7-2016

The U.S. Response to OECD-BEPS and the EU State Aid Cases

Daniel Shaviro
NYU School of Law, daniel.shaviro@nyu.edu

Follow this and additional works at: http://lsr.nellco.org/nyu_lewp

Part of the Taxation-Transnational Commons, and the Tax Law Commons

Recommended Citation
http://lsr.nellco.org/nyu_lewp/444

This Article is brought to you for free and open access by the New York University School of Law at NELLCO Legal Scholarship Repository. It has been accepted for inclusion in New York University Law and Economics Working Papers by an authorized administrator of NELLCO Legal Scholarship Repository. For more information, please contact tracythompson@nellco.org.
I have been asked to comment on the U.S. response to OECD-BEPS and the EU state aid cases. However, the word “response” is ambiguous. It could mean: What sort of response has there been in the U.S. international tax policy community? In other words, what is the main range of informed people’s views? And/or it could mean, how are U.S. policymakers likely to respond to OECD-BEPS and the EU state aid cases? I’ll briefly address both of these distinct, albeit interrelated, questions.

In terms of how U.S. commentators and analysts have tended to view these two developments, one principally EU-driven and the other wholly within the EU, the short answer is that their response has had a large negative component. OECD-BEPS gets mixed reviews in the U.S., but there is widespread hostility towards the EU state aid cases.

This is not necessarily my reaction to these cases – I’m just reporting it. To me, U.S. international tax policy should mainly be driven by our own self-interest, albeit with a high level of willingness to cooperate and pursue common goals, especially with peer countries such as those in the EU. But I expect other countries to act the same way, and think it would be silly to get upset about this. From that standpoint, even if the EU state aid cases are bad for the U.S., because our companies, largely owned by U.S. individuals, may end up having to pay more EU taxes, I understand and sympathize with where the European Commission is coming from.

* This short paper is the slightly expanded text of a talk I gave on June 1, 2016, at a conference in Amsterdam, cosponsored by NYU Law School and the Amsterdam Centre for Tax Law, concerning anti-BEPS implementation in the EU.
+ Wayne Perry Professor of Taxation, NYU Law School.
If the EC wants to restrain race-to-the-bottom internal fiscal competition between member states – a goal that makes sense, as we know in the U.S. from studies of intrastate fiscal competition – then it cannot allow labels, such as the use of the tax system to deliver subsidies, to prevent it from doing its job. And if one is adjudicating the merits of what has already been done, then of course the decisions will apply “retroactively.” If the Commission had settled for saying “OK, fine, but try it again and you’ll be sorry!,” it would likely have failed to deliver a credible message to EU governments.

The Commission claims to be acting within the scope of its existing authority under the Treaty of the Functioning of the European Union.1 Thus, the claim of undue retroactivity, unless it is based on expressly contesting this claim of authority within the framework of EU law, amounts to complaining that American taxpayers have been taken by surprise here. That may well have happened – but it equally happens, in U.S. tax law, whenever the Internal Revenue Service successfully uses a novel legal theory to apply existing law in ways that the adversely affected taxpayers had not anticipated.2 In that context, U.S. legal commentators generally agree that there is no impermissible retroactivity, even though the new theory applies unexpectedly to past acts.

I would be considerably less pleased about a policy of distinctively targeting U.S. companies. However, while this has been raised as a concern by U.S. critics of the Commission’s actions3 – and denied by EU officials4 – it is not established solely by the fact that most of the probes’ targets, thus far, have been U.S. companies. If they were the main ones

1 See European Commission, Communication from the Commission, Commission Notice on the notion of State aid as referred to in Article 107(1) TFEU (Brussels, 2016).
2 An example might be Gregory v. Helvering, 69 F.2d 809 (2d Cir. 1934), aff’d, 293 U.S. 465 (1935), establishing substance over form doctrine as an important element of U.S. federal income tax law.
3 See, e.g., Letter by Jacob Lew, Secretary of the Treasury, to Mr. Jean-Claude Juncker, President of the European Commission, February 11, 2016.
4 See, e.g., Letter by Margrethe Vestager, Member of the European Commission, to Jacob Lew, Secretary of the Treasury, February 29, 2016.
getting selective and discriminatory rulings from countries such as Ireland and Luxembourg, then one would expect them to feature prominently in neutrally selected state aid investigations. However, the question of whether there is any significant evidence of selection bias – taking as given the (in my view reasonable) decision to take up illegally targeted state aid via tax rulings – is one that I would like to hear more about.

