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FEATURED PERSPECTIVE

A Constructive U.S. Counter to EU State Aid Cases

by Itai Grinberg



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The author proposes that the U.S. Treasury consider applying a little-known U.S. tax law to counter the European Commission's pending state aid investigations.

U.S. Treasury officials and members of Congress from both parties have expressed concern that the European Commission's current state aid investigations are disproportionately targeting U.S.-based multinational enterprises.¹ At the same time, a Treasury official recently suggested in congressional testimony that there are limits to what Treasury can do beyond strongly expressing its concerns to the commission. In

that testimony, Treasury's representative hinted at two specific pressure points: whether the state aid investigations could undermine U.S. tax treaties with EU member states; and whether any assessments paid by the foreign subsidiaries of U.S. MNEs as a result of state aid investigations would be creditable for U.S. income tax purposes.

Thus far, no one has raised a third pressure point: the potential application of section 891 of the U.S. tax code, which specifically addresses discriminatory taxation of U.S. MNEs. If the Obama administration were to find that the EU state aid cases imposed discriminatory taxes on corporations of the United States, U.S. income tax rates on citizens and corporations of certain European countries could double. Although the United States has never applied section 891, this may be a case where its consideration is appropriate.

Why wouldn't Treasury study the issues raised by the EU state aid investigations under section 891? The answer might be that section 891 feels like a provision from a bygone era, primarily because the issues it addresses simply have not arisen in decades.

But section 891 seems to have been enacted precisely to address concerns like those raised by the EU state aid investigations. Moreover, studying the questions that arise under section 891 represents a less drastic and more pragmatic U.S. response than threatening to terminate our tax treaties. It also opens the possibility of imposing a consequence that is meaningful to foreign sovereigns, unlike the prospect that the United States would deny foreign tax credits to U.S. MNEs. Finally, as a legal matter, the questions that arise under section 891 regarding the EU state aid investigations may chronologically precede the questions that arise under section 901. Thus, focusing on the questions that section 891 poses could be a means to encourage European institutions to conclude the EU state aid cases in a sensible manner.

¹See e.g., Testimony of Robert Stack, deputy assistant Treasury secretary (international tax affairs), Senate Finance Committee (Dec. 1, 2015), available at <http://www.finance.senate.gov/imo/media/doc/01dec2015Stack.pdf> ("We are concerned that the EU Commission appears to be disproportionately targeting U.S. companies."); Press Release, House Ways and Means Tax Policy Subcommittee Chairman Charles W. Boustany Jr., R-La., Chairman Boustany Opening Statement: Examining the OECD Base Erosion and Profit Shifting (BEPS) Project (Dec. 1, 2015), available at <http://waysandmeans.house.gov/chairman-boustany-opening-statement-examining-the-oecd-base-erosion-and-profit-shifting-beps-project>; and Remarks of Senate Finance Committee Ranking Member Ron Wyden, D-Ore., at Finance Hearing on OECD BEPS Reports (Dec. 1, 2015), available at <http://www.finance.senate.gov/hearings/international-tax-oecd-beps-and-eu-state-aid>.

Background

EU State Aid

Article 107(1) of the Treaty on the Functioning of the European Union (TFEU) provides that state aid that affects trade between EU member states and threatens to distort competition by favoring certain undertakings is incompatible with the EU single market.² EU state aid rules require that incompatible state aid be recovered in order to ameliorate the distortion of competition created by the aid.

The state aid rules were originally designed to prevent EU member states from subsidizing domestic enterprises. Under the state aid rules, the commission can demand assessments that claw back state aid, including what it views as underpaid taxes, going back 10 years with interest. In a series of decisions reaching back decades, the commission has found specific cases of state aid that violate EU rules and required the offending member state to recover that aid from the affected company.

State aid decisions focusing on indirect subsidies provided through tax benefits are not new as a general matter. The commission has been bringing tax-related state aid cases since at least the mid-1980s. Tax-related state aid decisions reached by the commission have almost always been upheld by the Court of Justice of the European Union.

