

University of Miami Law School

## University of Miami School of Law Institutional Repository

---

Articles

Faculty and Deans

---

1990

### The Direct Investment Tax Initiatives of the European Community: A View from the United States

Stanley I. Langbein

*University of Miami School of Law*, slangbei@law.miami.edu

David H. Rosenbloom

Follow this and additional works at: [https://repository.law.miami.edu/fac\\_articles](https://repository.law.miami.edu/fac_articles)



Part of the [International Trade Law Commons](#), and the [Tax Law Commons](#)

---

#### Recommended Citation

Stanley I. Langbein and David H. Rosenbloom, *The Direct Investment Tax Initiatives of the European Community: A View from the United States*, 18 *Intertax* 452 (1990).

This Article is brought to you for free and open access by the Faculty and Deans at University of Miami School of Law Institutional Repository. It has been accepted for inclusion in Articles by an authorized administrator of University of Miami School of Law Institutional Repository. For more information, please contact [mperez@law.miami.edu](mailto:mperez@law.miami.edu), [library@law.miami.edu](mailto:library@law.miami.edu).

withholding tax due on dividends paid by the French holding company of a foreign parent of the withholding tax due on dividends received from abroad by the French holding company.

Clearly, the suppression of withholding taxes between the EC Members could result for France in the loss of its current favourable tax position as regards intercorporate flows of dividends.

## Conclusion

Confirming the remark made by Professors Lindenkrona and Mattson,<sup>7</sup> the new EC Convention does seem to constitute a significant step towards finding new solutions to tax disputes in the field of international transfer pricing between associated enterprises. It is however to be hoped that the fact that its initial duration validity is limited to five years and the abusive recourse to the concept of 'serious penalty' will not unduly reduce its efficiency and that this convention will bring forth greater tax management security for European enterprises.

As to the Directive on mergers, it will allow operations of rationalization between EC companies. For this purpose, internal laws will have to be modified.

So far, the final provisions of this Directive could limit its significance.

In fact a Member State may refuse the application of the Directive's provisions where the purpose of a merger, a division or a contribution of business is clearly to avoid tax, or where such an operation results in a company, whether participating in the operation or not, no longer fulfilling the necessary conditions for the representation of employees or company organs according to the arguments which were in force prior to that operation.

On the one hand, the Directive on parent companies could in our opinion have negative budgetary effects for the different Member States. On the second hand, it seems that this text could rapidly turn the Member States into harmonizing their fiscalities as far as dividends taxation is concerned. No doubt in fact that this step is necessary to consolidate a real European market for companies.

<sup>7</sup> *Intertax* 1990/5: 'How to resolve international tax disputes? New approaches to an old problem'.

# The direct investment tax initiatives of the European Community: a view from the United States

Stanley I. Langbein, Associate Professor of Law, University of Miami Law School, Coral Gables Florida

H. David Rosenbloom, Member Caplin & Drysdale, Chartered, Washington, D.C.

The European Community stands ready to adopt three new initiatives governing the taxation of direct investment by businesses from one Member State in other Member States. Two of these are in the form of Directives from the Community's Council.<sup>1</sup>

<sup>1</sup> Directives are one of three types of European Community legislation authorized by Article 189 of the EC treaty. 'Regulations', the most powerful species of Community legislation, 'have general application', and are 'binding in [their] entirety and directly applicable in Member States'. 'Directives' are 'binding, as to the result to be achieved upon each Member State to which [they are] addressed' but 'leave to the national authorities the choice of form and methods'. 'Decisions' are 'binding in [their] entirety upon those to whom [they are] addressed'. Treaty Establishing the European Economic Community, Mar. 25, 1957, Art. 189, 1973 Gr. Brit. T.S. No. 1 (Cmd. 5179-II) (official English version, 298 U.N.T.S. 11 (unofficial English trans.)).

In a series of rulings in the 1970s and 1980s, the European Court of Justice held that Directives could be invoked against Member States in national courts if the member had not adopted within a specified time limit the prescribed implementation measures. *Grad* case 9/70 [1970] E.C.R. 825; *Van Duyn v. Home Office* case 41/74 [1974] E.C.R. 1337; *Rutili* case 36/75 [1975] E.C.R. 1219; *Royer* case 48-75 [1976] E.C.R. 497; *V.N.O.* case 51/76, [1977] E.C.R. 113; *Ratti* case 148/78, [1979] E.C.R. 1629; *Becker* case 8/81, [1982] E.C.R. 53. See generally *Coming to Terms with EEC Directives*, 106 Law Q. Rev. 144 (1990).

One concerns the imposition of withholding tax on intercorporate dividends from a subsidiary to a parent corporation.<sup>2</sup> The second Directive concerns the deferral of gains tax on cross-border acquisitions in which equity interests in the acquiring party are used as consideration.<sup>3</sup> The third initiative is a multilateral Convention among the Member States of the Community concerning the arbitration of transfer pricing disputes.<sup>4</sup>

All three initiatives are aimed at removing aspects of Member State domestic tax laws which may impede the formation of cross-border intercorporate groups. In fact, the initiatives are part of a larger policy, and effort, on the part of the Community to foster political and economic integration of Member States by rationalizing and harmonizing the law concerning business combinations across national boundaries.<sup>5</sup> The most important current initiative in this area, outside the tax area, is the Council regulation governing cross-border mergers, which became effective 21 September 1990.<sup>6</sup> The recent initiatives represent the Community's first foray into the area of taxation. The tax Directives, in contrast, for instance, to the merger regulation, are unambiguously liberalizing, harmonizing the differing national laws on a level which will substantially 'lower' taxes triggered by cross border acquisitions.

The tax initiatives, and the larger policies they serve, represent a challenge to United States business and United States policy. The two Directives represent tax techniques which are in certain respects more liberal than parallel features of US tax law. The Directives thus promise, or threaten, a regime which will favor intra-Community investment over cross-border investment between Community Member States and the United States. At the same time, the features of US domestic law which are more restrictive than the Directives reflect important tax policy concerns, which have been carefully developed over a course of years and which have been adopted in legislation only after difficult political struggles. There is a serious question whether US policy should respond to the Directives by trying to counteract their competitive effects.

If United States policy remains intact, intra-Community investment will enjoy certain advantages. But an effort to counteract this effect will raise tax policy concerns about the equity of US tax law. It may be that the latter concerns outweigh the former, and that the United States will have to accept a 'bias' in favor of intra-Community investment. Indeed, that may be part of what the EC Council is seeking, through the Directives, to achieve.

