EUROPEAN UNION
DELEGATION TO THE UNITED STATES OF AMERICA

COMMENTS BY THE EUROPEAN COMMISSION TO THE INTERNAL REVENUE SERVICE, U.S.DEPARTMENT OF THE TREASURY

REQUEST FOR COMMENTS: DEDUCTION FOR FOREIGN-DERIVED INTANGIBLE INCOME AND GLOBAL INTANGIBLE LOW-TAXED INCOME, REG–104464–18, PUBLISHED ON MARCH 6, 2019

Submitted by:

The Delegation of the European Union
to the United States of America
May 6, 2019

Comments to the Notice of Proposed Rulemaking on the

Deduction for Foreign-Derived Intangible Income and Global Intangible Low-Taxed Income

The European Commission has noted the publication of a notice of proposed rulemaking on the deduction of foreign-derived intangible income (FDII) and global intangible low-taxed income (GILTI) pursuant to the Tax Cuts and Jobs Act (TCJA), P.L. 115-97.[1] The proposed rulemaking is linked to previous proposed rulemakings to which we provided comments stating our concerns in regards to their conformity to US treaty obligations.[2] The Commission welcomes the opportunity to provide further comments to the latest proposed rulemaking.

The EU fully supports the stated aim of the TCJA to reduce tax avoidance and aggressive tax planning in accordance with international best practices. Nevertheless, TCJA section 250 and the proposed implementing regulation on FDII are (1) most likely breaching US obligations under the World Trade Organization (WTO) and other international obligations, and (2) not fit to reduce tax avoidance and aggressive tax planning:

(1) The tax treatment of FDII effectively provides US corporations a tax deduction directly linked to the exports of goods and services, subject to a narrowly defined number of exclusions and conditions. The size of the FDII tax deduction is directly determined by the ratio of foreign to domestic sales, and based upon actual income generated through exports. A similar benefit is not granted to US corporations earning income from domestic US sales of the same goods and services. As a result, US corporations are provided a financial contribution to export with the size of the benefit determined by export performance.

    Given the design and effect, the FDII tax deduction is most likely a prohibited export subsidy under the WTO Agreement on Subsidies and Countervailing Measures. This measure is therefore in conflict with US treaty obligations. It is worth noting that the US spearheaded efforts to prohibit export subsidies during the Uruguay Round. The categorisation as prohibited export subsidy is supported by the fact that the FDII tax deduction is replacing the domestic production activities deduction, and therefore in turn the domestic international sales corporation, foreign sales corporation, and extraterritorial income exclusion regimes, all of which were found non-compliant with US obligations under the WTO. Even if one tries to argue that the FDII tax deduction was not intentionally conceived as a replacement to non-compliant past systems, it does share similar properties in terms of structure that appear most likely to fulfil the same categorisation as a prohibited export subsidy.

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[1] Internal Revenue Service, Notice of Proposed Rulemaking, 84 Fed. Reg. 8188 (Mar. 6, 2019).

[2] Comments by the European Union to the US Internal Revenue Service on the Base Erosion and Anti-Abuse Tax of 19 February 2019.

The Congressional Research Service shares the view that FDII *"would probably violate the WTO rules against export subsidies. FDII might also be viewed abroad as a harmful tax regime. . . .*[3]

(2) As the proposed FDII rule states, it is the aim to put US corporations exporting to foreign markets on equal footing with US corporations that receive a reduced tax rate on GILTI from these markets. However, the FDII tax deduction fails to deliver on this as it applies irrespective of the effective tax rate of the foreign destination, and therefore the potential GILTI tax, and is not proportionate to the actual economic costs. In addition, economies offering tax rates below the FDII deduction will remain unaffected as, even with GILTI, effective tax rates remain lower.

The failure to achieve its stated purpose is also captured by the fact that, despite its name, the FDII deduction is irrespective of any intangibles. Hence, it cannot be an expedient solution to reduce the shift of intangibles to lower-taxing economies, or provide a level-playing field. The FDII deduction instead distorts a level-playing field by providing a financial subsidy to exports in an attempt to increase the competitiveness of US corporations in foreign markets. The design of the FDII deduction is incentivising tax avoidance and aggressive tax planning by offering a possibility to undercut local tax rates in foreign economies. In result, the FDII is an incentive for foreign economies to lower corporate tax rates in a 'race to the bottom.'

The Commission encourages tax measures that incentivise research and development (R&D) spending, which is crucial for economic growth, as long as they are both well-designed and in line with international commitments. However, the FDII provisions are broader than targeted R&D tax credits and expensing provisions, which only apply to specific types of R&D expenditure. The FDII applies to exports and rewards outputs irrespective of innovation, rather than subsidising R&D inputs. The measure is therefore most likely an ineffective way of supporting R&D.

