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Discussion

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Discussion After the Speeches of H. David Rosenbloom and Robert Brown

QUESTION: *Professor King*: I wanted to pursue the question of arbitration and settlement of dispute where there is an overlap in taxation between Canada and the United States. In the treaty there is a provision for competent authority, which means that the tax people from both countries settle their dispute where there is an impact from both countries on the same income in Canada and the United States.

There has been reference to arbitration here. What are your views on whether the competent authority is working satisfactorily from a time standpoint? If you have arbitration who would be the arbitrators? Is a change in that regard a good deal?

ANSWER: *Mr. Brown*: The first question is whether the Competent Authority or Mutual Agreement provisions of Canada- U.S. Tax Treaty are working.

I think they are working reasonably well. The complaint is that they take a devil of a long time and they are rather complex. That simply means that if there is a dispute between the two authorities as to how to divide up the income pie, Canada and the U.S. tax authorities will get together and try to reconcile it. They can only achieve that if they are working on more or less a common basis of how to proceed.

If, for example, the U.S. were to adopt, one method of income allocation, and Canada were to follow another quite different method, you should not assume that the competent authority procedure would be able to reconcile that kind of thing.

So there is a moderate amount of confidence in the present workings of it. But some fear that if we just keep on with competent authority, we we will not get there, because the competent authority clause just means the two governments try and get an agreement. It does not guarantee that they will.

The alternative and binding arbitration would involve appointing someone independent to arbitrate the matter, and to give a final decision that is legally binding. The decision would override domestic law. That might be nice; however, I do not think it is practical. I do not see any government, particularly the U.S. Government, giving up those kind of tax rights to an independent party.

I think that what you do need is to strengthen the competent authority procedure and to build it with more processes so it becomes increasingly effective. There is a commitment to really attempting to make it work. But there should also be a committment to a common methodology. I think this would begin to help. But I would interested in David's thoughts.

ANSWER: *Mr. Rosenbloom*: I am essentially more pessimistic. The competent authority in the past, as distinguished from the near-term future, should really be looked at country-by-country. And the United States' competent authority experience with Canada is the absolute best in the world. The United States' competent authority experience with certain other countries is dismal. Competent authority procedures can take up to five, seven, eight years to resolve in the United States. So I think the past has not been uniformly great, but it has worked pretty well with respect to Canada.

In the United States the competent authority operates under a severe handicap, in that the people who administer our treaties are not the people who negotiate them. That is also true in Canada. And there is something of a disconnect between agreements at the negotiating table and the way in which they are actually implemented. That is a problem with calling for better use of the competent authority. We simply do not have the people do it. We are not prepared to commit those resources.

Where I get pessimistic is the future. If you have to extract one concept from my feelings about this program, it is that, in looking at the direction in which we are going, the trend line is down.

There has been cooperation in the past with Canada. It has been pretty satisfactory. But the United States has launched a highly theoretical system of substantive rules and Canada has said very clearly that they will not be able to award relief. So the countries are very much at loggerheads, and no amount of resources in the competent authority is going to be able to resolve transfer pricing disputes, which incidentally represents about 90 percent of all competent authority matters. So I think at least the short- to medium-term ability of the United States international tax treaty network to resolve these disputes is not good.

Now I think arbitration might help. Arbitration is a two-edged sword because, in the past, the lack of arbitration has caused the competent authorities, particularly in discussing with Canada, to work hard to achieve agreements. But there are some countries, particularly Japan, where really seems to be no way of resolving some very substantial cases involving transfer pricing. I am not sure how many years of hundred million dollar transfer pricing adjustments are required before arbitration looks appealing. However, I am not at all convinced that the United States would, ever freely use arbitration.

QUESTION: *Ms. Coward*: I would be interested in your comment on the relationship between the use of the tax policy, and in particular tax incentives, and how this relates to the use of subsidies and other economic development instruments.

I know that at the international level there have been efforts to keep government and finance departments out of the "hurly burly" of

the international trade negotiations. At the same time as we see increasing discipline on subsidies as economic tools, the use of tax policy and tax incentives seems to be coming more obvious and certainly there are questions being raised about it, whether there is actual conflict or not. I wondered if you had any comments or had thought about those issues?

