September 8th 2006

AmCham EU comments on CCCTB – Non-Discrimination and Other Treaty Issues

Executive Summary

- Any business legally registered in a CCCTB eligible country should be allowed to participate in the CCCTB scheme. Excluding foreign-owned companies would be in contravention of the principles set in the Article 24 of the OECD international tax treaty model.
- AmCham EU is concerned that the proposed CCCTB scheme would allocate foreign-parented branch more income than would be allocated under an arm's length method. The resulting differential would contradict Article 7 of the tax treaty.
- As Article 9 of the tax treaty can only be raised by governments, it is likely that allocation between subsidiaries would not raise any problem under the CCCTB allocation mechanism.
- In the medium term, re-negotiating tax treaties with third countries is the best way to address taxation of foreign owned branches.
- As a short term solution, income of foreign owned branches could be calculated under the CCCTB rules, but allocation could be calculated using the arm's length principle. In this way, for US tax purposes, the legal liability to tax would not be modified. Some type of compensating payment could then be made between CCCTB Member States.

Introduction

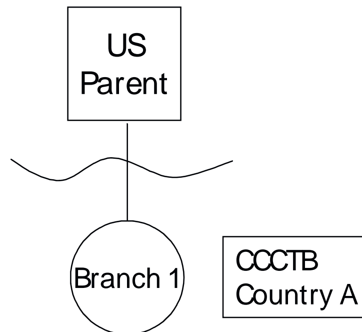
The American Chamber of Commerce to the European Union (AmCham EU) is the voice of companies of American parentage committed to Europe towards the institutions and governments of the European Union. It aims to ensure an optimum business and investment climate in Europe. AmCham EU facilitates the resolution of EU – US issues that impact business and plays a role in creating better understanding of EU and US positions on business matters. Its member companies are typically present in most EU Member States. As such, we would like to submit an analysis of issues raised by the CCCTB scheme for US-owned permanent establishments.

For the purpose of illustrating our analysis, we will examine four possible cases:

- a US parent company owns a branch in a CCCTB country;

- a US parent company owns a branch in each of two separate CCCTB countries;
- a US parent company owns a subsidiary in one CCCTB country and a branch in another CCCTB country and
- a US parent company owns subsidiaries in two separate CCCTB countries.

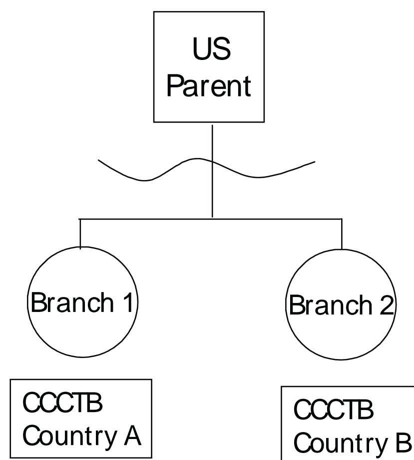
<u>Scenario 1: a US parent company owns a branch in a CCCTB country</u>



Non-discrimination: 1.1 According to Article 24 (3) of the OECD Model, Branch 1 should be allowed to participate in CCCTB. The OECD Model requires that a branch be treated no less favourably than an enterprise in any Country A.

Creditability of Tax: 1.2 Tax paid under CCCTB should be creditable in the US (assuming all other US requirements are also met). While more income may be included in the tax base than would have been the case under the local rules - and, therefore, that higher tax may result - is irrelevant for US creditability purposes. So long as the CCCTB is clearly an income tax, the details of what makes up the base do not matter.

<u>Scenario 2: a US Parent company owns branches in two separate CCCTB countries</u>



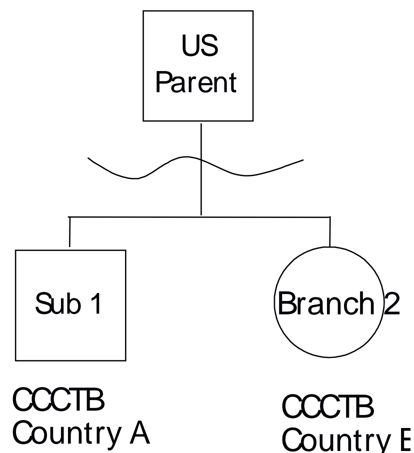
Non-discrimination: 2.1 As in the example above, both branches should be able to voluntarily use CCCTB. Any different treatment would represent discrimination.

