SLAUGHTER AND MAY

Fiscal State Aid - some limits emerging at last?

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In my introductory chapter last year ("*Fiscal State Aid: the Kraken Wakes?*"), I wrote about a slumbering monster whose existence had barely been detected for many years but was now threatening to wreak havoc on well-established tax practices and principles. The threat is becoming ever more apparent, especially in Germany and the UK, but the monster is also beginning to encounter real resistance. Here, then, is "*Fiscal State Aid: Part II*".

Although the UK's Brexiteers have shown no interest in the subject, this is one imposition that can definitely be sourced to the EU, and specifically the European Commission. The prohibition on State Aid is contained in the main EU Treaty and is an understandable adjunct to the single market, designed to prevent Member States favouring domestic businesses (or inward/outward investment more generally). But in the past few years the Commission has shown that legislation and rulings in the tax sphere may be vulnerable in a way that would once have been unimaginable.

Nor in fact can Brexit be relied upon to provide an answer, even for UK corporates. The UK government has said that it will replicate the EU's State Aid rules after Brexit –though it would be a considerable constitutional novelty for any court or independent body to have a specific remit to strike down legislation, given the sovereignty of Parliament.

As I noted last year, the Commission's activism has led to criticism that its investigations have become a tax policy tool - part of a coordinated EU wide response to perceived corporate tax avoidance - and are straying a long way from the original purpose of the Treaty prohibition. Moreover, there is a significant transatlantic dimension: where the Commission has targeted tax rulings, the taxpayers have more often than not been US multinationals. To American eyes the more aggressive approach can look very much like a tax grab by the EU and Margrethe Vestager, the energetic EU Commissioner in charge of competition policy, was recently dubbed the "tax lady" by US President Trump.

As I also noted, fiscal State Aid presents new challenges for advisers too. 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. By contrast, detailed knowledge of the relevant domestic tax system is rather less important. Thus, while Slaughter and May has acted for a global financial services company on a State Aid dispute before the High Court in the UK and is advising several UK groups on the Commission's potential challenge to the UK's CFC rules (discussed below), we are also advising a multinational on a Commission investigation into alleged State Aid granted by the Luxembourg tax authority.

For those impatient to know what form the incipient resistance is taking, I have three developments in mind. They are all discussed in detail below but could be summarised as follows: (i) a reversal by the CJEU of the General Court's decision in the *Heitkamp* case, which concerns a perfectly inoffensive German rule intended to help companies in financial distress; (ii) an acknowledgment from the Commission that a ruling given to McDonald's by the Luxembourg fisc did not constitute State Aid merely because it produced

a surprisingly good result for the taxpayer; and (iii) in a case called *A-Brauerei*, trenchant criticism from an Advocate General of the Commission's whole approach when challenging tax legislation.
The CJEU judgment came out at the end of June 2018 and the other two developments date to September 2018. Is it too much to hope that the tide is finally turning?

Why is State Aid Relevant to Tax?

The EU does not have competence with regards to direct tax matters; Member States are supposed to have full sovereignty over the design of their direct taxation systems. However, it has long been recognised that the prohibition on State Aid could in principle catch discriminatory tax measures and there were a few instances in past years where particular legislative features fell foul of it.
The prohibition was previously set out in Article 87 of the EC Treaty and now appears in Article 107(1) of the Treaty on the Functioning of the European Union ("TFEU"). This is worded as follows:

> "Save as otherwise provided in the Treaties, 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 breach 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 broken down the Treaty rule into the following four elements:

- Is an economic advantage provided to an undertaking?
- Is it provided by a Member State and financed through state resources?
- Is it "selective" in favour of a particular undertaking or category of undertakings or in favour of a particular category of goods?
- Does it distort or threaten to distort competition and affects trade between Member States?

In cases of alleged State Aid concerning legislative measures or rulings in the tax sphere, the second and fourth elements are usually 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); if they are selective, they will invariably strengthen the position of one category over another with the potential to distort competition.

Thus the focus is on "economic advantage" and "selectivity". More particularly, 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 given; 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 taxpayer in receipt 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.)

The financial consequences of a negative Commission decision are potentially severe for the company said to have received the aid. Indeed, applying for annulment of a Commission decision does not automatically release the relevant Member State from its obligation to implement the recovery order; thus following a challenge from the Commission to a tax ruling issued by Ireland, in September 2018 Apple paid €14.3bn into an escrow account established by Ireland even though conclusion of the appeal is doubtless some way off. The *Apple* case is discussed briefly below.

This example illustrates an unusual feature of State Aid challenges more generally. The Member State in question will be the immediate target of the challenge and will in most cases lead the appeal. Yet if the appeal fails, the Member State will also be the immediate beneficiary as it will receive any payment then required from the relevant taxpayer(s).

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.

The standard approach

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.