Until the recent assault on U.S.-based MNEs, however, state aid cases in the tax area generally involved statutory rules that selectively favored domestically headquartered companies in a given EU member state. In contrast, in the new cases the commission is claiming that sovereigns provided illegal state aid to foreign-headquartered companies merely by providing them legal certainty through tax rulings that do not even seem to be “selective” — in that similar rulings were broadly available from the tax administrations of those same EU governments. In addition, the new state aid cases largely relate to transfer pricing matters, which present notoriously difficult fact-specific determinations. For these reasons, the current EU state aid tax investigations are novel and unprecedented.

Moreover, the remedy 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 state aid law was originally intended. In these cases, when the commission finds that a member state has provided illegal state aid, the remedy is to require that member state to collect a revenue windfall from a foreign-headquartered MNE. That does make for great

²Consolidated Version of the TFEU, article 107(1), May 9, 2008, 2008 O.J. (C 115) 91-92.

politics: When the commission reprimands a member state for violating EU law, that member state wins.³

President Obama and others have suggested that, at least in the technology sector, the European Commission’s regulatory agenda in the past few years has often amounted to a protectionist attack on U.S. companies, driven by frustration at European companies’ inability to compete in that area.⁴ The new state aid investigations could be seen as part of that broader trend.⁵ Starting in 2013, the commission’s tax-related state aid investigations have focused like a laser on rulings issued to U.S. MNEs. In fact, all but one of the company-specific investigations and almost all of the amounts in controversy involve U.S. MNEs. This enforcement reality contrasts with the fact that tax rulings of the type that the commission has recently decided to examine were also routinely procured by European-headquartered multinationals.

Section 891

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.⁶

In the course of congressional debate over section 891, Sen. David I. Walsh, D-Mass., presented a floor statement that provides some insight into the statute’s purpose. He suggested that if an administration were to “cause inquiry to be made” into whether a foreign tax was discriminatory, “it would seem natural that the President, through his executive offices, might obtain an agreement . . . to remove such features. If this were done there would be no occasion for the President to issue [a proclamation under Section 891], and the section would have accomplished its result in an amicable manner.”⁷

³Michael J. Graetz, “Behind the European Raid on McDonald’s,” *The Wall Street Journal*, Dec. 3, 2015.

⁴See, e.g., Murad Ahmed, Duncan Robinson, and Richard Waters, “Obama Attacks Europe over Technology Protectionism,” *Financial Times*, Feb. 16, 2015.

⁵Indeed, international relations scholars often point out that state aid is one of the most politicized of the EU’s regulatory policy levers. See, e.g., Michelle Cini, “The Soft Law Approach: Commission Rule-Making in the EU’s State Aid Regime,” 8 *J. Eur. Pub. Pol’y* 192 (2001).

⁶Sec. 103, Revenue Act of 1934 (1934) (current version at 26 IRC section 891 (2015)).

⁷78 Cong. Rec. 9318, at 9319 (1934) (statement of Sen. David I. Walsh).

In the context of the EU state aid investigations targeting foreign subsidiaries of U.S.-headquartered MNEs, the language of section 891 raises two preliminary issues of statutory interpretation: the meaning of “corporations of the United States” and the meaning of “being subjected to discriminatory taxes.”

Walsh’s floor statement helps clarify the intent of Congress as to those issues. He explained that the language “corporations of the United States” was intended to refer to “American concerns.” The discrimination section 891 was intended to combat does not seem to be limited to tax burdens formally imposed on the domestic subsidiaries of a U.S. MNE. Rather, in light of the legislative history, the statutory term “corporations of the United States” may be best understood to encompass any subsidiary within the worldwide affiliated group of a U.S. MNE. Thus, for purposes of section 891, European subsidiaries of Amazon, Apple, McDonald’s, and Starbucks are all likely to be “corporations of the United States.”

