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NFTC Comment on Consultation on factual examples and possible ways to tackle double non-taxation cases (the "Consultation")

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By email and fax

The National Foreign Trade Council (NFTC), organized in 1914, is an association of some 250 U.S. business enterprises engaged in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial and service activities, and our members have for many years been significant investors in many countries, including all of the EU Member States.

I am writing in response to the Commission's Consultation on double non-taxation (the "Consultation"). The Commission has stated that it is undesirable that taxpayers may be subject to so-called international "double non-taxation" on their cross-border activity within the EU market, "as this gives the taxpayer a competitive advantage compared to other [EU] taxpayers who are subject to ordinary taxation." Therefore, the Commission has stated, it is presenting the Consultation to the public in order to gather evidence of double non-taxation within the EU and in relation with Third Countries, and plans that the results of the consultation will be used to identify and develop an appropriate policy response to double non-taxation. The NFTC urges the Commission to view the evidence it gathers through an appropriate lens.

Reality belies simplicity

While there may be instances of what has been called "tax arbitrage," much of it is unobjectionable, and the process of determining that an instance of it is "bad" tax arbitrage is inherently complex. Use of the term "double non-taxation" suggests a simplicity of judgment that is absent in the real world of cross-border taxation. The appropriate way to evaluate a difference (if any) between two taxing jurisdictions' treatment of an item of income is to consider why the respective jurisdictions' tax laws may both be desirable from the perspectives of the relevant policy-makers, yet different.

As we also point out below, responses to "double non-taxation," which often take an overly simplified approach to international tax differences, have resulted (taking the United States as an example) in poor tax policy outcomes.1 In relation to Third Countries, there generally are few international rules limiting the independence of taxing jurisdictions to set their own tax policies either by taking into account others' policies or by ignoring others' policies. The NFTC believes that bilateral tax treaties remain the only appropriate tool to address differences between independent sovereigns' tax rules on income from cross-border activities, and in doing so, are the appropriate mechanism for separating the permissible from the impermissible tax arbitrage.

Non-uniformity inheres in international taxation

Taxation of income from activities that cross the borders of independent taxing jurisdictions is, inevitably, non-uniform. When income-generating activities are wholly conducted within a single tax jurisdiction, only the tax rules of that jurisdiction are implicated. When income is generated by cross-border activities, at least two jurisdictions' policies are involved, and they will generally have differences.

The NFTC believes that it is crucial that the Commission keep in the forefront of the Consultation that independent countries are making decisions about tax policy based on what they properly perceive is the best way to structure their tax systems. There are legitimate tax policy debates surrounding any number of international tax issues, and countries may choose among a variety of justifiable positions in structuring their domestic laws. For example, there are a variety of choices surrounding how best to alleviate double taxation; how best to determine corporate residence; or how best to support productive investment. One nation's "tax arbitrage" is often another nation's "good tax policy."

It could be said, in an overly simplified way, that "double non-taxation" describes the situation whenever the following is true: Tax-policy differences between 2 jurisdictions result in *less* tax being imposed on a taxpayer with *cross*-border activities than would be imposed if the activities were confined to *one* of the two jurisdictions. Yet to use that term would be an over-simplification because disparities are "built-in."

If each jurisdiction's laws are fully complied with (and each jurisdiction's tax authorities would agree that is the case), there may be no objection by either to so-called double non-taxation. If however a taxing jurisdiction *is* concerned about this situation, and the concerned jurisdiction happens to be the lower-taxing one, it can decide to abandon its existing policy and impose more tax than it would have in the absence of its concern. If the concerned jurisdiction is the higher-taxing jurisdiction, it can decide to abandon its existing policy to "make up" for the other jurisdiction's failure to make a change.

Inconsistency is not inherently problematic

1 The EU is of course free to decide someday in the future to depart from its present law regarding the degree of independence that each Member State has to set its own tax laws. Absent such a departure, the members of the NFTC leave it to other, more EU-focused organizations of which they are members to comment on ensuring consistency between the Consultation and present EU law.

Whether either *ought* to change its own policy raises questions the complexity of which belies the simple terminology employed. Such differences are not a tax policy concern in one country if the tax result in the other follows merely from inconsistent laws. And if one country may see more than a simple inconsistency—e.g., some sort of tax competition—that perception could not prove the other country's policy is flawed. Only when the tax policy of one jurisdiction is the predicate for the tax policy of another jurisdiction—a rare occurrence outside a narrow class of cases—would it be important to the second jurisdiction's tax policy to take into account how cross-border activity is taxed by the first jurisdiction.