But let me turn now from my own personal views to the broader U.S. reactions that I mean to describe. Again, it’s been mixed on OECD-BEPS, reflecting our own longstanding international tax policy debates. But it’s been predominantly hostile, rather than mixed, on the EU state aid cases.

U.S. international tax policy debate tends to have two warring sides. First, there’s the anti-tax side. It’s led by the U.S. multinationals that want to pay less tax, by their allies (both paid and unpaid), and by people who are ideologically anti-tax. Second, there’s the anti-tax avoidance side. Its proponents believe that U.S. and other multinationals have been paying too little U.S. tax (and/or taxes generally) – a belief that may reflect the proponents’ views about fairness, progressivity, efficiency, and/or just revenue.

Unsurprisingly, the anti-tax side has been verging on apoplexy in response to both OECD-BEPS and the EU state aid cases. Consider, for example, a letter that an umbrella group, called the Coalition for Tax Competition – embracing multiple affiliated entities such as the Americans for Tax Reform, National Taxpayers Union, the Campaign for Liberty, and the Small Business and Entrepreneurship Council – recently sent to the Congressional appropriations chairs.5 This was not an isolated fringe group politically. For example, Grover Norquist, one of the principal signatories, has been called (albeit, with a touch of hyperbole) the most powerful man in Washington. He is the author and chief enforcer of adherence to the anti-tax pledge that

all Republican candidates are required first to make and then to keep, effectively on pain of excommunication. Norquist even issues widely-heeded rulings on whether or not a given Republican’s proposals would violate the pledge. So the signatories are well-connected people in Republican Party circles.

The letter (of course) denounces the OECD-BEPS project, which it says “target[s] American corporations for a massive tax grab.” More particularly, however, it urges Congress completely to eliminate U.S. financial support of the OECD. That obviously would be a significant change, although I don’t have inside information on whether it’s meant to be taken seriously, or instead is just a warning shot across the bow.

What about the other side in U.S. international tax policy debate? This includes the Obama Administration, given its frequent sympathy for an anti-tax avoidance agenda. Robert Stack, the Deputy Assistant Secretary of the Treasury for International Tax, has expressed support for the OECD-BEPS process as a whole, and for particular initiatives such as its Action 2, addressing hybrid mismatch arrangements. However, Stack has also spoken about aggressively defending U.S. positions against other countries that he says are trying to overreach at the expense of U.S. companies.

In sum, therefore, on OECD-BEPS, one side is vehemently against the process, while the other side, at best, is partially and cautiously supportive. This asymmetry reflects the fact that, if the main result of OECD-BEPS is that U.S. companies end up paying more tax to EU countries, that’s not good for the U.S., at least directly, given that we don’t get a share of those tax revenues.

Now let’s turn to EU state aid. You can probably guess what the anti-tax side in the U.S. debate is saying. But what about leading U.S. legal scholars? Michael Graetz of Columbia Law
School recently published an op-ed in the Wall Street Journal entitled “Behind the European Raid on McDonald’s.”⁶ A couple of choice quotes: “To a U.S. lawyer steeped in the requirements of due process and the rule of law, the process by which these fines were decided doesn’t pass the smell test …. [T]he European bureaucrats have found a new offense and imposed massive liability retroactively.”

