Fiscal State Aid: the Kraken Wakes?

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Introduction

The international tax arena has become increasingly fraught, for multinationals in particular. The OECD's "BEPS" project is the most obvious example of this trend, encouraging the introduction of new restrictions and anti-avoidance measures in most major jurisdictions outside the US; see the next piece for a discussion of some of the more significant rules brought in by the UK. But I should like to use this article to examine a rather different challenge, the full extent of which is only beginning to be appreciated.

I refer to the burgeoning enthusiasm of the European Commission for the application of "state aid" principles to the tax legislation and tax rulings of EU Member States. The establishment of a Task Force on Tax Planning Practices in 2013 appears to have triggered a step change in enforcement, but it was only with the "Luxleaks" in late 2014 (see further below) that the issue really came to prominence. Under the energetic direction of Margrethe Vestager, the EU commissioner in charge of competition policy, the Commission has now challenged legislation or rulings in multiple Member States and has ordered tax authorities to recover many millions (or in one case billions) of euros' worth of back taxes from taxpayers who are said to have benefited from unlawful state aid. And while crossborder activity is not a necessary element of any state aid enquiry, in practice multinationals have been the target.

This is not in fact an entirely new development. Although Member States are meant to enjoy sovereignty over the design of their direct taxation systems, there have over the years been a few instances in which particular legislative features have fallen foul of the prohibition on state aid. But a trickle is threatening to turn into a flood. Taxpayers (and tax authorities) would certainly say that recent decisions of the Commission, and of the EU courts on appeal, are widening the ambit of state aid and encroaching on fiscal autonomy. The Commission has been accused of treating its state aid investigations as a tax policy tool – part of a coordinated EU wide response to perceived corporate tax avoidance – rather than a means of enforcing existing state aid rules. And to American eyes the more aggressive approach can look very like a tax grab by the EU.

Fiscal state aid also presents new challenges for advisers. They must have expertise in both big-ticket tax litigation and, of course, in the principles of state aid – usually the province of a competition lawyer. But detailed knowledge of the relevant domestic tax system is rather less important, indeed Slaughter and May is currently advising from London on a case that has no connection with UK tax.

Why is State Aid Relevant to Tax?

Article 107(1) of the Treaty on the Functioning of the European Union provides that "any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market".

Cash subsidies are an obvious example, but aid can also involve the state foregoing revenue to which it would otherwise be entitled, for example through tax exemptions and reliefs. A Member State's tax practices can fall foul of the state aid regime in a number of ways, most commonly through (a) legislative measures that favour particular economic sectors, categories of undertakings or regions, or (b) discretionary tax rulings that favour individual undertakings. Recent decisions and trends relating to these two forms of fiscal aid are discussed separately below.

Case law of the EU courts has established that there is unlawful state aid, including unlawful fiscal aid, if:

- an economic advantage is provided to an undertaking;
- it is provided by a Member State and financed through state resources;
- it is "selective" in favour of a particular undertaking or category of undertakings or in favour of a particular category of goods; and
- it distorts or threatens to distort competition and affects trade between Member States.

In cases of alleged state aid concerning legislative measures or rulings in the tax sphere, it is the selectivity and economic advantage requirements, respectively, that cause the most difficulty. The second and fourth elements tend to be uncontroversial. Legislative measures and tax rulings are, by definition, provided by the state and financed out of state resources (whether at national or local level); and if they are selective, they will invariably strengthen the position of one category over another with the potential to distort competition.

For cases involving discretionary rulings, the pertinent issue is often whether tax authorities have provided an individual undertaking with an advantage that diverges from the "normal" practice of the Member State, thereby providing an "economic advantage". In cases involving legislative measures such as tax reliefs, the measure clearly exists to convey some sort of economic advantage and the case typically turns on whether that advantage is "selective" in favour of any sufficiently clear and definable category of undertakings.