Creditability: 2.2.1 Some tax may potentially be disallowed as a credit by the US, if one branch is allocated more income than it would have been allocated using the arm's length method (in contravention of Article 7, as mentioned above). It is important to note that in order to get a full tax credit in the US, the US would require that the taxpayer contest the assessment with the relevant tax authority. However, this might be difficult if the taxpayer had voluntarily elected to apply CCCTB rules and cannot be considered as a true "compulsory levy". In this case, the US would only give a credit for a *pro rata* amount of the tax, based on the arm's length amount of income.

2.2.2 It is worth clarifying that the same result would occur whether the non-arm's length amount of income allocated to the branch was taxed at a higher or a lower rate than in country of the other branch. The Article 7 issue goes to the amount of income, not the amount of tax.

2.2.3 There is, potentially, a "voluntary tax" issue raised by this scenario. However, given the fact that the CCCTB would be a valid income tax (and not, for example, a soak-up tax[1]), this should not be a problem[2].

Scenario 3: US parent owns a subsidiary in CCCTB country A and a branch in CCCTB country B



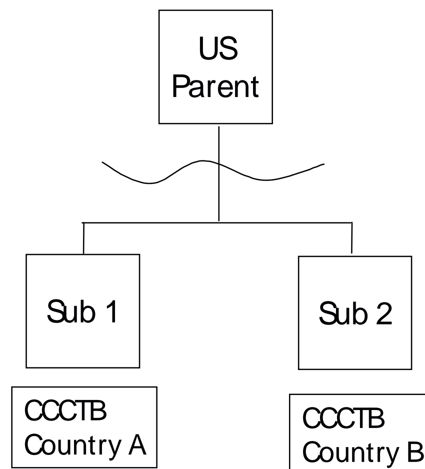
Non-discrimination: 3.1 As in the examples above, both Subsidiary 1 and Branch 2 should be able to freely participate in CCCTB. While the case of the subsidiary may not be as clear as that of the branch, because of the differences between Articles 7 and 9, AmCham EU's reading of the US tax treaties suggests that excluding a US-owned subsidiary from a system open to domestically-owned subsidiaries would be discriminatory.

[1] Some foreign laws in source countries make clear that a tax (often a withholding tax) will only be imposed if the resident country allows a credit, but not if it does not. This tax is non-creditable in the US as a "soak up tax".
[2] It should be noted that voluntary tax is a matter of US domestic law, rather than a treaty issue.

Creditability: 3.2.1 In this case an issue will arise, as in 2.2.1 and 2.2.2, even if the tax rates in Countries A and B are the same. If income is allocated from Subsidiary 1 to Branch 2, then the US parent company will end up paying more tax than would be justified under the arm's length method because the amount of income allocated to the branch has increased. Again, it is not the higher tax as such that matters, but, rather, the fact that total branch income will have increased, which seems to contravene general article 7(2) provisions. The fact that the overall amount of tax on the subsidiary and branch taken together has not increased under this scenario is irrelevant. It is the fact that the amount of income on the branch has increased that is important.[3] In addition, this may also raise some difficulties regarding Article 23 B (Credit).

3.2.2 If, under the same set of facts, more income was attributed to the subsidiary than the branch, similar issues would likely arise. Article 9 relates to associated enterprises in the two contracting states, and the branch and subsidiary - or parent of the subsidiary - are indeed associated enterprises. The fact that Article 9 can only be raised by governments, however, makes it less likely that the country which has income allocated to it under CCCTB will complain.

Scenario 4: US parent owns subsidiaries in two separate CCCTB countries



Non-discrimination: 4.1 Again, the logic holds that Subsidiary 1 and Subsidiary 2 should have the right to use CCCTB. Any other outcome would qualify as discrimination under US tax treaties.