The initiative represented by the multilateral Convention presents significant opportunities for the United States, as well as for the international community at large. The provisions of the Convention calling for arbitration of transfer pricing disputes are similar to provisions recently negotiated in US bilateral income tax conventions, notably the convention with the Federal Republic of Germany.<sup>7</sup> Recent US experience with transfer pricing disputes has not been good. The disputes are extensive and burdensome;<sup>8</sup> the standards governing their resolution are vague, and seem to be becoming more, rather than less, so; the large amounts involved have attracted political and media attention, including suggestions that foreign-owned US companies are cheating on their taxes or otherwise engaged in misconduct.<sup>9</sup>

In this atmosphere, the development of a new arbitration procedure can only be welcome. It may not solve the root problem in the transfer pricing area – the lack of definitive standards for allocating tax jurisdiction. However, it should help.

In the pages that follow, we discuss the features of the Community initiatives which are

<sup>2</sup> This Directive [hereinafter the First Directive] has not yet been made public. This article was prepared on the basis of an unpublished draft which, of course, is subject to change.

<sup>3</sup> This Directive [hereinafter the Second Directive] has also not been published, and the comment set forth in note 2 applies to it as well.

<sup>4</sup> The multilateral Convention [hereinafter the Convention], like the Directives, has not yet been published. The comment in footnote 2 also applies here.

<sup>5</sup> See, e.g., von der Groeben, *Competition Policy as Part of Economic Policy in the Common Market*, 1965 E.C. Bull. No. 8, at 5.

<sup>6</sup> Council Regulations (EEC) No. 4064/89 of 21 December 1989, on the Control of Concentrations between Undertakings, O.J.L. 395/1 (1990). See generally Fine, *EC Merger Control in the 1990s: An Overview of the Draft Regulation*, 9 Nw. J. Int'l L. & Bus. 513 (1989).

<sup>7</sup> Convention for the Avoidance of Double Taxation of Income, United States-Germany, signed 29 August 1989, CCH Income Tax Treaties §4932.

<sup>8</sup> The burdens imposed on US tax administration by the enforcement of extant transfer pricing rules were recently detailed by the Commissioner of Internal Revenue and other Government witnesses before the Oversight Subcommittee of the House Ways and Means Committee. See Statement of Fred C. Goldberg Before the Subcomm. on Oversight, Comm. on Ways and Means of the House of Representatives, 10 July 1990, reprinted at 18 TAX ANALYSTS HIGHLIGHTS AND DOCUMENTS (11 July 1990).

<sup>9</sup> On the ambiguity of prevailing transfer pricing standards, see Langbein, *Transaction Cost, Production Cost, and Tax Transfer Pricing*, Tax Notes, 18 September 1989, p. 1391. On the question of compliance by foreign-owned companies, and the relation of that question to the problem of the substantive standards, see Statement of Stanley I. Langbein to the Subcomm. on Oversight, Comm. on Ways and Means of the House Representatives, 1 August 1990, reprinted at 18 TAX ANALYSTS HIGHLIGHTS AND DOCUMENTS 2153 (24 August 1990).

different from US tax law, and the US tax policy concerns which are implicated. The final section discusses the multilateral Convention in the context of the contemporary posture of the transfer pricing issue.

The First Directive concerns the 'common system of taxation applicable in the case of parent companies and subsidiaries of different Member States'.<sup>10</sup> It deals principally with the taxation of profit remittances by a 'subsidiary' to its parent, where the parent company's 'home' state is one member of the Community but the subsidiary's 'home' is a different Member State. A parent-subsidiary relationship exists for purposes of the Directive when the 'parent' owns 25 per cent or more of the capital of the 'subsidiary';<sup>11</sup> Member States are permitted to modify the condition to make it depend upon voting rights rather than capital.<sup>12</sup>

The Directive has two substantive provisions, one governing taxation by the home state of the parent company, and the other governing taxation by the home state of the subsidiary. The first provision requires that the parent's home state either refrain from taxing profits distributed by a subsidiary, or that it accord a tax credit for an appropriate portion of the corporate tax paid by the subsidiary to the subsidiary's home state, plus a credit for any withholding tax appropriately imposed upon the distribution.<sup>13</sup>

The second substantive provision of the Directive disallows withholding taxes entirely, on subsidiary-to-parent distributions, except in limited and transitional instances involving Germany, Greece, and Portugal.<sup>14</sup> It is this provision which represents the more novel and far-reaching innovation of the Directive.

The requirement of an exemption or an 'indirect' tax credit occasions little difficulty for US tax policy, since the United States accords such a credit under its domestic law.<sup>15</sup> Indeed, most states of the Community already either accord a comparable indirect credit or exemption to foreign earnings. Thus, a potential US investor will not be disfavored as against an investor in an EC Member State; both will receive home country relief with respect to taxes imposed by the host state.

There is one potential competitive effect of the rule, although it is probably a minor one. When an investor resident in a Member State considers a 'foreign' investment, and the home state does not by its domestic law provide either an indirect credit or an exemption, the EC Directive will have the effect of favoring investment in another Community Member State over an investment in the United States (or a third country). This effect is likely to be minor, however, because most Member States provide either a credit or exemption as a matter of domestic law. Even where they do not, the United States has bilateral conventions with nearly all the Member States, and these conventions generally provide for either exemption or credit by the treaty partner for corporate and withholding taxes imposed by the United States.

The withholding tax provisions of the Directive, by contrast, represent a departure from present practice and a challenge to US international tax policy. At present, most states impose withholding taxes at somewhat high statutory rates on dividends paid by their residents to non-resident shareholders – the rate in the United States is 30 per cent.<sup>16</sup> In practice, these rates are reduced by treaty – to still somewhat high levels for dividends paid to 'portfolio' investors and usually lower levels for dividends paid to 'direct' investors. In the OECD and United States model income tax conventions, and in most bilateral US conventions, the rates are 15 per cent for portfolio dividends and 5 per cent for dividends on 'direct' investment.<sup>17</sup> Such 'direct' investment always involves corporate ownership of a subsidiary, but its precise definition varies from convention to convention. In older US conventions, a 95 per cent ownership interest, ordinarily expressed in terms of voting power, was required to qualify for the lower dividend rate.<sup>18</sup> In newer conventions, a 25 per cent threshold, usually expressed as a percentage of capital value, is ordinarily set forth.<sup>19</sup> The proposed US model

<sup>10</sup> First Directive (prefatory material).

<sup>11</sup> *Id.* Art. 3(1)(a).

<sup>12</sup> *Id.* Art. 3(2).

<sup>13</sup> *Id.* Art. 4(1).