Investigations and Appeals Process

Member States are required to notify the Commission of any proposal to grant aid that may be incompatible with EU state aid rules, and to wait for the Commission's approval before putting any such proposal into effect. Notification triggers a preliminary investigation period during which the Commission has two months to determine whether the proposal constitutes state aid, and if so, whether the aid is nonetheless compatible with EU rules because its positive effects outweigh the distortion of competition. If serious doubts remain as to the compatibility of the measure, the Commission must open an in-depth investigation.

If the Commission becomes aware of aid having been granted without its prior approval, it will follow a similar investigation procedure and may issue a negative decision ordering the Member State to recover the unpaid amount, plus interest, from the beneficiaries of the aid. State aid can be recovered up to 10 years after it has been awarded, and this clock can be "paused" by certain acts taken by the Commission, such as requests for information.

A negative decision can be appealed by the Member State to which it is addressed or any interested person (such as a beneficiary of the aid) by application to the EU courts for annulment. An application can be made, for example, on grounds of error of law or manifest error of facts, and will be considered by the General Court (the court of first instance) and/or the Court of Justice ("CJEU") (the highest EU court). (Decisions of the General Court are denoted with the prefix "T-" and decisions of the CJEU are denoted with the prefix "C-", with the suffix "P" if they are appeals from the General Court.) However, applying for annulment of a Commission decision does not automatically release the Member State from its obligation to implement the recovery order. For the beneficiary company, therefore, the financial consequences of a negative Commission decision are potentially severe.

Tax Legislation as a Form of State Aid

As noted, investigations which concern legislative measures usually turn on whether the advantage granted by such legislation is "selective" in favour of any sufficiently clear and definable category of undertakings. In determining whether a particular legislative measure is "selective", the Commission generally applies a three-step test:

- First, it identifies the "system of reference". This is the "normal" tax position in the relevant Member State.
- Second, it determines whether the relevant measure "derogates" from the system of reference in favour of a certain category of undertakings or goods as compared to other undertakings or goods that are in a similar factual and legal situation. If a derogation exists, the Commission will draw the conclusion that the measure is *prima facie* selective.
- Third, it determines whether the derogation is nevertheless justified by the nature or general scheme of the system of reference. Only objectives inherent to the tax system (such as preventing fraud, tax evasion or double taxation) can be relied upon to justify a *prima facie* selective tax measure. Extrinsic objectives (such as maintaining employment) cannot form a basis for possible justification.

Special tax regimes

The obvious target would be a tax regime which encourages corporate taxpayers to establish themselves, or to carry on some specified activity, in a particular EU jurisdiction. Many Member States have introduced such regimes over the years in the name of tax competition.

One notable example is Belgium. It gave favourable treatment to "Belgian Coordination Centres" until a state aid challenge forced it to scrap the regime. It then brought in the "notional interest deduction", but that has been of limited value in an era of very low interest rates, and it also has an "excess profit" exemption.

The last of these could be seen as favouring (and designed to favour) Belgian companies that are part of multinational groups. The Commission announced in January 2016 that it regarded the exemption as providing a selective tax advantage that amounted to unlawful state aid. Belgium has therefore been told to recover the exempted tax from the groups concerned. In response, it has introduced retrospective legislation aimed at doing just that and this is now being challenged by the relevant taxpayers.

The UK has also been an enthusiastic tax competitor and, just as the finishing touches were being added to this article, the Commission announced that it was launching an in-depth investigation into an aspect of the UK's regime for taxing controlled foreign companies ("CFCs"). As part of a complete overhaul of this regime a few years ago, the UK brought in a "partial finance company exemption" which can effectively exempt from the CFC charge 75% of the interest paid to an offshore subsidiary by another member of the group, so long as the payer is also offshore. The Commission says it "has doubts" as to whether this exemption complies with state aid rules.

As an aside, I would note that escaping the prohibition on state aid is one of the benefits cited by fervent supporters of Brexit. Somehow I do not expect this particular example to loom large in their rhetoric.