Creditability: 4.2 Unlike the discussion above on scenario 3 at 3.2.2, where Subsidiary 1 (or 2) is allocated more income than it would be under the arm's length method, it seems that the application of the allocation formula may not violate a US treaty model. Article 9 can extend to the treatment of two subsidiaries under common control, although, again, it

[3] Although there may be a technical argument that, because the US does not require the foreign country to have the same source rules as the US, then CCCTB is, in essence, to be regarded as a type of sourcing rule, and, thus, permissible.

would require government intervention for it to be invoked. In this case, it is arguable that the US would not have standing to raise the issue because (unlike the case with the branch owned directly by a US parent) no US company is directly being taxed in either Country A or B. Thus, in this case, the allocation between subsidiaries in Country A and Country B seems more analogous to a transfer pricing adjustment. Another question that could affect creditability relates to whether this is a voluntary tax, but, as in other scenarios, that, on balance, seems unlikely. So, in this case, the tax paid in Country A could be credited even though part of the payment may be based upon Country B profits, as calculated under the arm's length method.

Conclusion

5.1 The challenge is to bridge the differences caused by the application of the treaty provisions on one hand, and the CCCTB regime on the other. In order to satisfy treaty requirements, tax can only be levied on an arm's length amount earned by the branch (or subsidiary, in certain cases). However, the CCCTB has a two-step process. First, income is calculated applying the rules of the common base. Only as a second step is income allocated. If it were possible to stop after the first step some problems could be avoided as the application of the rules setting forth the tax base does not implicate tax treaties - as long as it has the general features of an income tax. It is the allocation mechanism which causes problems *vis a vis* the arm's length method.

5.2.1 Re-negotiating tax treaties – be they bilateral or multilateral – is certainly the best way to deal with the income earned by non-resident from sources in CCCTB jurisdictions. As we understand that this could be a time-consuming process, Following are AmCham EU's thoughts on alleviating some of the issues which will arise in the interim period.

5.2.2 One approach would be for Countries A and B to continue to tax branches of non-residents solely on arm's length amounts. This would be done using the CCCTB base, but not the allocation formula. For US tax purposes, therefore, the legal liability to tax would not have changed. If this were to result in less tax on the branch than under the CCCTB allocation formula (for example, because of a differential between the two countries' rates), there could be a compensatory mechanism operated at the level of the two tax authorities. Thus, the country which receives less than it would otherwise have would be compensated – perhaps by payments between the two countries, or perhaps by payments out of some central fund. This would not involve the taxpayer in paying more tax. Even were Countries A and B subsequently to make transfer payments to reflect what would have occurred under the application of CCCTB, this action would not change the arm's length nature of the legal liability for tax in those two countries at the level of the entities. In this case, there should be no conflict with US tax provisions.

5.2.3. Alternatively, it might be possible to levy tax on a branch at a higher rate than normal. For example, under the CCCTB, branch with 100 units of income at a 20% rate would result in 20 units of tax. Under the arm's length method, however, there would only be 50 units of income. Thus, to raise 20 units of tax, the tax rate on that income would be 40%. That way the amount subject to tax would continue to be the arm's length

base, but the tax paid would be the figure that would have resulted under the CCCTB. However, this could raise several difficulties: As a practical matter, there would need to be a multiplicity of rates (i.e. flexible rates adjusting to the tax base). Furthermore, it is likely that this would be discriminatory under certain circumstances. This proposal might be hard to make work from a practical point of view, but AmCham EU would be happy to discuss this at greater length.

* * *

The American Chamber of Commerce to the European Union (AmCham EU) is the voice of companies of American parentage committed to Europe towards the institutions and governments of the European Union. It aims to ensure an optimum business and investment climate in Europe. AmCham EU facilitates the resolution of EU – US issues that impact business and plays a role in creating better understanding of EU and US positions on business matters. Total US investment in Europe amounts to $964 billion, and currently supports over 3.6 million jobs.

* * *