<sup>14</sup> *Id.* Art. 6. Thus, the required credit for withholding taxes necessarily pertains only to the tax regimes of these states.

<sup>15</sup> INTERNAL REVENUE CODE Section 902(a).

<sup>16</sup> *Id.* Sections 871(a), 881(a).

<sup>17</sup> Report of the OECD Fiscal Committee, *Model Double Taxation Convention on Income and Capital* (1977).

<sup>18</sup> *E.g.*, Convention for the Avoidance of Double Taxation of Income, United States-Switzerland, 22 September 1951, 2 U.S.T. 1751, Art. 10.

<sup>19</sup> *E.g.*, Convention for the Avoidance of Double Taxation of Income, United States-Denmark, 17 June 1980, T.I.A.S.

convention links the test to the 10 per cent-of-voting-stock test found in domestic law provisions relating to the indirect foreign tax credit.<sup>20</sup>

This pattern is reflected in conventions in force among the nations of the developed world, including the EC Member States. Thus, direct investment dividends are presently subject to taxation—at low rates, to be sure, but the taxation is real. The Directive represents a significant change.

The change will give intra-Community investment a tax advantage over investment crossing borders between the United States and the Community. If an investment opportunity presents itself in the Community, an investor from another Community state will be able to invest without incurring a withholding tax, whereas a United States investor will not. This difference may be swamped by differences in home country tax rates; but it may not, and in any event the withholding tax requirement will enhance (or counteract) whatever competitive effects the tax structures of the two countries otherwise have.

The same is true for the Community investor who seeks a 'foreign' investment. If the investor invests in a second Community state, the investment enjoys withholding tax exemption. If the investment is made in the United States, a withholding tax will be imposed. If the investor's home state is a 'credit' jurisdiction, this may not matter, because the difference will be 'absorbed' by the credit allowed at home. But foreign tax credit systems operate in complex ways, and in many cases the home state tax law will not fully accommodate the consequences of the withholding tax difference. In such cases, the Directive will have competitive consequences, adverse to United States businesses in the capital markets.

One response would be, of course, for the United States to change its policy, abandoning withholding taxes on direct investment dividends, at least where the Community is concerned. In the case of the Community investor and the United States investment, this could be achieved by unilateral legislation, although such legislation would probably have to take the form of a general repealer of the withholding tax, not a provision targeted at Community state investors. In the case of Community investments, the United States could secure neutrality only by means of some kind of international agreement. Under prevailing arrangements, this would mean changes in US bilateral conventions with each of the Community members. Recently suggestions have been made concerning a single tax convention between the United States and the Community as a whole.<sup>21</sup> This seems a long way off, but it might be possible to explore a special purpose agreement with the Community concerning the subject matter of the new Directives and the multilateral EC Convention. An agreement of this nature might provide for reciprocal withholding tax exemption by the United States and by signatory EC Member States.

The question is whether such an arrangement, even if feasible, is desirable. The United States in recent years has exhibited a rather ambivalent policy toward withholding taxes. Legislation in 1984 repealed the tax on 'portfolio' interest, leaving 'direct investment' interest taxable.<sup>22</sup> This constituted a retreat from policies favoring withholding taxes. Two years later, in 1986, the United States adopted a branch profits tax,<sup>23</sup> with the specific purpose of placing US business done through a branch on the same tax footing as business done through a subsidiary insofar as a 'second level' tax on 'remitted' profits is concerned.<sup>24</sup> Initiatives of the last decade in the US tax treaty policy have aimed at curbing 'treaty shopping' and other abuses which are in large part efforts to avoid withholding taxes.<sup>25</sup>

It appears that at least some withholding taxes still find support in the United States. Broadly speaking, current US policies in this area can be assessed by dividing investments in the United States into two categories. The first concerns investments which represent capital that is readily 'redeployed'. In most such instances, the investor's return will be a 'marginal' one, a going rate of interest or a standard wage rate, or the like. A portfolio debt instrument represents such an investment, as indeed may a portfolio equity instrument, or some real

<sup>20</sup> US Model Income Tax Treaty of 16 June 1981, 1 CCH Tax Treaties ¶211, Article 10, para. 2(a); INTERNAL REVENUE CODE Section 902(a).

<sup>21</sup> See Wrappe, *The Protectionist Potential of the Imputation Form of Corporate Integration*, *Tax Notes*, 7 May 1990, pp. 727, 730 & n. 21 (citing statement of Assistant Secretary of the Treasury Kenneth Gideon and a letter from Treasury Secretary Nicholas Brady to Representative Dan Rostenkowski, Chairman of the Ways and Means Committee, to the effect that the United States should consider negotiating a single convention with the EC).

<sup>22</sup> INTERNAL REVENUE CODE Sections 871(h), 881(c).

<sup>23</sup> *Id.* Section 884.

<sup>24</sup> See Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* 1036-37 (1984).

<sup>25</sup> See, e.g., Convention for the Avoidance of Double Taxation of Income, United States-Cyprus, March 19, 1984, T.I.A.S. 10965. See generally Rosenbloom & Langbein, *United States Tax Treaty Policy: An Overview*, 19 Col. J. of Transnational Law 359 (1981).

estate investments. The second category represents investments which constitute 'specific assets', and involve capital not readily redeployed.<sup>26</sup> The investor's return here is apt to involve some element of what economists call a 'rent', a supernormal profit not easily replicated by alternative investments.<sup>27</sup>

The history of 'source' or 'origin' basis taxation, both in the United States and in the agreements which form the basis of contemporary international tax arrangements, reveals a dichotomy in the treatment of these two types of investment. There is a reluctance to accord 'source' states the right to tax income of the former kind, and indeed some reluctance of source states to impose such taxes.<sup>28</sup> This is because capital of the kind involved is highly motile; if the source state taxes it in a manner which results in a higher overall tax rate, the capital is able and likely to move to another jurisdiction.

By contrast, the second type of investment – exhibiting 'asset specificity' and involving an element of economic rent – is ordinarily taxed by the host state. Since the asset is specific, the capital is not in a position to move; in this sense, the host state in imposing taxation is simply 'sharing' in the rent. Moreover, given the character of the income, the foreign investor's presence probably represents some displacement of local investors. According the host state a right to tax compensates it for a loss of what, in the absence of the cross-border investment, would be unambiguously part of its tax base.<sup>29</sup>

Direct investments have always been seen as second category investments under international tax arrangements; this principle underlies the host state's normal right to tax income derived from permanent establishments. The second level of tax imposed on such investments – imposed at the time of distribution – is a more difficult matter. That taxation has been reduced by treaty, to a considerable extent out of a desire to accord an 'affiliation privilege' to incorporate arrangements, so that businesses are not overly taxed simply because they are stacked in 'tiers'.

