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BEFORE THE COMMITTEE ON WAYS AND MEANS
HEARING ON THE GLOBAL TAX ENVIRONMENT IN 2016 AND IMPLICATIONS FOR INTERNATIONAL TAX REFORM

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Chairman Brady, Ranking Member Levin, and distinguished members of the Ways and Means Committee, good morning. My name is Itai Grinberg, and I am an Associate Professor of Law at Georgetown University Law Center. It is a pleasure to appear before you today to discuss the global tax environment and its implications for international tax reform. My testimony will focus on the European Commission's state aid investigations with respect to tax ruling practices and the implications for US international tax policy.

The international tax environment around the world is becoming both less stable and less favorable to American business. The Base Erosion and Profit Shifting (BEPS) Project at the Organisation for Economic Co-operation and Development (OECD) was justified as an attempt to prevent the old framework for international taxation from falling apart and being replaced by unilateral actions, double taxation of cross-border business, and what the OECD termed "global tax chaos."[1] Unfortunately, the post-BEPS environment already shows signs of becoming characterized by much of the global tax chaos the BEPS Project was supposed to prevent. We are seeing an increase in unilateral actions, growing disregard for long-standing international tax norms, and more double tax disputes, especially in the transfer pricing area. The European Union (EU) state aid investigations with respect to tax ruling practices represent an extreme example of the emerging challenges in this new international tax environment.

Background on State Aid

EU law generally prohibits so-called "state aid" that threatens to distort competition within the European Union by favoring certain businesses.[2] The Directorate General for Competition of the European Commission effectively has plenary authority regarding what countries, companies, or practices to investigate or not investigate under these rules. When it finds illegal state aid, it can demand assessments that claw back that aid, including what it views as underpaid taxes, going back ten years with interest.

The state aid rules date to the late 1950s and were originally designed to prevent EU member states from subsidizing domestic "national champion" companies in ways that

[1] Organisation for Economic Co-operation and Development [OECD], *Action Plan on Base Erosion and Profit Shifting*, at 10-11 (2013), http://www.oecd.org/ctp/BEPSActionPlan.pdf.
[2] Consolidated Version of the TFEU, art. 107(1), May 9, 2008, 2008 O.J. (C 115) 91-92.

would undermine a competitive marketplace within Europe. In a series of decisions reaching back fifty years, the European Commission (Commission) has found specific cases of state aid to violate EU rules and required the offending member state to recover that aid from the affected company. The history and scholarship surrounding state aid law suggest that this regime has been an important political tool of the Commission in many contexts.

State aid decisions focusing on indirect subsidies provided through tax benefits are not new as a general matter. The first tax-related state aid case dates to the 1970s. In the late 1990s the Commission issued a notice on the application of state aid rules to business taxation.

Until recently, state aid cases in the tax area generally involved statutory rules that selectively favored domestically headquartered companies in a given EU member state or regimes that provided tax benefits to only a very narrow group of taxpayers. Then, just as press exposés and high-profile legislative hearings abroad concentrated the attention of the European public on legal tax planning undertaken by US multinationals—often simply to achieve effective tax rates that were comparable to their global competitors—the Commission decided to take its state aid work in a new direction. In the cases against Amazon, Apple, Fiat Chrysler, Starbucks, and McDonald's, the Commission is claiming that EU member states provided illegal state aid to foreign-headquartered companies merely by providing them legal certainty through tax rulings that clarified how generally applicable national law would apply to those companies' facts.

These tax rulings do not appear to meet the Commission's own requirements for finding state aid in that they do not seem to be "selective." Similar rulings were broadly available from the tax administrations of those same EU governments that issued the rulings being challenged by the Commission. Moreover, the relevant national governments strenuously assert that those rulings were consistent with the general income tax systems of the relevant countries. Finally, the new state aid cases largely relate to transfer pricing matters, which present notoriously difficult fact-specific determinations that are ill-suited to a state aid analysis.[3] For all of these reasons, the current EU state aid tax investigations are novel and unprecedented.