GFKL

Competitive tax regimes may be the obvious target but it is becoming clear that the Commission believes the state aid principle has a broader remit in the tax sphere. The recent case of *GFKL* (T 620/11) suggests that it has the potential to catch legislative measures that are commonplace in many Member States.

GFKL concerns a state aid challenge to a provision of German law that was designed to support companies in financial difficulty. Under German law, losses incurred in previous tax years can be carried forward to future tax years (the "Carry Forward Rule"). To discourage loss-buying (the purchasing of loss-making companies to access their historic losses), German law also states that a lossmaking company will automatically forfeit its ability to carry forward fiscal losses if it is subject to a significant change in control (the "Forfeiture Rule"). However, there is an exception to the Forfeiture Rule to permit the acquisition and rescue of companies in financial difficulty. Losses can be carried forward in spite of a significant change of control if the company in question is in "distress" (the "Restructuring Clause").

In applying the three-stage test, the General Court identified the Carry Forward Rule, rather than the Forfeiture Rule, as the correct scheme of reference. It found that all companies which have undergone a change of control, whether in financial distress or not, are in a comparable factual and legal situation, but that the Restructuring Clause derogated from the system of reference in favour only of those companies in financial distress. The General Court also confirmed that supporting companies in financial difficulty was not an objective intrinsic to a tax system (it sought to achieve a different policy objective from that of merely ensuring the implementation of the tax system itself) and therefore did not justify the derogation.

GFKL is currently under appeal to the CJEU and will be of concern to Member States across the EU, many of which have tax measures in place designed to assist companies facing insolvency; the UK, for example, gives preferential treatment under its "loan relationship" (corporate debt) rules to companies in distress. It is also difficult to see how the Restructuring Clause can be described as "selective" when most, if not all, companies are clearly capable of being in financial distress.

The CJEU has never been sympathetic to that argument. It does not matter how broad the favoured category of undertakings or goods is: if a measure is not available to all types of business, it is likely to contravene state aid rules. Thus in the seminal case of *Adria-Wien*

Pipeline (C-143/99), the CJEU held that a rebate from energy taxes entailed selective aid to the entire manufacturing sector because it was available only to undertakings whose activity consisted primarily of the production of goods. Similarly in *Gibraltar* (C-106/09 P), it was held that a proposed new tax regime which favoured offshore companies was selective aid even though the offshore sector comprised over 99% of undertakings in Gibraltar.

Santander/World Duty Free

In fact, the CJEU has now confirmed that the state aid rules may apply even to those measures that are, in principle, open to all companies. This emerged from its decision at the end of 2016 in the joined cases of *Santander* (C-20/15 P) and *World Duty Free* (C-21/15 P). The cases concerned a Spanish tax provision which gave Spanish companies acquiring a shareholding of at least 5% of a non-Spanish company a tax deduction for amortisation of goodwill. No such tax relief was available for a Spanish company acquiring a shareholding in a local company. The General Court had found that the tax relief was not selective, and not therefore state aid, because it was not restricted to a particular category of business or the production of any particular category of goods, but was potentially available to all Spanish companies that wanted to acquire shareholdings of at least 5% in foreign companies.

The CJEU, however, overturned this decision and referred the case back to the General Court. It held that, in demonstrating the selectivity of a legislative measure, it was not necessary for the Commission to identify a particular category of undertakings that exclusively benefited from that measure. The relevant measure was "selective" simply by virtue of discriminating between undertakings which hold 5% of a foreign company and undertakings which hold 5% of a Spanish company, when those undertakings are otherwise in a comparable factual and legal situation. *Santander* and *World Duty Free* essentially merged the three-step analysis into one question: does the measure place the recipient in a more favourable position than entities in a comparable factual and legal situation in light of the general goals of the reference system? This in turn raises another important question: to what extent are different situations factually and legally "comparable"? On this question, both the Commission and the CJEU seem clear in their view that this is always a decision for the EU rather than individual Member States.