Even the Commission staff itself seems unable to reconcile the dispersion of tax policy authority among independent states with the task of the Consultation, as is apparent when we read in the staff working paper on the Consultation that "[t]he decisions in single member states on how to tax certain types of income received by resident and/or non resident are therefore outside the scope of this consultation as direct taxation generally falls within the competence of the member states." To the extent that the Consultation deals with EU states "in relation with Third Countries," and putting aside binding international agreements, the quoted passage almost amounts to a statement that what is *within* the scope of the Consultation is a null set. The decisions referred to in the quoted passage essentially cover *all* tax policy decisions save for the few affected by international agreements.

Judgments about the importance of disparities in tax policies bearing on a single cross-border activity will be separately arrived at by the separate taxing jurisdictions involved. It will often be the case that inconsistencies are of policy interest to neither side, or worrisome only to one, in each case because the two jurisdictions have robustly differing policy preferences. In those cases where *both* sides are troubled by an inconsistency, it is possible that a single reason for their concern is commonly shared. But it is just as likely that the bases of their concerns are the subject of totally disparate views. Bilateral negotiation may resolve the matter in the first case; in the second case, resolution may be impossible because the differences stem from irreconcilably different policy preferences.

Independent tax jurisdictions can reconcile differences bilaterally, if at all

We encourage the Commission not to be swayed by some of the claims being made by nongovernmental organizations of corporate "tax dodging" in the cross-border context. It has been our experience that their reports purporting to uncover instances of "double non-taxation" typically represent what, on reflection, are unwarranted "knee-jerk" reactions. Such reactions rarely, if ever, stand up to the serious considerations that inform real tax policy decisions of policy-makers.

This has been proven, time and again, by policy-makers' inability even to arrive at *internal* judgments distinguishing between "good arbitrage" and "bad arbitrage." The "Tax Reform Act of 1986" enacted by the United States, and its prior and subsequent history, represent an epic saga of struggles with, arrivals at, and rethinkings of, such judgments. Decisions to address a particular type of tax arbitrage as "bad" have ended up defeating the ultimate objective of single taxation by imposing double taxation. The U.S. "dual consolidated loss" rules and "interest expense allocation" rules are examples of that failure. Even when first proposing, in 1998, a law requiring the U.S. tax administrator to prescribe general "regulations clarifying the

tax consequences of hybrid transactions," the Administration of President Bill Clinton made it clear it did *not* see a need to prevent all "tax arbitrage."2

Perhaps for this reason, countries have distinguished between desirable and undesirable double taxation or non-taxation via bilateral tax treaties, and the NFTC supports the U.S. tax treaty program and those of other countries. Residence tie-breakers, limitation-on-benefits rules, provisions dealing with profit-participating debt, and rules dealing with fiscally transparent entities are examples of cases in which two independent tax jurisdictions have been able to rationally limit under-taxation that would otherwise be thought to ensue if the other treaty rules were applied without them.

The NFTC appreciates the opportunity to respond to the Consultation, and urges the Commission to consider these comments in evaluating the matters to which the Consultation is addressed.

Sincerely,

William A. Reinsch
President

2 "[T]he regulations would not be authorized to deny tax benefits or results that arise in connection with hybrid transactions solely because such transactions involve the inconsistent treatment of entities, items and transactions (i.e., 'tax arbitrage'). For example, where U.S. tax law considers a U.S. person the owner of a leased asset (and the U.S. person contemporaneously and consistently reports the transaction accordingly), and foreign law applied to the same facts nevertheless characterizes a foreign person as the owner of the same asset, U.S. depreciation deductions claimed by the U.S. person generally would not be denied on the basis that such deductions are inconsistent with the purposes of Code section 168. See Tech. Adv. Mem. 9748005 (Aug. 19, 1997). Similarly, interest deductions of a U.S. person with respect to a hybrid debt security that is treated as equity in the jurisdiction of the security holder generally are consistent with the purposes of Code section 163, and thus should be allowed unless such deductions are inconsistent with the purposes of other U.S. law (including U.S. treaty obligations) (e.g., because application of a treaty to the hybrid security would inappropriately eliminate worldwide tax rather than serve to alleviate double taxation)." Department of the Treasury, General Explanations of the Administration's Revenue Proposals 144-45 (February 1998).