The Commission fully supports efforts to ensure that any reform of the US tax code will be non-discriminatory and in line with the US international commitments, notably those of the WTO. We already expressed concerns with the FDII deduction in the past, notably in a letter of 12 December 2017 addressed to Treasury Secretary Mnuchin by four Vice-Presidents and Commissioners. We conveyed the same concerns again during the 2018 US Trade Policy Review at the WTO.

The Commission remains ready to protect the economic interest of the European Union in light of discriminatory rules and practices. Therefore, we are looking forward to intensify our cooperation on ways to remove any discriminatory elements of the US tax reform while improving international taxation, notably through the G20 and OECD work strands, as well as bilaterally.

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[3] J. Gravelle & D. Marples, Congressional Research Service, *Issues in International Corporate Taxation: The 2017 Revision (P.L. 115-97) at 35 (*May 1, 2018).

Exhibit 1

European Commission

Valdis DOMBROVSKIS
Vice-President

Jyrki KATAINEN
Vice-President

Cecilia MALMSTRÖM
Commissioner

Pierre MOSCOVICI
Commissioner

Brussels, 12.12.2017

Dear Secretary Mnuchin,

The European Commission has been following the ongoing discussions on the US tax reform with great interest and has already had the opportunity to engage on the issue with a number of US counterparts for which we are grateful. The European Commission fully recognises the US government's interest in reforming its domestic tax system. As a matter of principle, the European Commission, like the US, is fully committed to tackling tax base erosion and profit shifting.

However, the draft US tax bill as it currently stands contains elements that risk seriously hampering trade and investment flows between our two economies. We believe it is in our joint interest to avoid this.

In addition, the draft tax bill may also lead to unfair trade practices or discrimination that would appear to be incompatible with WTO rules and other international commitments taken by the US. In this respect, the European Commission shares the concerns voiced recently by several of our Member States relating to a number of elements in the US tax bill.

Firstly, the proposed Base Erosion and Anti-abuse Tax (BEAT - Senate bill) would not apply to comparable related party payments between domestic US companies, which as with the house excise tax could give rise to discrimination and incompatibility with WTO rules. It would not allow for the credit of foreign taxes paid and we understand that it is not exclusively targeted at abusive situations. Therefore, it could impact on genuine commercial arrangements and lead to double taxation of the same payments, notably in the finance industry. Moreover, it could impact intra-group payments which are necessary for the financial sector to comply with financial stability requirements (e.g. interest on TLAC debt in the banking industry).

Secondly, the focus on the deduction for foreign derived intangible income under the envisaged global intangible low-tax income (GILTI - Senate bill) would apply the preferential tax treatment to a broader range of intellectual property than other internationally accepted regimes. It appears that the preferential tax treatment would also be given to intellectual property that was initially created outside the US. This would be contrary to the OECD Base Erosion and Profit Shifting (BEPS) Action 5 report with its modified nexus approach.

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Secretary of the Treasury
Mr. Steven Terner Mnuchin
Department of the Treasury
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Moreover, this measure would seem to result in an export subsidy since income from exports of intellectual property rights and goods would appear to be taxed less than income generated by domestic sales. The fact that the deduction would be contingent upon export performance could potentially make this subsidy prohibited by the WTO Agreement on Subsidies and Countervailing Measures.

Finally, as it currently stands the proposed excise tax (House bill) would risk violating WTO rules since it would not apply to comparable related party payments between domestic US companies. The excise tax could potentially breach the WTO General Agreement on Tariff and Trade (GATT 1994 on trade in goods) as well as the WTO General Agreement on Trade in Services (GATS).

The European Commission fully supports your efforts to ensure that any reform of the US tax code will be non-discriminatory and in line with the US international commitments, notably those of the WTO and existing double taxation treaties.

We are looking forward to continue our cooperation on ways to improve international taxation, notably through the G20 and OECD work strands, as well as bilaterally. We wish you well in this final phase of your important legislative work.

Yours sincerely,

Valdis DOMBROVSKIS

Jyrki KATAINEN

Cecilia MALMSTRÖM

Pierre MOSCOVICI

Copies to:

Senator Orrin Hatch, Chairman of the U.S. Senate Finance Committee, Chairman of the Joint Committee on Taxation

Congressman Kevin Brady, Chairman of the House Committee on Ways and Means, Vice-Chairman of the Joint Committee on Taxation

Senator Mike Crapo, Chairman of the U.S. Senate Committee on Banking, Housing, and Urban Affairs

Congressman Jeb Hensarling, Chairman of the House Financial Services Committee

Congressman Paul Ryan, Speaker of the U.S. House of Representatives

Senator Ron Wyden, Ranking Member of the U.S. Senate Finance Committee

Senator Sherrod Brown, Ranking Member of the U.S. Senate Committee on Banking, Housing, and Urban Affairs

Congressman Richard Neal, Ranking Member of the House Committee on Ways and Means

Congresswoman Maxine Waters, Ranking Member of the House Financial Services Committee

Gary Cohn, Director at the National Economic Council

Andrew J. Olmem, Deputy Director at the National Economic Council