Nevertheless, US domestic law takes seriously the tax on intercorporate dividends, even in a direct investment context. In fact, the United States has historically asserted a broader right to tax dividends derived from US business operations than European nations have asserted in parallel circumstances, and indeed a broader right than European nations have ever conceded to the United States. This policy has been reflected historically by the US 'second dividend' and 'second interest' taxes,<sup>30</sup> as well as by such dividend-substitute penalty taxes as the accumulated earnings tax and the personal holding company tax.<sup>31</sup> The policy is reflected currently in the branch profits tax.

The tax on direct investment dividends, in short, plays a vestigial but still vital role in US tax policy. It is a fair tax in that it falls, crudely but in general, upon income which bears some aspects of an economic 'rent', and thus is in a position to bear the tax without serious economic consequence. It is both fair and efficient in that it keeps foreign investors on a footing equal to that of domestic competitors.

That is United States policy. The European Community takes a different view, or at least sees the tax policy involved as subordinate to other policies. The EC policy is to encourage cross-border acquisitions. The objective is to enhance economic ties among Member States, the better to secure long term economic and policy interconnections.

The EC's Directive undoubtedly has some effect on the competitive position of US

<sup>26</sup> The concept of asset specificity is most succinctly stated generally in O. Williamson, *The Economic Institutions of Capitalism* 52–56 (1985). Its relevance to income tax matters is sketched in Langbein, *supra* note 9, at 1401.

<sup>27</sup> For a discussion of the historic origins of the distinction between income from passive/motile/redeployable/portfolio investment and that from nonredeployable 'fixed' investments, see Rosenbloom & Langbein, *supra* note 26, at 366–67, 370. For a contemporary discussion suggesting distinctions between tax policy toward portfolio investment and 'international business income', see Frisch, *The Economics of International Tax Policy: Some Old and New Approaches*, *Tax Notes*, 30 April 1990, pp. 581, 588–89.

<sup>28</sup> See Rosenbloom & Langbein, *supra* note 26, at 364–67; Report on Double Taxation, submitted to the Financial Committee by Professors Bruisn, Einaudi, Seligman & Sir Joseph Stamp, League of Nations Document E.F.5.79 F.19, reprinted in League of Nations Publications, II Economic & Fiscal (No. 28) (1923).

<sup>29</sup> See Langbein, *supra* note 9, at 1410–11; Statement of Stanley I. Langbein, *supra* note 9, at 2157.

<sup>30</sup> The 'second dividend' tax is a tax imposed upon dividends paid by foreign corporations if a certain portion of their income is derived from a US business. The second dividend tax is imposed at present by virtue of Section 861(a)(2)(A), which makes certain dividends of foreign corporations 'United States source' income. The 'second interest' tax was imposed by Section 861(a)(1)(B) of the Code as in effect prior to the Tax Reform Act of 1986. It has been repealed, but its function has been largely assumed by the 'branch level interest tax' imposed in connection with the branch profits tax by Section 884(f) of the Code.

<sup>31</sup> The imposition of these taxes on foreign corporations represents a major difference between the OECD and Treasury Department model conventions. Article 10(5) of the OECD expressly prohibits the imposition of taxes of this kind by one Contracting State on corporations of the other. The Treasury Department's model convention does not include this provision, and the United States entered a reservation to the OECD Model reserving its right to impose the penalty taxes.

businesses. The United States might respond by adopting unilateral measures or seeking agreements which mitigate or counteract these effects. But there are also important tax policy concerns involved, which would be disserved by such measures. It may be that, for the United States, accepting marginal competitive consequences is an evil lesser than the sacrifice of historic policies intended to enhance the overall equity of the US tax system.

The Second Directive, considerably more complex than the first, is unlike either the First Directive or the multilateral Convention in that it pertains to matters which heretofore have not customarily been the subject of international tax agreements. The First Directive requires crediting of taxes or exemption of income by a home government, and restricts the imposition of withholding taxes by a host government; rules addressed to these matters are customarily included in bilateral double taxation conventions. The multilateral Convention sets forth procedures governing transfer pricing disputes; so do the mutual agreement provisions of double taxation conventions, although the procedures set forth in the multilateral Convention are different and more elaborate. But the Second Directive introduces a new subject, by regulating the timing of taxation of certain transactions by Member States. And it has a new objective, that of facilitating if not promoting cross-border business combinations.

The Directive applies to four categories of transactions: 'mergers', 'transfers of assets', 'divisions', and 'exchanges of shares'. There seems to be some overlap here. A 'merger' involves three kinds of transactions: a transfer of all assets and liabilities of a company to an existing company; a transfer by two or more companies of all assets and liabilities to a newly formed company; or, in what the United States would call a liquidation of a wholly owned subsidiary, a transfer of all assets and liabilities to a company holding all securities representing the transferor's capital.<sup>32</sup> In the former two cases, the transfers must be 'in exchange for the issue' to the transferor's shareholders of 'securities' of the transferee company, in each case allowing for the payment of up to 10 per cent nominal value, or, in the absence of nominal value, accounting par value, in cash (or, presumably, other 'boot' consideration).<sup>33</sup>

A 'transfer of assets' is an 'operation' whereby a company transfers 'all or one or more branches of its activity' to another company in exchange for the 'transfer of securities' – the Directive does not specify to whom – representing the capital of the transferee company.<sup>34</sup> A transfer of assets thus encompasses partial transfers of assets in exchange for stock – a transfer of a kind which, under US domestic law and the domestic law of many Member States, is not invariably free of tax even in wholly domestic transactions. Moreover, in the case of a transfer of all assets and liabilities, a transaction may fall into the definition of both a 'merger' and a 'transfer of assets' for purposes of the Directive.

An 'exchange of shares' is defined to encompass 'operations' whereby a company 'acquires a holding in the capital of another company such that it obtains a majority of the voting rights in that company in exchange for the issue to the shareholders of the latter company, in exchange for their securities, of securities representing the capital of the former company', subject to permission to use cash for up to 10 per cent of the consideration.<sup>35</sup> Certainly it is possible under US corporate law to structure a transaction which fits within both the definition of a 'merger' and this definition of an 'exchange of shares'; it is probably equally possible to structure such a transaction under the laws of many of the EC Member States. Moreover, the category into which a transaction falls is probably consequential, because the Directive explicitly permits an exchanging shareholder's Member State to tax gain arising out of a subsequent transfer of the securities received in an exchange 'in the same way as the gain' arising out of the transfer of the 'securities existing before the acquisition'. A comparable provision is not inserted with respect to 'merger' transactions. Presumably, in a 'merger' or 'asset transfer' transaction, the 'subsequent transfer' rule would apply to the facet of the transaction which entails a 'share exchange', *i.e.*, the shareholder level exchange; this is not, however, entirely certain.