Tax Rulings as a Form of State Aid

While these challenges to tax legislation are perhaps the most concerning, at least from a UK perspective, it is the Commission's pursuit of tax rulings given by Member State tax authorities that has captured the headlines.

Tax rulings are common practice throughout the EU. They are effectively comfort letters which give the requesting companies clarity on how their tax liabilities will be calculated. Although not problematic in themselves, tax rulings can constitute unlawful state aid when they confer an economic advantage and are not approved by the Commission prior to being issued.

The "Luxleaks"

Tax rulings granted to major multinationals have been attracting considerable public and political attention in recent years, especially against the backdrop of constrained public budgets. The controversy was amplified by the leaking, on 5 November 2014, of several hundred tax rulings issued by the Luxembourg tax authorities in respect of over 300 companies. Since then the Commission has concluded several in-depth investigations, targeting tax rulings issued by Ireland (to Apple), the Netherlands (to Starbucks) and Luxembourg (to Fiat and, most recently, Amazon). The largest claim to date relates to Apple: in August 2016, the Commission ordered Ireland to recover up to €13 billion, plus interest, from Apple. Ireland has not done so and on 4 October 2017 the Commission referred it to the CJEU for failure to implement the recovery order.

Most of the Commission's tax ruling investigations have concerned transfer pricing arrangements. Thus in *Apple*, *Fiat*, *Starbucks* and *Amazon*, the Commission is contending that the rulings endorsed intra-group pricing that departed from the conditions that would have prevailed between independent operators; in other words, the Commission is saying that the pricing does not comply with the arm's-length principle. In its case law, the CJEU has held that if the method of taxation for intra-group transactions does not comply with the arm's-length principle, it provides an economic advantage to one company.

Of course national tax administrations have long taken an interest in multinationals' cross-border pricing arrangements, and in this respect there is an intriguing angle to the *Amazon* case. The Commission has told Luxembourg to reclaim €250m relating to what it says was an unlawful tax ruling given in 2003 (then confirmed in 2011) which concerned a royalty payable by a Luxembourg subsidiary. Meanwhile, the Internal Revenue Service ("IRS") has launched a conventional inquiry into the US end of the same arrangements; it lost at first instance but in September 2017 it filed an appeal. The IRS is claiming more than four times as much as the Commission has said should be repaid by Amazon to Luxembourg. But the media is more focused on Margrethe Vestager's perceived crusade against US-headed multinationals, so to date it is the Commission's demand that has made the news.

McDonald's and *Engie*

The Commission's two most recent investigations are of particular interest because they imply a broadening of the Commission's enforcement efforts in the area of tax rulings, similar to that seen with legislative measures.

On 3 December 2015, the Commission opened a formal investigation into two tax rulings given by Luxembourg to McDonald's. It considered that one of them constituted unlawful state aid because it exempted the US branch of McDonald's Luxembourg subsidiary from local tax under the US/Luxembourg double tax treaty, despite such profits also being exempt from US tax under US law. The profits were derived from royalties paid by European franchisee restaurants to the Luxembourg subsidiary for the right to use the McDonald's brand and associated services. They were then transferred internally to Luxco's US branch.

This is the first time the Commission has challenged a Member State's application of a double tax treaty under the state aid rules.

A key issue will be whether McDonald's economic advantage arose out of a unilateral act of Luxembourg (thus constituting state aid), or was the result of a disparity between the Luxembourg and US tax regimes.

Then on 19 September 2016, the Commission launched an investigation into tax rulings given by Luxembourg to Engie (formerly GDF Suez) in respect of certain intercompany zero-interest convertible loans. According to the Commission, the rulings treated the convertible loans inconsistently, as both debt and equity, which gave rise to double non-taxation and hence an economic advantage that was not available to other groups subject to the same national taxation rules in Luxembourg. The rulings allowed the borrowers to make provision in their accounts for interest payments (without actually paying any interest) and to deduct such imputed amounts as expenses, while at the same time lenders could avoid tax on their profits because income on equity investments (which the loans would convert into) was exempt from taxation under Luxembourg law.

