Editorial

The Fine Art of Retaliation

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Recently I had to speak at an international tax seminar in Paris. It was almost inevitable that the poor US speaker before me received a great deal of flak from the French audience on the recently enacted 'enhancement' of the earnings stripping rules. Listening to the complaints, it struck me once again that the new rules indeed represent yet another sad example of the legislative efforts of the US Congress to hurt foreign investors as much as possible.

Most of the complaints from the French audience came as no surprise and my colleague speaker, in danger of being held personally responsible for this new piece of outrageous legislation, could only repeat in various ways his strong disapproval and concern.

When he went through the various techniques to reduce the impact of the new rules by, for instance, seeking unrelated party, non-guaranteed financing, an observation from the public was made which silenced even him for several moments. A Frenchman, representing one of the big State-owned French industries, told him that this route would exclude French banks since the French State owns a major stake in almost all large French banks and, as a result, these would be considered 'related lenders'.

The discussion then turned to a possible remedy by invoking protection under the France-US Tax Treaty. It was, however, pointed out that in the legislative history of the earnings stripping rules it had been made quite clear that legislators hold the opinion that the rules are in perfect harmony with the arm's length principle embodied in the treaty. Likewise, the US Administration does not believe that the guarantee provision of the new rules violates the non-discrimination clauses of US income tax treaties. The rules just happen to fall heavily on foreign investors.

The debate then turned to what the French government could do. Almost inevitably, the word 'retaliation' was dropped.

Just a few days before, California, hoping to put an end to the dispute with the United Kingdom and the EC, had enacted legislation modifying the most onerous provisions of its unitary tax system. This was certainly not the result of the fact that the Californian legislator had seen the 'light' and was returning from his previous sins. By no means.

Indeed, the Clinton Administration's signal of support for California, as demonstrated by its initial inaction in the *Barclays* case, had provided yet another reason for the state to play the sit and waiting game. It was only due to the very concrete threats of retaliation made by, especially, the United Kingdom against US corporations with a 'qualifying presence in California', that made the legislator think twice and finally substantially change the unitary tax system in the waning moments of its 1993 session (the clock was stopped in order to pass the legislation on time).

The earnings stripping rules lend themselves perfectly to retaliatory action. The governments of EC countries could, for instance enact legislation which 'mirrors' the enhanced earnings stripping rules and apply them to local subsidiaries of US-based multinationals. No doubt, such action would be very costly to the United States since it has been a net exporter of investment capital between 1990 and 1992 and since many US companies made a serious effort to shift debt into foreign subsidiaries as a result of the 1986 Tax Reform Act.

Of course, one must hope that the threat of such retaliatory legislation will be sufficient and that such measures never need to be executed. The *Barclays* case has taught that the United States, quite wisely, does respond to a real threat of retaliation. It is a matter of diplomacy and cooperation between the EC countries concerned to give both the threat of retaliation credibility and at the same time, allow a workable compromise to be found. Where retaliation is inevitable it should be commensurate with the harm done to EC-based investors, hopefully causing the United States Congress to think twice before it enacts new discriminatory provisions. Such a carefully considered balance would, as the Brits have shown, turn retaliation into the fine art of retaliation.