The Directive sets forth seven operative rules governing taxation of these transactions by Member States, of which four govern treatment at the 'corporate level'. The basic rule is that the transaction must be tax-free.<sup>36</sup> The corollary is a 'carryover basis' rule, under which the state of the company to which assets are transferred will permit the taxpayer to use only a

<sup>32</sup> Second Directive Art. 2(a).

<sup>33</sup> *Id.*

<sup>34</sup> *Id.* Art. 2(c).

<sup>35</sup> *Id.* Art. 2(d).

<sup>36</sup> *Id.* Art. 4(1).



'carryover basis' of assets, the historic cost basis in the transferor's hands, for depreciation and post-acquisition gain or loss purposes.<sup>37</sup>

The third and fourth rules govern what the United States would call 'attribute carryover'. A state must permit an acquiring company to carry over 'provisions or reserves' which are partly or wholly tax exempt in the hands of the transferor.<sup>38</sup> Presumably this would affect such items as bad debt or insurance reserves. The Directive appears to require the state of the acquiring company to honor such reserves even if there is no explicit provision for doing so under that state's domestic law. The fourth rule governs a matter widely familiar to US tax lawyers, the carryover of accumulated losses. The state of the acquiring corporation is required to permit such a carryover, but only to the extent that state would allow the carryover if the transaction was between its own domestic entities.<sup>39</sup>

The shareholder level rules, the fifth, sixth, and seventh rules, have been adverted to above. The basic rule requires deferral of tax on gain derived from the shareholder's exchange of shares.<sup>40</sup> The corollary (sixth) rule is that the shareholder takes a carryover basis in its shares.<sup>41</sup> The seventh rule permits taxation by the state of the shareholder's residence of the pretransfer appreciation upon a subsequent transfer of the shares received in exchange for the shares originally held.<sup>42</sup> The Directive does not appear to mandate a disallowance of shareholder loss upon a transfer in a transaction subject to the Directive. This matter is thus apparently left to the domestic laws of Member States.

The United States, of course, has domestic law rules which afford tax treatment roughly similar to those envisioned by the Directive. The Internal Revenue Code makes provisions for 'reorganizations',<sup>43</sup> as well as corporate divisions,<sup>44</sup> which in general are transactions in which one business entity effects an acquisition of another principally using its own equity securities; the original holders of equity interests in the 'target' become equity holders in a larger enterprise consisting of the acquiror and the target, and there is thus a 'continuity of interest' in the business originally operated by the target.<sup>45</sup> The tax treatment prescribed by US law parallels that prescribed by the Directive: nonrecognition of gain at the corporate level with respect to the asset transfer,<sup>46</sup> coupled with a carryover of asset basis;<sup>47</sup> nonrecognition of gain at the shareholder level with respect to the share exchange,<sup>48</sup> coupled with carryover of basis<sup>49</sup> and taxation of nonqualifying consideration (cash or other property not constituting an equity interest in the 'continuing' enterprise);<sup>50</sup> carryover of tax attributes, including accumulated net operating losses,<sup>51</sup> although the latter carryovers are now greatly restricted in cases where there is a significant shift in ownership of the entity having the accumulated losses.<sup>52</sup>

There are technical differences between US law and the Directive, of course. In some respects, the Directive is more restrictive: for instance, it requires that 90 per cent of consideration received by an exchanging shareholder be interests in the continuing enterprise;<sup>53</sup> US law requires only 50 per cent 'continuity'.<sup>54</sup> In other respects, the Directive is less restrictive than US law. One notable instance, indicated above, is in connection with asset transfers which involve only a portion of the assets of an enterprise. US law does not normally allow tax-free treatment of such transactions, unless the transferor is in control of the transferee immediately after the transaction.

It may be that, in a number of respects, the scope of the Directive is broader, in mandating nonrecognition, than the domestic laws of Member States. If this is the case, the effect of the Directive would be to stimulate intra-Community, cross-border acquisitions and combinations as opposed not only to extra-Community, cross-border transactions, but as opposed to

<sup>37</sup> *Id.* Art. 4(2).

<sup>38</sup> *Id.* Art. 5.

<sup>39</sup> *Id.* Art. 6.

<sup>40</sup> *Id.* Art. 8(1).

<sup>41</sup> *Id.* Art. 8(2).

<sup>42</sup> *Id.*

<sup>43</sup> INTERNAL REVENUE CODE Section 368(a).

<sup>44</sup> *Id.* Section 355.

<sup>45</sup> Regulations Sec. 1.368-1(c).

<sup>46</sup> INTERNAL REVENUE CODE Section 361(a).

<sup>47</sup> *Id.* Section 358(a).

<sup>48</sup> *Id.* Section 354(a)(1).

<sup>49</sup> *Id.* Section 358(a).

<sup>50</sup> *Id.* Section 356.

<sup>51</sup> *Id.* Section 381(a), (b), (c)(1).

<sup>52</sup> *Id.* Section 382.

<sup>53</sup> Section Directive Art. 2(1).

<sup>54</sup> Regulations Sec. 1.368-2(a).



transactions that would be wholly domestic for the Member States involved. There is nothing in the Directive, except in specific instances such as the loss carryover requirement, which confines its rules to cases where parallel treatment is accorded purely domestic transactions. These circumstances indicate the seriousness of the Council, and the Directives, in protecting and encouraging cross-border business combinations, even in the face of competing policy concerns.

While US law contemplates tax-free (nonrecognition) treatment for 'reorganizations' involving domestic parties, the rules are modified in significant ways when one of the parties is foreign. It is these modifications which mean that cross-border transactions involving one United States party and another party, target or acquirer, from a Community Member State, will be treated very differently from transactions involving parties only from Community Member States. These differences pose challenging questions for US policy, and raise questions about competitive relations between the United States and the Community.

United States law imposes two quite different and distinct limitations on tax-free treatment when one of the parties to a reorganization is foreign. These have a different history and serve different purposes. The first embraces circumstances where the transaction involves a transfer of property by a United States person to a foreign corporation. The second comprises all other circumstances where a foreign corporation is involved. The simplest case in this latter category is an acquisition by one domestic corporation of a foreign subsidiary of another domestic corporation in exchange, for example, for the first corporation's voting stock.