Itai Grinberg of Georgetown Law School recently testified before the House Ways and Means Committee to the effect that the U.S. should seriously consider invoking Internal Revenue Code section 891.⁷ This is a previously obscure provision that permits the president to double the U.S. tax rates of residents of countries that he or she finds have been discriminating against U.S. residents.

What about public officials? Senator Hatch, the chair of the Finance Committee, sent a letter to the Treasury urging full consideration of sanctions under section 891. And Robert Stack at the U.S. Treasury, while circumspect about section 891, has said that the European Commission is unfairly targeting U.S. companies, being unfairly retroactive, and reaching for revenues that belong to the U.S. if anyone, not to EU countries.

I personally consider it highly unlikely that the Obama Administration would indeed invoke section 891, and thereby unilaterally double the U.S. tax rates on residents of EU countries. But the fact that this is even being discussed tells us something about the tenor of U.S. responses to the EU state aid cases.

The vehemence of these responses partly reflects national self-interest. People in the U.S. may benefit when we get greater tax revenues from our multinationals. But again, we don’t

---

⁶ This op-ed, which appeared in the Journal on December 3, 2015, is available online at http://www.wsj.com/articles/behind-the-european-raid-on-mcdonalds-1449187952.

benefit, at least directly, when someone else gets the revenues. However, I suspect that it isn’t just about fiscal self-interest. Group identity also plays a role. One sometimes finds a belief in U.S. circles that Europeans distinctively resent famous American companies and culture. This may be viewed as having influenced the decision to pursue the state aid cases, mainly with respect to U.S. companies. Americans tend to resent feeling resented.

Disparate EU and American views of the state aid cases may also reflect differential framing of the context in which these cases arose. Americans may tend to think of the cases as an aggressive first move by the European Commission. To Europeans with whom I have spoken over the years, however, the relevant story starts a bit earlier, with our regulatory adoption of the check-the-box rules\(^8\) in 1996. These rules notoriously undermined the capacity of our subpart F rules to limit foreign-to-foreign tax shifting by U.S. companies, such as from high-tax EU countries to either EU or non-EU tax havens. U.S. commentators sometimes view the check-the-box rules’ international effects as an accidental byproduct of a rationalization effort that was aimed primarily at ill-functioning domestic rules that tried to distinguish between corporate and non-corporate entities. Such commentators may also, if they are in the anti-tax avoidance camp, view the rules’ undermining of subpart F as a mistake that indirectly undermined U.S. efforts to protect the domestic tax base against profit-shifting. EU commentators, by contrast, have informally expressed to me a view of the check-the-box rules as reflecting a conscious U.S. policy decision to aid U.S. companies’ efforts to engage in foreign profit-shifting at the expense of high-tax EU (and other) countries.

One might ask why high-tax EU countries should need a well-functioning subpart F in order to restrain U.S. companies’ profit-shifting at their expense. Why can’t they simply strengthen their own source rules instead? The answer, I suspect, is that subpart F, where

\(^8\) See Treasury regulations sections 301.7701-1 through 301.7701-3
effective, eliminates tax competition between such countries with respect to inbound investment by U.S. multinationals. Thus, the EU state aid cases might be seen as addressing the void that we are thought deliberately to have created, twenty years ago, by weakening our subpart F rules to the detriment of our friends in the EU.

My point here is not to say who is right or wrong about all this. Rather, it is to offer suggestions regarding why people on the two sides view the EU state aid cases so differently. Interests may differ, but so do perceptions. And it might be helpful for those on each side to have a better understanding of the thinking on the other side that creates feelings of justification and good faith, going beyond mere fiscal self-interest.

Now let’s turn to the question of what, if anything, U.S. policymakers actually are likely to do with regard to OECD-BEPS and the EU state aid cases. Since the Obama Administration’s days are waning, this is really a question about next year and afterwards.