Walsh also explained that being subjected to discriminatory taxes under the laws of a foreign country referred to those taxes that are framed, imposed, and enforced “so as to result in a special tax burden upon American concerns, greater than those imposed on the enterprises of [the foreign country] or of the most-favored nation.” The issue that section 891 focuses on is not, in the senator’s telling, solely about whether the legal rule imposing a tax on an American concern is facially neutral. Rather, whether a tax is discriminatory seems intended to focus on the impact of the foreign rule as applied.

Open Questions

A wide variety of questions about how section 891 might interact with the state aid cases — as well as the application of section 891 more generally — have received almost no attention. It might, therefore, be fruitful for Treasury to make an open-ended request for public comments. For instance, there are important questions to be addressed about the relationship between section 891 and U.S. tax treaties, the circumstances under which a tax measure should be viewed as being discriminatory, and the meaning of the term “foreign country” for purposes of section 891.

Section 891 and U.S. Tax Treaties

One might contend that section 891 contravenes U.S. tax treaties and therefore has no effect. U.S. tax treaties generally override domestic law by reducing U.S. taxes on foreign persons in exchange for reciprocal reductions in foreign taxes on U.S. persons. They also uniformly include nondiscrimination articles. Under U.S. law, treaties and statutes have coequal status. When a revenue statute and a tax treaty provision conflict, generally the later-in-time rule is controlling. Thus, one view might be that by doubling the rate of tax on a foreign country’s citizens and corporations, section 891 contravenes our treaties. In that case, since

all the relevant treaties were concluded after the enactment of section 891, those treaties would prevail and prevent application of section 891, so long as a treaty with the particular EU member state remains in force.

On the other hand, a fundamental judicial tenet is that treaties and statutes are to be reconciled wherever possible. One question, therefore, is whether the application of EU state aid rules in a discriminatory manner, followed by retroactive revenue reclamation, would be permissible under the United States’ tax treaties with the relevant EU member states. For EU law purposes, the TFEU generally trumps bilateral income tax treaties, and so the fact that state aid findings may violate the tax treaties of EU member states may not be dispositive.

But for U.S. law purposes, the TFEU does not have and cannot be granted this quasi-constitutional status. To the extent that the outcomes of discriminatory state aid cases violate the United States’ tax treaties with EU member states, application of section 891 may not be inconsistent with our tax treaties. Rather, the better reading may be that section 891 remains an operative provision, at least in part, to the extent that discriminatory or extraterritorial taxation by a foreign country violates the terms of a tax treaty of the United States.⁸

When a Tax Is Discriminatory

Under section 891, whether corporations of the United States are subjected to discriminatory taxes under the laws of a foreign country appears to refer to the manner in which the taxes are imposed and enforced, rather than merely whether the underlying foreign rules being applied to corporations of the United States are themselves facially neutral. That conclusion, however, leaves open a very wide set of questions about the standard for determining whether corporations of the United States are being subjected to discriminatory taxes.

The Meaning of ‘Foreign Country’

Another open question turns on the meaning of the term “foreign country” for purposes of section 891. The meaning is important because if the administration were to conclude that U.S. corporations were being subjected to discriminatory taxes under the laws of the EU (as opposed to the laws of a member state), a question would arise whether the EU is a “foreign country” for purposes of section 891.

Our understanding of the meaning of the term “foreign country” for international tax purposes depends to a significant degree on a 1932 Supreme Court case,

⁸Alternatively, section 891 might be viewed as a statutory vehicle for responding to tax treaty violations with a partial treaty suspension. For a discussion of partial tax treaty suspensions, see Richard L. Doernberg, “Selective Suspension or Termination of Income Tax Treaty Provisions,” *Tax Notes Int’l*, Nov. 1990, p. 1130.