The former case – involving a property transfer from a US person to a foreign corporation – has been the subject of restriction since the Revenue Act of 1932. The concern here is retaining US taxing jurisdiction over pre-transfer appreciation in the transferred assets. Prior to the 1932 Act, parties who held appreciated property which they wished to dispose of might transfer the property to a foreign corporation which they controlled; the corporation could then dispose of the property outside the United States, and the disposition would be free of US tax.<sup>55</sup> Tax would be imposed upon the liquidation of the foreign corporation, or other transfer of the proceeds of the sale to the shareholder; but taxation might be deferred indefinitely if the shareholder had no immediate need for the proceeds.

The statutory response was twofold: as a condition to tax-free treatment of the 'incorporation' or 'reorganization' transaction, the taxpayer was required to secure a ruling from the Revenue Service to the effect that the transaction did not have tax avoidance as its principal purpose.<sup>56</sup> In addition, an excise tax was imposed on certain transfers to foreign entities.<sup>57</sup>

These provisions have since been amended several times. During the 1960s the Revenue Service adopted a set of guidelines governing when transactions would or would not be deemed to have tax avoidance as a principal purpose.<sup>58</sup> These were relatively strict, generally permitting tax-free treatment only for transactions by which an active business was transferred to a foreign corporation.<sup>59</sup> United States courts generally adopted a more lenient approach,<sup>60</sup> and this, in turn, led the Congress in 1984 to revise the statutory provisions substantially.<sup>61</sup> As a general proposition, the amendments eliminated the ruling procedure and the indefinite 'tax avoidance purpose' standard, and incorporated the IRS guidelines into the statute.

Under these amendments, in effect today, a transfer of property to a foreign corporation by a US person generally does not qualify for nonrecognition treatment except in specified circumstances.<sup>62</sup> The most important of these is the transfer of an active business.<sup>63</sup> A second important circumstance is the transfer of stock of a *foreign* corporation to a second foreign corporation.<sup>64</sup> The statute, however, confers authority upon the Treasury to modify this rule by regulations.<sup>65</sup> In fact, the Treasury has adopted regulations which greatly limit the provision when the foreign corporation whose stock is transferred was a controlled foreign corporation – more than 50 per cent owned by US persons who each owns at least 10 per cent

<sup>55</sup> See *Pitcher v. Comm'r*, 84 T.C. 85 (1985).

<sup>56</sup> Act of 6 June 1932, ch. 209, Sec. 112 (K), 47 Stat. 173.

<sup>57</sup> *Id.* Section 901.

<sup>58</sup> Rev. Proc. 68-23, 1968-1 C.B. 821.

<sup>59</sup> *Id.*

<sup>60</sup> See *Dittler Bros. v. Comm'r*, 642 F. 2d 1211 (5th Cir. 1981); *Hershey Foods Corp. v. Comm'r*, 76 T.C. 312 (1981), gov't appeal dismissed, No. 81-2096 (3d Cir. 1981).

<sup>61</sup> See Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1984* 425-26, 428-29 (1984).

<sup>62</sup> INTERNAL REVENUE CODE Section 367(A)(1).

<sup>63</sup> *Id.* Section 367(a)(3).

<sup>64</sup> *Id.* Section 367(a)(2).

<sup>65</sup> *Id.* Section 367(a)(5).

of the stock of the corporation.<sup>66</sup> Thus, most transfers of foreign subsidiaries of US corporations will be subject to some taxation by the United States, even if the transferee is another foreign corporation.

When there is no transfer of property by a US person to a foreign corporation, there is no problem of pre-transfer appreciation. However, where the transfer is of, say, stock in a foreign corporation by one US corporation to another, there is a different concern, growing out of US laws relating to 'deferral'.

These laws were adopted originally in 1962. Their genesis was concern about the earnings of foreign subsidiaries of US companies.<sup>67</sup> In 1962, proposals were made to tax currently all such earnings to US parents.<sup>68</sup> Such far-reaching proposals were not adopted, but the United States instead adopted a number of provisions aimed at curbing the effects of the 'deferral'.

The best known of these are the 'subpart F' provisions,<sup>69</sup> which tax currently certain 'tax haven' income<sup>70</sup> of foreign corporations 'controlled', according to a detailed statutory definition,<sup>71</sup> by US persons. The 'subpart F' provisions also treat certain loans of foreign earnings (whether derived from tax havens or not) as distributions subject to current taxation.<sup>72</sup> The provisions of primary concern here were aimed at curtailing the 'conversion' of ordinary foreign income into capital gains upon a disposition of foreign corporation stock. These provisions mandate, in general, that when stock in a controlled foreign corporation is disposed of, the gain earned, to the extent of accumulated earnings of the foreign corporation, be treated as a distribution of profits.<sup>73</sup>

As and when adopted, these rules of 'conversion' were intended generally to be adverse to taxpayers, because they changed income subject to lower capital gains rates into income subject to higher ordinary income rates. In 1986, however, Congress equalized the ordinary and capital gains rates. Under this integrated rate structure, treatment of gain on the sale of stock as a dividend is generally advantageous to the taxpayer, because it authorizes a 'deemed paid' credit for foreign taxes paid by the subsidiary on the earnings.<sup>74</sup>

The 'conversion' concern is the source of the second limitation on tax-free treatment of reorganizations involving a foreign corporation party. Treasury Regulations impose a 'toll charge' upon any transfer, even if otherwise qualifying for nonrecognition treatment, when the stock of a corporation which was a controlled foreign corporation is transferred to another person and after the transaction the corporation is no longer a controlled foreign corporation, or is not controlled by the same US shareholders which controlled the corporation previously.<sup>75</sup>

Accordingly, if a US corporation transfers a wholly owned subsidiary to either a second US corporation, or to a foreign corporation, the transferor corporation is subject to tax on the accumulated earnings of the foreign corporation. This income is treated as a dividend from the subsidiary disposed of; a deemed paid foreign tax credit is available for foreign taxes paid by the subsidiary on its earnings.

Given this state of US law, there is potential for real discrimination flowing from the Second Directive. The discrimination is against businesses operating in Community Member States which are owned or controlled by US interests, in relation to other similarly situated businesses, locally owned or owned by interests from other Member States. Assume, for example, a German corporation is in the market for an acquisition in Italy, and it wishes to effect the acquisition by means of an issue of its own securities. Under the Second Directive, if the target is a locally owned business, or owned or controlled by a corporation of some other Community member, then Italy, Germany, or any other Community Member State involved would be required to exonerate the shareholder level exchange of securities from tax; in addition, there could be no tax on any exchange of assets by the Italian business which the transaction was structured to entail. On the other hand, if the business was owned or controlled by US interests, the gain would be taxable. If the transfer was of a 'branch' of a US business, the asset transfer would be taxable to the extent it involved unrealized receivables, installment contracts, intangible property or the like. If the transfer was of

<sup>66</sup> Income Tax Regulations Sec. 7.367(b)-4.

