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Kimberly S. Blanchard of Weil, Gotshal & Manges writes that misunderstanding of the U.S. taxation of worldwide income may be the basis for controversies surrounding European Competition Commission ''state aid'' cases. Most EU countries instead use territorial systems to tax business income, the author writes. ''While the significance of this basic difference is well understood in the U.S., there is much evidence suggesting that it isn't truly appreciated outside the U.S.''

Taxes and State Aid: Some Light to Go With the Heat

BY KIMBERLY S. BLANCHARD

In recent months the controversies over the European Competition Commission's foray into tax law in the guise of ''state aid'' have generated more heat than light. I won't get into the spitball-throwing, most of which is about politics rather than tax. Let us talk about taxation.

I believe that the disconnect between the way the commission views its actions and the negative way pretty much everyone in the U.S. views its actions may in large part be explained by reference to a critical difference in the income tax systems of the U.S. and those prevailing in the European Union. I haven't seen any discussion of this critical difference in the state aid literature to date.

While the U.S. continues to tax the business income of its corporate and individual residents on a worldwide basis with a foreign tax credit, most other countries, including most countries in the EU, employ a territorial system for business income. It is this difference that I believe explains much of the disconnect on the state aid front.

While the significance of this basic difference is well understood in the U.S., there is much evidence suggesting that it isn't truly appreciated outside the U.S. So before I turn to the reason why I believe this lack of understanding is critical to the state aid dispute, let me back up my claim that the EU ''just doesn't get worldwide.''

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BEPS, Haven Criteria Show Lapse

This first began to dawn on me when I read, or tried to read, the report on the Organization for Economic Cooperation and Development's base erosion and profit shifting (BEPS) Action 3, concerning controlled foreign corporations (hereinafter, the CFC report). As detailed in a previous column,[1] that report utterly failed to appreciate the enormous distinction between how CFC rules operate in countries that employ a worldwide tax paradigm and in countries that employ a territorial paradigm.

This mistake was repeated and amplified in a more recently issued BEPS report, ''Branch Mismatch Structures'' (hereinafter, the Branch report).[2] At least the CFC report gave lip service to the worldwide-territorial distinction in its introduction; the Branch report completely omits to note it, making recommendations wholly at odds with the manner in which a worldwide system operates.

For example, the Branch report explicitly assumes that the residence country will always exempt the income of a branch from taxation, which of course is never the case where the residence country is the U.S. The report contains a deemed branch payment rule re-

[1] Blanchard, ''BEPS Action 3: How Not to Engage With CFC Rules,'' 178 DTR J-1, 9/15/15.

[2] Aug. 22, 2016 (OECD).

quiring the residence country to tax certain branch income. Apparently it never occurred to the authors of the Branch report that the residence country might tax all the income of a branch.

Yet a third recent EU undertaking illustrates its failure to appreciate the very different tax landscape encountered in a country that taxes worldwide income. The EU is preparing a ''scorecard'' intended ultimately to put countries it views as noncooperative on tax matters on a tax haven blacklist. One of the criteria that the U.S. flunked in the first round was that it supposedly has ''preferential tax regimes.'' Yet, U.S. tax law contains nothing like the regimes prevailing in the EU, whether it be a patent box, an advance rulings practice, coordination center regimes, notional interest deductions, a participation exemption, special holding company regimes or, for that matter, a territorial system. Not to mention an excessive adherence to form over substance and the ability to treaty shop!

This explains why the new U.S. Model Treaty denies benefits to special tax regimes. It also explains why U.S. CFC rules contain branch rules intended to combat the sort of preferential tax regimes prevalent outside the U.S. No country in Europe has anything like these U.S. rules. What they do have are numerous special tax regimes, which were precisely what gave rise to the state aid controversies.[3]

It doesn't seem to matter how many times you tell a European that the U.S. taxes the worldwide income of U.S. residents, they just don't internalize the information. I suspect one reason for this is the common observation that, at least for active business income, the possibility of indefinite deferral means that the U.S. has a ''de facto'' territorial system. But to equate indefinite deferral with exemption is a simplistic and dangerous fallacy, as European investors in U.S. companies often learn to their chagrin.