ANSWER: *Mr. Brown:* Well, the simple answer is, it is a jungle out there. You will find other different countries, different states doing virtually everything. Around the world the use of direct subsidies to corporations is slowly declining. In part that is due to trade issues because these things are countervailable, and they can get you into trouble.

Nobody agrees what the definition of a subsidy is and you can still find some pretty outstanding issues, when for example, even in the United States a local government is trying to buy a big plant. The world is your oyster. They will build the roads. They will build sewers. They will build the plant with tax free bonds. They will do everything. And then they say this is not a subsidy.

I think that there is an issue, which has come up in some tax cases as to whether tax incentives are a subsidy. The general theory is that direct subsidies were bad, were countervailable, were discriminatory and should be phased out. But as for tax incentives, every country has tax incentives. When you really get down and pull it apart tax incentives are really just a different form of subsidies. They are delivered through a different delivery mechanism.

General tax incentives, like, concession on corporate rates, or an investment tax credit for all capital spending does not seem to get people worked up. But if Canada, for instance, delivered a particular tax incentive to the forestry industry through the tax system, it would pretty rapidly get into the *Software Lumber* case, and give rise to issues.

I think that around the world you will find that highly specialized subsidies, even those delivered through tax incentives, are likely in the decline but we will have lots of generally tax subsidies, basically as a means of influencing the level of overall economic behavior, rather than influencing a particular industry.

ANSWER: *Mr. Rosenbloom:* From a U.S. tax policy perspective, tax incentives have one basic flaw, which is that they do not work efficiently. The general attitude that the United States exhibited with respect to DISC and FISC programs which are explicit tax incentives can be summarized in lay terms as follows: "It other countries give subsidies for experts, then we shall retaliate by giving several billion dollars to our industries for conduct that they would engage in any way." One does not have to be a genius to see that such programs are incredibly expensive.

There is, however, another class of tax incentive which is hidden. In international taxation there are many rules that are not well understood, and that operate as a greater subsidy, a greater incentive, than the explicit incentives.

For example, we have a rule, which says that if you pass title to goods outside the United States, your income has a foreign source. Most people who are not conversant with the rules lose interest at this point, because to go on and explain the concept of a foreign source of income, requires a journey through our foreign tax credit rules, which, as Bob has already explained, are very complicated.

But the fact of the matter is that the title passage rule is an incredibly potent tax incentive. There have been a couple of assaults on it in recent years but it is still the law.

Speaking from the standpoint of a tax policy person, I think the best incentive one could give to cross-border business is a low rate of corporate tax. And you only can achieve that by keeping other incentives down. That has been the direction in the United States. We are not quite there yet, but we have been moving in that general direction.

Much of the rest of the world still prefers a model in which rates are high and you have a swiss cheese corporate tax, with incentives for various industries and specified behavior. In an ideal world, the United States would move in the direction of eliminating tax incentives, so there would not be an issue of comparing them with subsidies.

QUESTION: *Mr. Doh*: Does the increasingly stringent application of the arm's-length approach to transfer pricing result in a lower price for this transaction? Is it possible that we are setting up companies and running them differently than what we have been talking about, which involves margins for both profit and overhead?

ANSWER: *Mr. Rosenbloom*: I am glad you asked that. You are from the Commerce Department? Yes. The U.S. Government, bless their hearts, sees no contradiction whatever toward a foreign company when it says that the company sold the same product at a price that was both too high and too low. I have cases like that — there are scores of them. It applies not only to dumping, but also to customs. The connection between dumping or customs and tax is limited, I think, to drawing the attention of the Internal Revenue Service to a particular industry. It happened in automobiles. It happened in consumer electronics. It happened in a number of other imports. But there is zero consistency, indeed there is total inconsistency, in the application of the rules.

QUESTION: *Mr. Doh*: Is there any higher remedy for reconciling?