<sup>67</sup> See Surrey, *United States Taxation of Foreign Income*, 1 J. L. Econ. 72 (1958).

<sup>68</sup> See House Comm. on Ways & Means, *The President's Tax Message*, 87th Cong., 1st Sess. (Comm. Print 3 May 1961).

<sup>69</sup> INTERNAL REVENUE CODE Section 951-64. 'Subpart F' is a subpart of Part II of Subchapter N of the Code.

<sup>70</sup> INTERNAL REVENUE CODE Section 954.

<sup>71</sup> *Id.* Section 957(a).

<sup>72</sup> *Id.* Section 956.

<sup>73</sup> *Id.* Section 1246, 1248.

<sup>74</sup> Income Tax Regulations Section 1.1248-1(d).

<sup>75</sup> *Id.* Secs. 7.367(b)-4, 7.367(b)-6, 7.367(b)-7.

securities in a foreign subsidiary, it would be subject to tax to the extent of the accumulated earnings of the foreign subsidiary.

This is a meaningful difference, which is likely to have an appreciable impact upon the capacity of US corporations to dispose of business operations in Community Member States. For the fact of current taxation tends to be factored into the pricing of transactions. If a locally owned business or one controlled by interests in a Community Member State can be acquired tax free, while the acquisition of a US owned business will be subject to tax, an acquiring party will have to pay a higher price to the US owned business to compensate the seller for the tax cost of the transaction. The result is likely to be some 'stickiness' in the disposition of US owned businesses in the Community; and some sense of resentment on the part of US companies at being treated differently from locally owned or European owned competitors operating in the same markets.

The United States could attempt to counteract these competitive consequences. It could act unilaterally, restricting the rules which impose taxation in reorganizations of these types. Indeed, some unilateral changes in this direction could be made by the Treasury without legislation, because some of the occasions for taxation are imposed by regulation rather than by statute, and the regulatory powers conferred by the statutory provisions are broad.<sup>76</sup>

Any unilateral action presumably would affect all transactions involving foreign corporations, not only those involving corporations organized or operating in Community Member States. To avoid an 'overboard' response, the United States might seek bilateral or multilateral solutions. It might, for example, seek provisions in bilateral conventions with EC Member States which ensure that the treatment accorded Member State corporations by virtue of the Second Directive be accorded US owned corporations as well, at the same time ensuring that similar treatment would be available to both US and treaty partner corporations by virtue of the Convention. Or the United States might seek a multilateral agreement – a single agreement between the United States and the Community, either as part of a broader 'single tax treaty' with the Community or as a special purpose agreement<sup>77</sup> – to the same effect.

Any such solutions, particularly multilateral ones, would pose serious challenges and raise numerous questions and collateral issues. But before such issues are faced, there is a more fundamental question: whether these efforts are worth pursuing at all. The EC Directives will favor acquisitions in Europe of European-owned companies, in part by disfavoring acquisitions of US owned companies. This is in part the intention of the Directive. The consequence, too, is in part the product of US domestic law governing cross-border acquisitions.

Competitive consequences are not, however, the only policy concerns involved. To some extent those consequences exist apart from the Second Directive and apart from the existence of the European Community itself. After all, the provisions of US law overriding nonrecognition treatment of cross-border reorganizations disfavor acquisitions of US owned businesses as against acquisitions of locally owned businesses as long as the foreign jurisdiction involved accords nonrecognition treatment to wholly domestic transactions. In this sense, the Directive may be seen simply as making the Community a single large country; the 'discrimination' involved is no different, although given the size and importance of the 'country' involved, the competitive consequences are of a new order of magnitude.

Beyond this, it may be observed that the provisions of US law at issue serve policy concerns which are of an importance at least equal to the competitive balance at stake. The Section 367 tax on pre-transfer appreciation of assets transferred to a foreign corporation limits the deferral of taxation inherent in a system which does not currently tax asset appreciation. Most tax systems do not tax such 'unrealized' appreciation, owing to valuation difficulties, and the cash flow problems such taxation would create for taxpayers. 'Nonrecognition' is an extension of such restraint, even though 'nonrecognition' transactions involve the realization of gain. But deferral of taxation is always a balance between the practical difficulties of current taxation and a distortion in the measurement of economic income. In the context of cross-border transfers, the United States has decided that the measurement difficulties occasioned by a transfer of assets outside the jurisdiction, and the tax avoidance potential of such transfers, tip the balance in favor of current taxation. This judgment appears to be sound, and arguably one which should survive the introduction of a new concern – adverse competitive consequences flowing from the EC Directive.

Similarly, the 'toll charge' imposed when controlled foreign corporations are transferred represents a careful and historically hard won policy judgment which the introduction of

<sup>76</sup> INTERNAL REVENUE CODE Sections 367(a)(2), (a)(5), (b).

<sup>77</sup> See sources cited at note 22 *supra*.

competitive consequences of the kind described arguably should not disturb. The 'deferral' of taxation on foreign earnings represents an inroad against comprehensive taxation of US persons.<sup>78</sup> It is an accepted feature of the US tax system, born of concerns for practicality and international comity. But deferral becomes exemption if, through tax-free transactions, the status of a controlled foreign corporation can be ended without a constructive distribution of accumulated earnings. The override of nonrecognition effected by existing regulations is thus justified. Although the question is largely one of judgment, the competitive concerns introduced by the EC Directive do not seem sufficiently serious to warrant sacrifice of the principles underlying the rules now in effect.

In brief, the liberalizations effected by the Second Directive remove barriers to cross-border transactions which Member State tax laws impose at present. But there are serious questions whether the United States should follow suit in a broad relaxation of 'barriers' to cross-border transactions. Countervailing tax policy considerations counsel great caution before doing so.

Accompanying the two Council Directives is a third initiative, the multilateral Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises. The principal objective of the Convention is to establish an arbitration procedure to resolve transfer pricing disputes among Member States.