First of all, deferral, unlike territorial exemption, ends upon a disposition. Second, it blocks any ability to repatriate the deferred foreign earnings. For this reason, U.S. multinationals have to engage in what might appear to a non-expert observer to be artificial tax planning, only to get to the same place that a non-U.S. multinational would be without the need for any planning at all.

The commission's June competition report[4] justifies its rulings against certain EU countries on the ground that those countries are according tax benefits to multinationals that local taxpayers can't take advantage of. But the EU territorial model explicitly accords the benefit of complete, permanent tax exemption to foreign activity, which obviously isn't available to wholly local businesses. And it is far more generous than the tax results accorded to foreign activity under the U.S. worldwide system of taxation. The exemption system by definition gives rise to ''homeless income'' permanently, whereas the worldwide system does so only temporarily.

Differing Assumptions on Tax Jurisdiction

The most important distinction between a worldwide system of taxation with deferral and an exemption system lies in their very different assumptions concerning tax jurisdiction. It seems to me that this is where the rubber hits the road in the state aid controversy.

In a territorial system, once income is correctly sourced and transfer-priced outside the residence state of the ''home office,'' the residence state has disclaimed jurisdiction to tax that income. This, by the way, is why a territorial approach puts undue pressure on transfer pricing.

In contrast, under a worldwide system, the residence state indefinitely retains the jurisdiction over all of the income of its residents. The fact that it will give a (limited) foreign tax credit for foreign taxes paid on repatriated income that it views as properly allocable to a foreign country doesn't impact this basic jurisdictional claim.

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Let us apply this observation about jurisdiction to a couple of simple examples.

Example 1. U.S. corporation X operates a branch in Country A. Assume there is no tax treaty between the U.S. and Country A, such that there are no agreed-upon rules for allocating income of the branch to Country A. Country A might tax more, or less, income than U.S. allocation principles would allocate to the branch. If it taxes less, the ''windfall'' income will be fully subject to tax in the U.S. If it taxes more, the U.S. will seek to deny a credit for the excess, resulting in double taxation of that income.

Example 2. Same as Example 1, except that the branch is a branch of X's CFC. If Country A taxes less than the ''proper'' amount of income allocable to the branch, the U.S. won't tax it immediately, but will retain jurisdiction to tax the windfall at a later time. If Country A taxes more than the proper amount, the U.S. will seek to deny the indirect foreign tax credit for any repatriation of the CFC's earnings and profits.

Given the U.S.'s assertion of jurisdiction over the foreign income of its residents, the application of state aid rules to U.S.-parented companies inevitably creates double taxation. It is critical to notice that this result could never obtain among countries that employed territorial taxation. This is because none of those countries makes any claim to tax income earned outside its borders. If, in the examples above, the U.S. operated a territorial exemption regime, any undertaxation of the income of its branch or CFC would create a permanent subsidy, and one worth considering clawing back. But that isn't the case.

[3] Competition Commissioner Margrethe Vestager has said on more than one occasion that the U.S. doesn't have anything like the EU's state aid rules. This again illustrates the commission's ignorance on tax matters. Of course the U.S. has no such rules at the federal level, since it is a single country. But the 50 U.S. states have been dealing with analogous commerce clause issues, including in tax matters, for centuries, long before any such concept was ''invented'' by Europe.

[4] Report from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, ''Report on Competition Policy 2015,'' SWD(2016) 198 final (June 15, 2016).

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Competition Commissioner Margrethe Vestager has stated that the state aid assessments against U.S. companies would be offset to the extent the undertaxed income in question were taxed in the U.S., or indeed in any other country. This statement, more than anything, illustrates that the state aid cases aren't, in fact, about competition, but about a specific EU understanding about how tax rules work.

The assumption underlying the state aid cases is that the benefit supposedly conferred by the source state results in homeless income. This is always the case in a territorial regime such as that prevalent in Europe, but isn't so in the case of a worldwide regime such as that employed by the U.S.