The Commission claimed that the Luxembourg tax authority "failed to invoke established accounting principles", yet there seems little doubt that, in fact, the accounting used by debtor and creditor complied fully with the applicable principles.

The *McDonald's* and *Engie* investigations are a reminder that state aid enquiries are not limited to rulings on transfer pricing. Affected areas could include, for example, rulings on the qualification of hybrid entities (transparent or opaque), hybrid instruments (debt or equity, as in *Engie*), and other perceived "mismatch" arrangements. Rulings are more likely to be challenged if they involve some sort of factual determination by the tax authorities and especially if they concern structures with potential for what the tax world now knows as base erosion and profit shifting.

Significantly, in *Engie*, the Commission also suggested that a Member State could contravene state aid rules without making a tax ruling at all: it was enough in that case that Luxembourg failed to challenge the relevant transactions under its general anti-abuse rule ("GAAR"). It remains to be seen whether the Commission will pursue, or indeed the CJEU will accept, the proposition that merely accepting a company's tax return could amount to unlawful state aid. The charge of "selectivity" is also surprising given that, at the time, Luxembourg had only invoked its GAAR once in the 60 or more years since its introduction.

Conclusion

The application of the EU state aid regime to tax is a rapidly developing area and many unknowns remain. There is a clear trend, however, towards greater European interference in the tax regimes of Member States and this warrants close scrutiny. The Commission has expanded the application of state aid rules to encompass tax legislation that is, in principle, open to all companies. It is also moving beyond the focus on transfer pricing, with challenges to tax rulings that have been relied on for intra-group financing (*Engie*) and the structuring of IP holdings (*McDonald's*).

Implications

All seven of the Commission's investigations into tax rulings commenced in the last four years, so it is unlikely that the risk of a state aid challenge was fully evaluated when relevant transactions were entered into. Multinationals in particular will be taking another look at historic tax rulings and, alongside BEPS, the state aid regime will be an important factor in determining their future arrangements. It is perhaps noteworthy that Apple, Amazon, Apple, Fiat and McDonald's have all built up their operations in the UK since investigations began. In 2014, Starbucks moved its European head office from Amsterdam to London and Fiat merged into Fiat Chrysler, with headquarters in the UK. Amazon and Apple have both unveiled plans for new offices in London and, in late 2016, McDonald's announced that it was unwinding its Luxembourg tax structure and returning its European royalties business to the UK.

Legitimacy

There is also a fundamental question of tax policy and fairness here. The Commission's state aid investigations are taking place in the context of a global push against perceived corporate tax avoidance by multinationals; many commentators argue that, at least in some instances, multinationals are not paying enough taxes and are exploiting mismatches between national tax laws to lower their tax bill. I would query, however, whether state aid is an appropriate tool for dealing with such mismatches.

There are several obvious objections. Seeking retroactive recovery of unpaid taxes strikes a serious blow to the principle of certainty in law. Moreover, it is not clear why the Commission should be intervening in the allocation of multinationals' profits between countries, when the countries themselves are not. For example, neither Ireland nor the US welcomed the *Apple* investigation. The US government has made no secret of its opposition to the decision and, despite the prospect of a €13 billion windfall, Ireland is appealing the Commission's recovery order. The Irish government recognises that Ireland's allure for foreign investors is based to a significant extent on a tax system that is both competitive and predictable and, to quote the then Irish Finance Minister, "to do anything else [but appeal] would be like eating the seed potatoes".

For maximum legitimacy, reform in this area should be transparent and forward-looking, and come through consensus-building at the international level. That is of course exactly what the BEPS project seeks to achieve.

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