The Convention is thus largely procedural; it does not modify the substantive standards governing transfer pricing disputes. Indeed, the Convention restates the substantive provisions typical of bilateral double taxation conventions, that arrangements between associated enterprises,<sup>79</sup> or between a permanent establishment and its home office, should be those that would obtain among 'separate' and 'independent' parties.<sup>80</sup> The multilateral Convention also restates provisions for a 'mutual agreement procedure' to resolve disputes among Member States in implementing these profit allocation standards.<sup>81</sup>

The new features of the multilateral Convention are the provisions for arbitration of disputes. The Convention provides for the appointment of an 'advisory commission' to which any transfer pricing dispute may be referred. The commission is to consist of one or two members appointed by each competent authority of the states involved; and an even number of representatives appointed from a list of 'independent persons of standing', to be chosen either by mutual agreement among the states involved or, failing agreement, by a drawing of lots.<sup>82</sup> These appointees then select a Chairman, who must 'possess the qualifications required for appointment to the highest judicial offices in his country or be a jurisconsult of recognized competence'.<sup>83</sup>

The Convention provides for confidentiality of proceedings before advisory commissions.<sup>84</sup> It provides an opportunity for the taxpayers involved to appear before commissions, or for the commissions to direct an appearance by the taxpayers.<sup>85</sup> This is different from practice under the competent authority (mutual agreement) provisions of bilateral double taxation conventions now in force; taxpayers do not necessarily have any right to participate in such proceedings. The Convention provides an exception to the procedures for circumstances where the domestic law of a Member State precludes the competent authority from derogating judicial decisions;<sup>86</sup> France and the United Kingdom, by declaration appended to the Convention, have indicated their intention to apply this exception. The Convention also denies the benefit of its procedures to taxpayers subject to 'judicial or administrative proceedings, initiated with a view to a ruling that by actions giving rise to an adjustment of profits . . . one of the enterprises concerned was liable to a serious penalty'.<sup>87</sup> Each of the 12 signatories by declaration appended to the Convention indicates what it will deem a 'serious penalty' for purposes of its own law, within the purview of this provision.

The Convention is to take effect only at the third month following its ratification by the last signatory to ratify it.<sup>88</sup> It has a term of five years, six months prior to the end of which the signatories are to meet to consider an extension.<sup>89</sup> Any signatory is permitted to seek a

<sup>78</sup> See Surrey, *supra* note 67.

<sup>79</sup> Convention Art. 4.

<sup>80</sup> Convention Art. 4(2).

<sup>81</sup> *Id.* Art. 6.

<sup>82</sup> *Id.* Arts. 7(1), 9(1)-(2).

<sup>83</sup> *Id.* Art. 9(5).

<sup>84</sup> *Id.* Art. 9(6).

<sup>85</sup> *Id.* Art. 10(5).

<sup>86</sup> *Id.* Art. 7(3).

<sup>87</sup> *Id.* Art. 8(2).

<sup>88</sup> *Id.* Art. 18.

<sup>89</sup> *Id.* Art. 20.

revision of the Convention at any time; a conference is to be held to revise the Convention upon the request of any signatory.<sup>90</sup>

As a general proposition, the adoption of an arbitration procedure is a welcome, even overdue, development. Existing procedures for resolving transfer pricing disputes, which usually involve large dollar amounts, are not going well, at least in the United States. Applicable legal standards are ambiguous. The resolution of cases, both at the administrative and the judicial level, has tended to turn on ad hoc and subjective determinations, without the articulation of consistent standards as guides for future cases. Judicial decisions tend to involve lengthy factual statements detailing histories of the industries and companies involved; followed by summaries of economic evidence gathered to support varying pricing methods; followed by selection of a particular method for resolving the dispute with little explanation why the particular method is superior or whether and to what extent it would be applicable in other circumstances.<sup>91</sup>

The lack of standards leads to confusion and uncertainty in case development. Because a variety of standards is potentially applicable, evidence must be developed with regard to numerous potential theories, without any notion as to which one will ultimately be selected. In cases involving developed country jurisdictions with relatively high tax rates, the competent authority procedure is almost inevitably invoked at some point.

In these circumstances it is worth trying almost any new approach to resolving disputes, and arbitration along the lines mandated by the Convention offers promise. The Convention's procedures appear to be well designed to ensure fairness to Member States as well as taxpayers, to protect taxpayer rights to confidentiality, and to expedite the resolution of these ordinarily complex disputes.

The United States would do well to adopt provisions along the lines of the Convention as part of its opening negotiating position in bilateral treaty negotiations. The United States has already signed one convention, with Germany, which includes a rudimentary arbitration provision.<sup>92</sup> It is distinctly possible that arbitration will eventually be the order of the day in transfer pricing matters.

The central question in the area, however, concerns substantive standards and pricing methods, and it is doubtful that these problems can be resolved by new procedures. Indeed, the new procedures will be counterproductive if they deflect attention from the crisis at hand with respect to standards. A growing body of thought, at least in the United States, recognizes that the arm's length standard is inherently indeterminate, that it is essentially a 'reasonableness' standard leaving most substantive decision-making to the discretion of administrators or courts. This situation is unacceptable in the United States at least—if nothing else because, given the dollar amounts at issue, the rules leave indeterminately allocated amounts of revenue so large as to be significant, and politically sensitive, from the standpoint of the national budget. The transfer pricing question accordingly is attracting widespread political and media attention in the United States; and concern focuses upon an apparent pattern of low taxation of earnings of foreign-owned US corporations.<sup>93</sup>

Arbitration will not solve the problem of substantive standards. Arbitration is inherently designed to foster ad hoc determinations; it is not an adjudicatory process aimed at elaborating precedents and ensuring consistency in the resolution of cases. There is a danger that arbitration will distract the international community from the task of re-examining the law and developing alternatives which can be concretely applied to particular cases. This task is imperative. The transfer pricing problem is large and growing; its budgetary significance alone ensures it will not disappear. Arbitration is a palliative, not a comprehensive solution.

The recent Community initiatives concerning taxation of direct investment—the two Directives and the multilateral Convention—present interesting challenges to US policy. The Directives will create some competitive advantages for intra-Community investment in relation to cross-border investment between the United States and Community Member States. The United States needs to examine whether to move to counteract these consequences, and to decide whether doing so is worth the costs that would be entailed, in terms of otherwise existing tax policies and tax equity. The Convention represents a salutary development, which will mitigate some of the procedural difficulties of contemporary transfer pricing disputes without, however, addressing the core of the intractable transfer pricing problem.

<sup>90</sup> *Id.* Art. 21.

<sup>91</sup> See sources cited at note 9 *supra*.

<sup>92</sup> See note 7 *supra*.

<sup>93</sup> *New York Times*, 18 February 1990, p. 1, col. 8; *Los Angeles Times*, 10 July 1990, p. 3, col. 5; *Wall Street Journal*, 10 July 1990, p. 18, col. 1; *USA Today*, 11 July 1990, p. 5B (Money (Green) section).