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 %.

21. 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). <u>This double taxation is due to the fact that the US tax claim is unilaterally extended to profits attributable to a foreign tax jurisdiction.</u>

<u>Loss Case</u>

22. The consequences of the application of the unitary system described above would be even worse in 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. In such a situation not only the Californian losses will have reduced worldwide profits of the enterprise but in addition the (as explained earlier) particularly favourable

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effects of the indirect formula will attribute an excessive part of the reduced worldwide profits to the US state concerned.

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.

23. 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 $ 968 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

24. 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.

25. 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 through

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out 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.

26. 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.

27. Large quantities of non-financial data 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

28. The unilateral extension of the US tax claim to the detriment of foreign jurisdictions and its grave consequences for non-American enterprises active in the US is a serious impedement 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.

29. 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 at 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 the US tax claim and the grave consequences resulting from it for non American enterprises carries the risk of seriously disturbing international trade and investment relationships. It may take away the legal basis on which such international relationships are built. This may also have consequences for foreign investment of US enterprises in other industrialized countries.

30. What is even more dangerous, is that developing countries who do not sometimes have well developed tax administrations tend naturally to some form of indirect method of profit determination which might be for them much easier to handle than profit determination based on direct accounting. The American practice may now 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 for some of the US States.

Special Aspects

"Discrimination"

31. The treatment of non-American enterprises on a non worldwide tax basis in the US could by no means be considered as giving an undue advantage in comparison with the treatment of American firms. Nearly all tax systems of the world have a fundamental distinction between own (resident) enterprises and foreign (non-resident) enterprises. It is fully up to a state whether it taxes its own enterprises on a worldwide basis and how it avoids double taxation. On the other hand foreign enterprises are already to long international tradition liable to tax a given date only on the profits from the activity exercised in that state. This shows very clearly that no argument can be drawn from the fact that in the case of US enterprise worldwide profits are apportioned between several US states, that foreign enterprises could be treated in the

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same way. Despite this statement it remains a questionable matter whether the treatment of US enterprises is compatible with principle of fair treatment of international investment as has been stressed by the Dutch Government already.

Legal action

32. In the Shell Petroleum NV V Franchise Tax Board case the argument has been put forward that: based on a courts decision "Sumitomo Shoji", the US subsidiary cannot invoke an F.C.N. treaty (because the treaty only gives rights to the foreign parent), but also the foreign parent is not entitled to invoke the treaty since it is not subject to US tax.

The mere fact that such argument can be put forward heightens the risk that all F.C.N. treaties may have no practical meaning. The question must be raised as to what sense it makes conclude international treaties if in practice they cannot be invoked either by the US subsidiary or by the foreign parent.

This underlines the urgency of not relying only on courts decisions on unitary taxation but legislative clarification of the situation is necessary.

33. It should be added that Supreme Court decisions have made reference to the lack of any congressional action to regulate the taxing activities in this field and although a number of legislative initiatives have been launched in recent years none have managed to reach the statute book. The GAO report of July 1982 quotes the Willis Report of 1964 in saying that "international tax policy should be formulated by the Federal Government and not by individual states and goes on to quote the Supreme Court judgement in Moorman Manufacturing Company v Blair (1978) that the legislative power granted to Congress by the Commerce clause of the constitution would mean that it is to that body and not the Court that the Constitution has delegated such policy decisions.

It is to the US Congress that the trading partners of the US must look for a resolution of the present impasse. The working group now in session can give a clear lead to Congress by spelling out the requirements of a fair and equitable system which will satisfy the just demands of the international trading community and by drawing to the attention of Congress the consequences of continuing inaction.

COMMISSION
OF THE
EUROPEAN COMMUNITIES

Directorate-General for
External Relations

Brussels, 11 November 1983
PL/nl

O.E.C.D. STEEL COMMITTEE - PARIS, 9 and 10 November 1983

Subject : U.S. speciality steel measures
- Statement by E.E.C. representative, P. LUYTEN

Mr Chairman,

I wish to welcome the news that anti-dumping and countervailing duties in the United States applied against certain specialty steel items in France and Germany are being reviewed. We very much hope that this review will also extend to the products for which there are such duties against the United Kingdom (1).

Ambassador Lighthizer said that the United States specialty steel industry remains in depressed conditions. I shall comment on that and shall not again talk about "Williamsburg" and the O.E.C.D. and the G.A.T.T. Ministerial meetings ... I wish to come up with a number of facts. The production of specialty steel in the United States during 1978-81 has been about 1 million tons a year. In 1982 it went down to 763.000 tons. Apparent consumption between 1978 and 81 has been about 1.200.000 tons a year i.e. about 100.000 a month. In 1982 consumption went down by 200.000 tons. Imports during 78-81 were about 160.000-170.000 tons a year. And in 1982 there was an increase of 27.000 tons i.e. 203.000 tons.

So in 1982 the consumption went down by 200.000 and imports went up by 27.000 and there was of course a situation of great pressure, there is no doubt about that with such a drop in consumption.