It’s a hard question to answer, because of the rather strange presidential election that we are having right now. It has become clear that Donald Trump might actually win, although I still consider that fairly unlikely. At a minimum, Trump at this point is clearly a wild card – less predictable than another Republican candidate, such as Cruz or Rubio or Bush, would have been. So if one is asking what U.S. policymakers are likely to do, one has to keep the Trump factor in mind. But let me start by assuming that Trump would simply act like a conventional Republican president.

Even under that assumption, in asking how the U.S. will respond to OECD-BEPS and the EU state aid cases in 2017 and afterwards, it’s all about the presidential election. We have a weak presidential system, rather than a parliamentary system. Just because you are elected president does not automatically mean that you can enact any part of your legislative program.
After 2008, President Obama just barely got healthcare through the Congress, and he couldn’t, at least through legislation, do anything about such topics as climate change or international tax policy.

While the Republicans have generally had stronger party discipline – at least, pre-Trump – in 2005, President Bush couldn’t do anything about enacting his Social Security and tax reform plans. In this regard, it didn’t help that President Bush had avoided discussing Social Security change and tax reform during the 2004 election campaign. Even in 2003, when he was riding high, he ended up getting just half a loaf on his corporate integration plan. It had called for dividend exemption, and instead the dividend rate was merely lowered in 2003 to 15 percent.

The U.S. legislative system has multiple check points that impede action, and that were meant to do so. But bipartisan consensus and compromise used to play a larger and more frequent role than they do now. There was bipartisan tax legislation throughout the 1980s. And even as recently as 2004, the first wave of inversions by U.S. companies led to a rapid legislative fix that got large majorities in both houses of Congress.  

But for the second inversion wave, over the last couple of years, there was not even a whisper of this. Republicans, controlling both houses of Congress, had zero interest in addressing the issue. So the Obama Administration decided to respond by testing the limits of existing Treasury regulatory authority.

The same thing will be true next year, if Hillary Clinton is elected president, unless the Democrats get control of both houses of Congress. And while they have a good chance at winning control of the Senate, at least conditioned on their winning the presidential election, they’d need an overwhelming landslide in order to have a decent chance of reclaiming the

---

9 In this regard, it didn’t help that President Bush had avoided discussing Social Security change and tax reform during the 2004 election campaign.
10 See code section 7874.
House. That’s just how slanted and undemocratic, with a small d as well as a large one, districting for House seats is today.

So, if the Democrats win, it’s all about the presidential election because only the Treasury, through regulations, will be able to respond. In this scenario, I would expect Hillary Clinton’s international tax advisors to have similar views to those of President Obama’s advisors. Thus, they might be cautiously and selectively cooperative and constructive with respect to OECD-BEPS, and mainly just rhetorical in their response to the EU state aid cases. However, given the likely legislative impasse, OECD-BEPS cooperation would probably just be through Treasury initiatives and executive agreements.

Now let’s suppose that Donald Trump wins the 2016 presidential election. In that scenario, Republicans would certainly keep the House, and would probably keep the Senate. The big questions here are twofold. First, would he end up governing like a conventional Republican, despite the exotic rhetoric and proposals that he’s brandished throughout the campaign? At this point, no one really knows – perhaps not even Trump himself.

Second, even if Trump were to govern like a conventional Republican, what does that mean these days? Keep in mind that the second place finisher, Senator Cruz, had a tax plan that would likely have increased the US. national debt by more than $10 trillion over the next ten years. He also pledged to cripple tax enforcement by eliminating the IRS, and (just to give a broader flavor) to carpet bomb the Middle East until the sands glowed.

The third or fourth place finisher, Senator Rubio, proposed tax cuts almost as large as those by Cruz. He also planned to revive the George W. Bush Administration’s extremely aggressive, and I would have thought conclusively discredited, first-term post-9/11 foreign policy. Moreover, all of the Republican presidential candidates vociferously opposed doing
anything about climate change, which many of them claimed was a deliberate falsehood propounded by a global conspiracy of evil scientists. So even if Donald Trump is a conventional Republican 2016 style, rather than something different and historically unprecedented in the United States, that would leave him a fair amount of swimming room in lightly charted waters.