ANSWER: *Mr. Rosenbloom*: No. Not only is there no higher remedy as a substantive matter, but it is not easy to see how as a procedural matter you could do it. The real problem is customs. Although

dumping is also a problem, the law there applies at a different level of the market. Dumping, as I understand it, applies to sales to ultimate consumers, so you could conceive of a situation where the sale from the foreign producer to the U.S. importer was too high, but the sale to the consumer was too low. You can twist yourself into a pretzel and find consistency there.

But Customs involves the sale from abroad to the United States. That is the very transaction that is tested under the transfer pricing rules. And there are plenty of cases where customs says that the price was too low and the IRS says that the price was too high. There is no remedy; moreover, Customs is in and out in a very short period of time. The Revenue service has not yet stirred and Customs is gone. By the time the Revenue Service arrives, often six, seven, even eight years have passed. So there is no remedy. There is no refund. There is no way to reconcile. And it is the same transaction. Interestingly enough, Congress does not seem concerned.

QUESTION: *Professor King*: I have a question on the 482, which involves the reallocation of income between what is applicable to the United States and what is applicable to the foreign subsidiary. These allocations favor the United States. They cause contention abroad because frequently the government has had the benefit of that income abroad and has taxed it accordingly. In some cases I assume they spent the money. Now, as a solution, what about addressing the time of audit, so you do not have so much time elapse between the U.S. audit and the need for reallocation, or the date when the income was incurred? Or should you do it by tax treaty modification?

ANSWER: *Mr. Rosenbloom*: Actually, the U.S.-Canada Treaty has a provision that is aimed at that subject, and it puts a lot of pressure on the Revenue Service. It says: "If there is a transfer pricing adjustment and the taxpayer fails to give notice to Canada within six years from the end of year to which the adjustment relates, we will not make the adjustment." The Revenue Service hates that provision. Six years is not enough time for them, and they have really tried to keep similar provisions out of subsequent treaties.

This is similar to the point that we were discussing in regard to dumping and Customs. I do not know if it is possible, but you would think it ought to be possible to accelerate audit activity. Much of the problem has to do with personnel. We can talk all we want about abstract principles and making the system more efficient, but when the auditors doing these basically thankless jobs are being paid a pittance compared to what they could be paid in private industry, particularly in our large cities where most of the audit work is, I do not see how we are going to ask a lot more efficiency from them.

The trend line is in the other direction. We have a three-year statute of limitation for tax cases in the United States, and there is a state-

ment in the Internal Revenue Manual that the statute of limitations will only be extended in rare and unusual circumstances.

I venture to say that, for any company above a relatively small level, it is a rare and unusual circumstance in which the statute is *not* extended, several times. Usually it is extended for up to eight or ten years. I think audits are getting longer; I am only up to 1984-1985 in what I am doing today. That is ten years behind the time. So I do not have a lot of optimism on this subject.

But you are quite right in saying that the governments have collected taxes and spent them.

In the recent case with Nissan, where the United States sought an adjustment of about three hundred million dollars, and got I think over hundred million dollars in tax, refunds were given in Japan and the local communities were very upset. They were forced to pay a portion of that refund, because the Japanese in that case did agree to a refund in the competent authority procedure, and it created a real political problem in the local jurisdictions.

QUESTION: *Mr. O'Grady*: Keeping in mind the deficit, how much would you say a potential tax revenue is tied up in this sort of revenue inventory, this ten-year inventory that remains to be dealt with?

ANSWER: *Mr. Rosenbloom*: That is an interesting question. I would say probably quite a bit. But to squeeze it out is a very time-consuming task. We had a case, a famous case, involving Suudstrand Corporation, which represents a capsulized version of the problem. The case involved two years of taxes of the company from the early 1980's. I believe that it took the Tax Court 11 years to work that through the system, and to come to a conclusion. At the end, the Tax Court's decision was hundreds of pages long. It was very fact intensive, but it said virtually nothing about subsequent years. And Suudstrand is now back in court for the subsequent years.

There is substantial potential revenue out there. But our system has invited this very lengthy, very costly litigation process, which I am not sure can be accelerated. If your suggestion is to bring the revenue in more quickly, I am just not sure how to do it.