Given the importance of state aid as a political tool of the Commission, the current investigations should perhaps be considered in the context of the Commission's broader regulatory agenda. The President and others have suggested that, at least in the technology sector, that agenda has often amounted to a protectionist attack on US

[3] Luxembourg and the Netherlands generally assert these same points in their appeals of the two final decisions reached to date by the Commission. Case T-760/15, Netherlands v. Comm'n, CURIA (Dec. 30, 2015), http://curia.europa.eu/juris/document/document.jsf?text=&docid=174409&pageIndex=0&doclang=en&mode=req&dir=&occ=first&part=1&cid=632814; Case T-755/15, Luxembourg v. Comm'n, CURIA (Dec. 30, 2015), http://curia.europa.eu/juris/document/document.jsf?text=&docid=174369&pageIndex=0&doclang=en&mode=req&dir=&occ=first&part=1&cid=633222.

companies, driven by frustration at European companies' inability to compete in that area.[4]

The new state aid investigations can be understood as part of that broader trend. All but one of the company-specific investigations and almost the entire potential amount in controversy involves US multinationals. This remains true even when the more general investigation launched by the Commission into Belgium's excess profits regime is taken into account. The enforcement reality that almost all the revenue at stake comes from US multinationals contrasts with the simple fact that tax rulings of the type that the Commission has recently decided to examine were also routinely procured by European-headquartered multinationals.

Moreover, the remedy that state aid law imposes against member states that provide illegal state aid is deeply inappropriate when applied to a foreign firm instead of the domestic "national champion" firms for which the state aid regime was originally intended when it was created in the 1950s. When the Commission finds that a member state has provided illegal state aid to a foreign firm, the remedy is to require that member state to collect a revenue windfall from the foreign-headquartered company. That does seem to make for great politics: when the Commission reprimands a member state for violating EU law, that member state wins.[5]

Concerns the State Aid Investigations Raise for US International Tax Policy

The state aid investigations raise basic rule of law issues in attempting to tax American business retrospectively rather than prospectively. The legal positions taken by the Commission also disregard international tax norms as they stood during the period the Commission is investigating. Importantly, the investigations could give rise to US multinationals paying EU member states amounts that may be creditable taxes under our law. Thus, the Commission's decisions may in effect amount to demanding a multi-billion dollar transfer from US taxpayers to the EU member states the Commission claims acted illegally.

These issues were articulated in testimony given to this committee and the Senate Finance Committee by Treasury Deputy Assistant Secretary Bob Stack, as well as in a letter from the Senate to Secretary Lew.[6] In addition to the concerns articulated in those

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[4] *See, e.g.*, Murad Ahmed, Duncan Robinson, & Richard Waters, *Obama Attacks Europe over Technology Protectionism*, FIN. TIMES (Feb. 16, 2015), http://www.ft.com/intl/cms/s/0/41d968d6-b5d2-11e4-b58d-00144feab7de.html#axzz3uIoMQGQb.

[5] *See* Michael J. Graetz, *Behind the European Raid on McDonald's*, WALL ST. J. (Dec. 3, 2015), http://www.wsj.com/articles/behind-the-european-raid-on-mcdonalds-1449187952.

[6] *OECD Base Erosion and Profit Shifting (BEPS) Project: Before the Subcomm. on Tax Policy of the H. Comm. on Ways and Means*, 114th Cong. (2015) (statement of Robert B. Stack, Deputy Assistant Secretary for International Tax Affairs, U.S. Department of Treasury); *International Tax: OECD BEPS & EU State Aid: Before the S. Comm. on Fin.*, 114th Cong. (2015) (statement of Robert B. Stack, Deputy Assistant Secretary for International Tax Affairs, U.S. Department of Treasury); Letter from Orrin G. Hatch, Ron Wyden, Rob Portman, & Charles Schumer, Comm. on Fin., U.S. Senate, to Jacob Lew, Secretary, U.S. Dep't of Treasury (Jan. 15, 2016),

settings, I believe it is important to consider whether these investigations rise to the level of discrimination against American business under section 891 of the Code, what these investigations tell us about whether the United States will be able to continue treating EU member states as sovereigns for tax purposes, and what the existence of these investigations tells us about the international climate the United States faces as it considers international tax reform.

Discrimination Against Corporations of the United States Under Section 891 of the Code

The state aid investigations raise serious questions about whether the European Union is discriminating against American business. After all, the Commission has requested a list of all companies that have received tax rulings from all member states, and it is clear that European-headquartered multinationals hold many such rulings. Yet all but one of the named investigations involve American companies. Section 891—a rarely mentioned provision dating to the 1930s—seems to have been enacted precisely to address the kinds of concerns raised by this type of fact pattern.