What about more recent monthly figures ? Production in the last quarter of 1982 of the items which are covered by the problem tariff measures was 140.000 tons, i.e. very low. The first quarter of this year, the figure was 204.000 tons; second quarter : 234.000 tons; in the third quarter of this year 291.000 tons i.e. about the traditional production

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(1) It was later pointed out to Amb. Lighthizer that the E.E.C. expected this review to be in conformity with the G.A.T.T. code with respect also to injury definition.

of 1.000.000 tons a year. Consumption is also going up and in June, July, August it was roughly 100.000 tons a month, whereas in January and February it was still only 80.000 tons. So, when the U.S. delegate talks about the industry "remaining in depressed conditions", I cite figures which show a very significant turnaround since the last quarter of last year.

What are the perspectives ? The forecast for real economic growth in the United States next year, was given as 5,5 % yesterday in this organisation by a U.S. source. The forecast by the O.E.C.D. of real economic growth, for example for Japan is 3,6 and for the Communities 1,5 %. Somebody has referred to the International Iron and Steel Institute forecasts. These have tended to be rather on the optimistic side in recent years, and have therefore to be taken with a note of caution : they foresee a 12 per cent increase in consumption of all steels in the United States. Even if this figure is too optimistic, the trend is distinctly up.

What is the conclusion ? In recent months the U.S. specialty steel industry is back where it was before 1982 as far as production and consumption are concerned. In the meantime on the import side for the quota products, the cutback is very sharp and ranges from 30 to 40 per cent, as compared to imports during the last three years. On tariffs there is an extra 8 % or 10 % which is a doubling of the duties. For high-cost products that is not negligible. The question for the Committee today is whether the U.S. action has not been taken in July 1983 on the basis of an appreciation of the situation in 1982 but which, when the measure was taken, had already considerably changed and was improving rapidly ? In view of these developments, does this not lead one to conclude that there is "shifting of the burden" ? It may be perhaps somewhat premature to draw final conclusions, but I am sure Mr Chairman, that in January when the Committee meets again we will have further figures and I am confident that they will bear out what I have said. I would like to make a rendez-vous with our American friends for January and come back on all this in that occasion. If these trends in consumption and production continue, the U.S. measures should rapidly be reviewed.

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Moreover how is the pressure for restructuring the U.S. industry going to exercise itself if basically imports are maintained at low levels for the quota products or discouraged for the tariff items while the domestic demand rises sharply ? We know that the US government will monitor the developments. We very much hope that it will watch the situation and conclude for itself whether there is "sharing of the burden" or rather "straightforward shifting of the burden" in contradiction with the ground rules of the Steel Committee ? .

May I again quote the USTR representative Mr Brock in the same statement which he made before the Senate Foreign Relations Committee 2 weeks ago ? After having described the American measures, he says, "... These restrictions are temporary and in complete conformity with our international trade obligations, including the obligation to notify and justify such trade barriers to the world trading community." "As a major supplier of specialty steel to the U.S., the Community has strongly protested our action. We believe that we have chosen the best way to deal with the difficult trade problem facing that industry. The Community's steel industry is protected from imports from many competing countries by bilateral agreements that limit the quantity and price of imports. These agreements, unlike U.S. actions, are not notified to the G.A.T.T. or the O.E.C.D. and they are not scheduled to expire on a certain date."

The sense of this is very clear. The American measures on specialty steel are better than what the Community does : in this connexion Mr Chairman, I wish to put a simple question to all our partners to arrangements with the E.E.C. here represented :
"if anyone of them prefers the U.S. approach on specialty steel to that adopted by the E.E.C., they are welcome to tell us, because right now the Council is discussing, in Brussels, the renewal of the arrangements for 1984 ."

Contrary to what Ambassador Lighthizer affirmed the Commission's proposals to the Council do not foresee more restrictive arrangements for next year. The E.E.C. will continue to behave as in the past, and aim at avoiding "shifting the burden". But it does believe in "some sharing of the burden". As far as the information about these arrangements is concerned, the message by Mr Brock is that the E.E.C. is not really telling this Committee what these arrangements are about. This is most surprising Mr Chairman ! American teams change frequently. When Ambassador

Dave McDonald was still representing the U.S. earlier this year, the E.E.C. had consultations with the U.S. several rounds, on the arrangements and in the month April, the E.E.C. again submitted to the Committee a paper describing our arrangements. And it has been willing /and has done so/ to reply to questions and give answers to further enquiries. We do believe that there is a need for the United States Delegation to look at the record, to look at their minutes of the consultations and not simply to continue to affirm that there is no transparency, that there agreements are restrictive with quota limits, etc. Yes, we have quantitative restrictions vis-à-vis the Eastern European countries because of their particular practices. With our other partners we are trying to come to reasonable solutions, sensible solutions with some price disciplines and, in number of cases, indicative amounts which are no quotas. That has been explained over and over again and I am surprised that the message seems to have to be repeated over and over again too.