Whatever one’s prediction regarding a Trump presidency, it probably would mean scratching the idea of any OECD-BEPS cooperation by the U.S. Nor would I rule out U.S. defunding of the OECD. After all, that idea already has support from inside the Republican establishment, and Trump has made noises about pulling out of NATO and the United Nations.

Would a President Trump invoke section 891? It certainly sounds like his style, but there are two reasons why he might not. First, it’s a tax increase, even if only for non-U.S. residents. Second, it’s not clear what a Trump Administration’s hiring and administrative processes would look like. If a small White House staff, drawn from outside the usual professional sources, exercises tight control on all new regulatory initiatives, a Trump White House might not even learn that section 891 exists.

I will close, however, by taking a longer-term perspective, which looks beyond the 2016 presidential election under the optimistic premise that sanity and the rule of law will prevail here. In the long run, I’d expect two sober reactions to the EU state aid dust-up. First, U.S. policymakers may conclude that the U.S. has actually benefited to a degree, albeit indirectly, from EC verdicts that imposed current tax costs on U.S. companies.

Suppose U.S. companies conclude, by reason of the state aid cases, that the EU is less of a tax planning heaven than they had thought, despite their fruitful past dealings with officials in countries like Ireland and Luxembourg. This might reduce future U.S. base erosion, even wholly apart from the long-term OECD-BEPS playout. Profit-shifting out of the U.S. by U.S.
companies tends to be an integrated two-stage process. First, they get the profits abroad, then they do the foreign-to-foreign tax planning that allows them to place the profits in tax havens. The EU state aid cases potentially could undermine U.S. companies’ confidence in this two-step, and this might conceivably affect, not just pure profit-shifting transactions, but even real investment choices that are complementary with it.

Second, U.S. policymakers may decide that the EU is onto something, when it focuses on base erosion by non-resident companies. The U.S. international tax rules today, as compared to those of peer countries such as Germany and the U.K., rely more heavily on residence-based rules to address profit-shifting, and less heavily on rules that are residence-neutral or that even target nonresident companies. In particular, the U.S. legal response to profit-shifting leans heavily on our CFC rules, which only apply to resident companies. For example, we have only a relatively weak rule addressing earnings-stripping, and we don’t have a global debt cap.

I would assume that non-U.S. companies today do even more profit-shifting out of the U.S. than U.S. companies, simply because they can. Indeed, this is one of the two main reasons for the recent inversion wave. Would-be U.S. inverters anticipated being able to strip more profits out of the U.S. once they could get around our CFC rules more easily. 11

A shift in the U.S. response to profit-shifting, so that it focused more than it presently does on non-resident companies, might look like an indirect deferred response to the EU state aid cases. As in: “You’re going after some of our companies? Great – we are going to go after some of yours.” Yet it might make sense substantively even if the state aid cases had never been brought. And it has potential domestic political support, wholly apart from any notion of responding to the EU. After all, U.S. companies are often fine with U.S. tax enforcement against

11 The second main reason for the second anti-inversion wave was to give the inverting companies easier access to “trapped” foreign earnings without incurring U.S. repatriation tax. See Daniel Shaviro, Ten Observations Concerning International Tax Policy, forthcoming in Tax Notes on June 20, 2016.
their foreign competitors, except insofar as they fear a spillover of the effort to target their own tax planning as well. And if the foreign multinationals have well-placed lobbyists and other friends in Washington, which is certainly possible, I myself have not as yet heard much either from them or about them.

Is this a pessimistic, quasi-trade war vision – the U.S. going after EU multinationals, while the EU is going after U.S. multinationals? It could be, but there is also an optimistic version, under which it fits into an ongoing multilateral effort to limit corporate tax base erosion and profit-shifting generally. And in any event, there are real limits to rational countries’ interest in discouraging inbound investment.12

---

12 See Shaviro, Ten Observations, supra.