Section 891 provides:

> Whenever the President finds that, under the laws of any foreign country, citizens or corporations of the United States are being subjected to discriminatory or extraterritorial taxes, the President shall so proclaim and the rates of tax imposed by sections 1, 3, 11, 801, 831, 852, 871, and 881 shall, for the taxable year during which such proclamation is made and for each taxable year thereafter, be doubled in the case of each citizen and corporation of such foreign country. . . .[7]

Difficult technical questions arise under section 891 when considered in connection with the state aid investigations. One of these regards the circumstances under which a foreign tax measure should be viewed as rising to the level of being discriminatory. On this issue, the legislative history of section 891 does seem to suggest that the analysis should focus on the impact of the foreign rule as applied. Thus, the fact that rulings are broadly available to multinationals across the globe, but that almost all the revenue at stake is coming from US multinationals, would appear to be highly relevant. Another issue relates to the relationship between section 891 and US tax treaties concluded with EU member states after the date of enactment of section 891. This is a highly challenging issue, but in my view section 891 may be made operative, at least in part, to the extent that discriminatory taxation by a foreign country violates the terms of a tax treaty of the United States. Separately, it is worth noting that for purposes of section 891, the European Union itself may be a "foreign country."[8]

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http://www.finance.senate.gov/imo/media/doc/Finance%20Committee%20Members%20Push%20for%20Fairness%20in%20EU%20State%20Aid%20Investigations.pdf.

[7] Revenue Act of 1934 § 103, 48 Stat. 680, 703 (current version at 26 I.R.C. § 891 (2015)).

[8] The issues discussed in this paragraph as well as other issues of statutory interpretation of Section 891 are covered in greater depth in Itai Grinberg, *A Constructive U.S. Counter to EU State Aid Cases*, TAX NOTES INT'L, Jan. 11, 2016, at 167.

Of course, actually applying section 891 would be unprecedented—but no more so than the Commission's decision to use its "competition law" to engage in retroactive tax takings from American businesses and attempt to alter EU member states' tax policies at the same time. Thus, although numerous practical obstacles and technical questions must be addressed, studying the issues that arise under section 891 in the context of the EU state aid investigations is an important policy step the US government can take.

How the United States Relates to the European Union in Tax Matters

Every EU member state has held itself out to the international community as sovereign for tax purposes, regardless of its membership in the European Union. The United States has conducted its international tax affairs in good faith based on that representation. The EU state aid investigations, however, suggest that member states of the European Union cannot uphold their bargains in the way one expects of a sovereign. Rather, we are learning that the EU state aid rules impose a stringent set of constraints on tax policy and administration in EU member states, and that these rules trump tax treaties reached by EU member states. For example, when the positions taken by the Commission with respect to the application of the arm's length standard under EU law are inconsistent with the understandings reached in tax treaties, the Commission appears to consider itself empowered to disregard the meaning of the arm's length standard intended by the relevant tax treaty.

The state aid investigations therefore bring into doubt the United States' ability to continue treating EU member states as sovereign for tax purposes. If the present EU state aid investigations continue and are upheld by the European Court of Justice, it could in effect amount to abrogating EU member states' tax treaties. The eventual result may be that the United States will need to formalize that decision by terminating its tax treaties with European sovereigns and negotiating a tax treaty with the European Union. Importantly, many EU member states, both large and small, would disfavor this outcome. That the Commission is undermining an element of sovereignty that member states tend to vigorously defend is further evidence that in these investigations the Commission has likely overstepped its bounds. Nevertheless, the Commission has now also announced that it plans to negotiate for state aid provisions in various agreements with third countries as a means to ensure that its vision of "fair tax competition" is adopted internationally.[9] So unless member states can change the course of events, US tax treaty policy appears to be on a collision course with the Commission.