*Burnet v. Chicago Portrait Co.*⁹ In that case, the Court held that subnational taxes imposed by the Australian state of New South Wales were imposed by a foreign country for purposes of the foreign tax credit because the purpose of the FTC was to alleviate double taxation and the Court recognized that double taxation can occur whether a foreign tax burden is imposed by a national government or a regional one. In reaching that conclusion, the Court made clear that “foreign country” is ambiguous. As the Court noted, “the term ‘foreign country’ is not a technical or artificial one, and the sense in which it is used in a statute must be determined by reference to the purpose of the particular legislation.”¹⁰

When crafting section 891 in 1934, Congress would have been aware of the 1932 decision in *Chicago Portrait* — which at the time was the Court’s most recent international tax decision. Depending on the purpose of the statute at issue, *Chicago Portrait* made clear that “foreign country” could mean either “foreign territory” or “foreign government” and, when referring to a foreign government, “it may describe a foreign state in the international sense,” but it might also mean “a foreign government which has authority over a particular area or subject-matter.”¹¹ Of course, the European Union has a territory and is arguably a foreign government with authority over particular subject matter, including competition policy, as the commission’s actions in imposing state aid assessments clearly establish.

Sequence of Analysis

As Treasury considers the tax treaty issues, FTC issues, and section 891 issues that arise when dealing with the state aid investigations, one practical question is: Which of these issues has to be dealt with first? Tax treaty termination is a pure policy decision with no required time frame for decision. Foreign tax creditability is determined under the compulsory payment rules, which require that a taxpayer exhaust all effective and practical remedies, including available judicial appeals, before claiming the credit.¹²

In contrast, EU law provides that once the commission decides that a member state provided a taxpayer with illegal state aid, that state must act without delay

to recover that aid from the taxpayer.¹³ As a result, although FTCs quite likely would not be available at the time the commission reached a decision (since appeals would be in process), that decision may mark the point at which a corporation of the United States is subjected to tax for purposes of section 891. Thus, the section 891 issues may arise well before either the tax treaty termination or section 901 issues are ripe.

Political Economy Considerations

The history of state aid law suggests that credible sources of economic and political pressure have significantly affected the development of EU state aid investigations over time. Hinting that tax treaties might need to be terminated is not, however, particularly credible as a source of pressure on the European Commission. The collateral damage caused by tax treaty termination would be very substantial and probably disproportionate to the harm caused by the current state aid investigations for all parties concerned. Nor can the U.S. bring credible pressure to bear on the commission by threatening that EU state aid assessments will not be creditable to U.S. MNEs. Indeed, the U.S. has already indicated to the commission that EU state aid assessments may be creditable foreign taxes for U.S. tax purposes, in order to explain that the United States has a direct stake in these proceedings, because if the FTC applies, U.S. taxpayers will foot the entire bill for any state aid assessments.

In contrast, section 891 constitutes a plausible source of leverage in connection with the state aid cases. Although the United States should be reluctant to invoke section 891, that step is substantially less drastic than terminating all EU member state tax treaties. Moreover, given the lack of guidance on precisely how section 891 applies, Treasury might be able to appropriately limit the impact of any finding under section 891.

Conclusion

This article started with a simple question: Why shouldn’t Treasury consider the issues raised by EU state aid investigations under section 891? True, tax rates have never doubled under section 891, and many tax lawyers have never heard of section 891. In an important sense, however, Congress intended these results: Section 891 was designed to create a deterrent that would discourage foreign governments from discriminating against U.S. citizens and businesses. Thus, when the rule of law works as it should abroad, section 891 simply does not come up. Maybe it is time for Treasury to study section 891, if only to remind our friends in the European Commission that it is the law of the United States. ◆

⁹*Burnet v. Chicago Portrait*, 285 U.S. 1 (1932).

¹⁰*Chicago Portrait*, 285 U.S. at 6, citing *Wayman v. Southard*, 10 Wheat. 1, 29; *Marriott v. Brune*, 9 How. 619, 635, 636; *American Tobacco Co. v. Werckmeister*, 207 U.S. 284, 293; *United States v. Louisville & N. R. Co.*, 236 U.S. 318, 333; *Inter-Island Steam Nav. Co. v. Ward*, 242 U.S. 1, 4; and *Porto Rico Ry., Light & Power Co. v. Mor*, 253 U.S. 345, 348.

¹¹*Chicago Portrait*, 285 U.S. at 5.

¹²Treas. reg. section 1.901-2(e)(5) (2015).

¹³OJ L 83/1 (Mar. 27, 1999), as amended, article 14.