International Climate in Which We Consider International Tax Reform

The European Union's state aid investigations are also one more indication of the urgent need for US international tax reform. Our singularly high corporate tax rate and worldwide system are severely out of line with international norms. These EU investigations highlight yet another negative consequence of having such broken and aberrant international tax rules. Our international tax system is allowing American

[9] *Communication from the Commission to the European Parliament and the Council on an External Strategy for Effective Taxation*, at 7, COM (2016) 24 final (Jan. 28, 2016).

businesses and the US fisc to be turned into pawns in an intra-European fight between the likes of (high tax) France and (low tax) Ireland.

Every other G7 country and 28 of the other 33 OECD member countries have international tax rules that allow their resident companies to repatriate active foreign business income to their home country without paying a significant additional domestic tax.[10] This system of taxation is usually referred to as "dividend exemption." Another important feature of dividend exemption systems is that they do not provide foreign tax credits for active foreign business income that can be repatriated tax-free.

Unlike exemption systems, our system generally provides a credit for foreign taxes in order to avoid double taxation. Unfortunately, in the current international tax environment, in which many countries are searching for politically painless revenue sources and most countries utilize exemption systems, the foreign tax credits provided by our current system are a ripe target for governments looking to effectuate transfers from US taxpayers to their own coffers.

Indeed, a report prepared by Policy Department A of the Directorate General for Internal Policies of the European Parliament's TAXE Special Committee proposes that the European Union should find ways to ensure state aid assessments are creditable taxes in those countries that "may grant a credit to a resident company for taxes paid abroad on foreign activities."[11] Although the language is somewhat opaque, the goal of the proposal is clear: to make certain that the revenue the European Union seeks through state aid investigations is extracted directly from the United States Treasury.

In this regard, it is important to recognize that a reformed system that includes a minimum tax could continue to leave the United States exposed to other countries seeking to extract revenue from US multinationals in ways that leave US taxpayers footing the bill. In contrast, a true dividend exemption system would not be vulnerable to efforts by foreign sovereigns to extract revenue from US taxpayers by way of imposing tax on US multinationals. Promptly enacting a dividend exemption system along with a mandatory deemed repatriation of presently undistributed foreign earnings might also reduce the temptation for the EU or other foreign sovereigns to target those historical earnings for additional foreign taxation.

The interconnectedness of today's global economy and the mobility of capital, intellectual property, and high-skilled labor makes all attempts to impose high income tax rates on multinational corporations counterproductive. The global market for corporate control combined with the continued home-country bias for high-quality headquarters

[10] *See also Evolution of Territorial Tax Systems in the OECD*, Report Prepared for Technology CEO Council, PwC 3 (Apr. 2, 2013), www.techceocouncil.org/clientuploads/reports/Report%20on%20Territorial%20Tax%20Systems_20130402b.pdf. (illustrating that 91% of the non-US OECD-headquartered companies on the Forbes 500 list of the world's largest companies for 2012 were headquartered in countries with a dividend exemption system).
[11] Raymond Luja, Directorate Gen. for Internal Policies, Policy Dep't A: Econ. and Sci. Policy, *EU State Aid Law and National Tax Rulings*, at 20, IP/A/TAXE/2015-02 (Oct. 13, 2015).

and R&D jobs means that mistakes in this area can be costly in terms of employment and opportunity, especially for the younger generation. The post-BEPS environment has accelerated the timetable on which we must act to reform our international tax system because BEPS is likely to succeed in requiring companies to align functions with tax benefits. Among other things, the BEPS Project was meant to prevent companies from shifting income to lower-tax jurisdictions without also shifting jobs to those jurisdictions. At least in that sense, BEPS is likely to succeed. Moreover, we cannot unring the BEPS bell. So without pro-growth, internationally competitive tax reform, we may well see high-quality American jobs migrate offshore. At minimum, this suggests moving to a much lower corporate tax rate and a dividend exemption regime that does not incorporate a minimum tax that is akin to a worldwide tax system.

It is also important to recognize that countries around the world are moving away from residence country taxation and towards source country taxation, and away from corporate income taxation and toward consumption taxation. One noteworthy consequence of these developments is to exacerbate the consequences of the disjunction in US law between the treatment of US-domiciled and foreign-domiciled multinationals. Thus, another priority in international tax reform should be to level the playing field in this regard. International tax reform efforts should work to define the US source base we intend to defend and consider taxing in the future exclusively on that basis, rather than on the basis of corporate residence.

Thank you for the opportunity to testify before you today. I would be delighted to answer any questions you may have.