Another perspective: AG's opinion in *A-Brauerei*

Pausing here for a moment, an Advocate General has very recently delivered an opinion which questions whether this is in fact the right approach at all. In *A-Brauerei* (Case C-374/17), a German court has requested a ruling on an exemption from land transfer tax (RETT) where the "transfer" occurs on the merger of the "transferor" into the "transferee" and the two companies are part of the same group.

The Commission of course takes the view that the exemption constitutes unlawful State Aid. It argues that the "reference system" is the German rule which, in principle, imposes a transfer tax on any transaction which results in a transfer of ownership of German real estate (including, it seems, on a straight intra-group transfer with no merger). On that basis, the exemption is a derogation and, says the Commission, selectivity is established.

This does seem an extreme position and the Danish Advocate General (Saugmandsgaard Øe) clearly has no sympathy for it whatsoever, even on the "reference system" approach. The specifics of the case are, however, less interesting than the wider observations made by the AG, expressed in notably forthright terms.

"Reference framework" method or "general availability" test?

Right at the start of his opinion, the AG makes the following claim: "the case-law of the Court on the issue of material selectivity is characterised by the co-existence of two methods of analysis, in particular in tax matters". Those are, he says, the "reference framework" method and what he calls "the traditional method of analysis … based on the general availability test".

The crucial distinction is that under the latter, there is no selectivity if any undertaking *could* avail itself of the relevant rule, subject to satisfying some basic criteria; putting this another way, a measure is only selective if the criteria "irrevocably exclude certain undertakings or the production of certain goods from the benefit of the advantage concerned". By contrast, the AG believes that the reference framework method "tends to turn the rules on State Aid into a *general discrimination* test, covering any criterion of discrimination" (his emphasis).

I will not attempt here to determine the correctness or otherwise of the AG's assertions in *A-Brauerei*. There is definitely merit in focusing on the nature of any conditions to the availability of the relevant advantage, though one cannot simply target any condition that is discriminatory on grounds of nationality, residence or jurisdiction as that is of course policed by a quite different set of EU principles, *viz* the "four freedoms". Nor am I convinced that the AG's approach would solve the problems posed by the application of State Aid principles in the tax sphere.

That said, his criticisms of the way in which these principles are being applied are certainly well made. He considers that the Commission's efforts should be "refocused on the measures which are the most damaging to competition within the internal market, namely individual aid and sectoral aid"; the Commission should <u>not</u> have "the power to 'smooth out' the national tax systems by requiring the removal of those differentiations legitimately established for social, economic, environmental or other reasons". He also detects unhappiness in the opinions of other Advocates General, citing Advocate General Wahl's – clearly correct – observations in the *Heitkamp* case (discussed below) to the effect that the identification of the reference framework is a major source of legal uncertainty, as well as comments from Advocate General Kokott in *ANGED* (2017).

<u>Special tax regimes</u>

Returning to the wider picture, one obvious target for challenges based on fiscal State Aid 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.

Belgium is a notable example. 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 introduced retrospective legislation aimed at doing just that and this is being challenged by the taxpayers affected.

<u>UK CFC rules</u>

The UK is another enthusiastic tax competitor. It too has amended its most obviously competitive offering – its version of the "patent box" concept – in the face of a potential challenge. But it may not have anticipated the attack which is now causing consternation for many UK multinationals.
In October 2017, the Commission announced that it was launching an in-depth investigation into certain aspects of the UK's regime for taxing controlled foreign companies ("CFCs"); a month later it released its preliminary decision to the effect that the rules are defective.

Some context will be helpful here. Around ten years ago, the UK moved from a system of taxing the worldwide profits of UK companies to a "territorial" regime which can, in principle, exclude non-UK profits. Then in 2012/13 the CFC rules were completely overhauled, in a manner consistent with that fundamental switch: the general idea is that profits earned by offshore subsidiaries should be caught only if they have been artificially diverted from the UK.

Non-trading (passive) income is of course a target for many CFC regimes because it can so easily be shifted from one jurisdiction to another. The UK's rules catch non-trading finance profits for this reason; the relevant legislation is in Chapter 5 of Part 9A of the Taxation (International and Other Provisions) Act 2010 ("TIOPA"). However, Chapter 5 is subject to a number of exemptions that are set out in Chapter 9 of Part 9A.

Exemptions for "non-trading finance profits"

First, Chapter 5 does not apply at all if the UK parent can show that the CFC is funded entirely from an external issue of equity capital by the group or from profits generated by members of the group in the same jurisdiction as the CFC (the "qualifying resources" exemption), or that the group does not have net interest expense in the UK (the "matched interest" exemption and together, the "full exemptions"). Second, in the event that neither of the full exemptions is available, 75% of the CFC's non-trading finance income is exempt so long as the group borrowers are themselves outside the UK too (the "partial exemption").

The UK's justification for the partial exemption is that UK funding for a CFC is likely to be provided wholly in the form of equity – a phenomenon sometimes called "fat capitalisation", as it is the reverse of the more familiar "thin capitalisation" – whereas for a UK multinational the typical mix of equity to debt would be in the region of 3:1. To give a simple illustration: UK parentco raises funding of 100, comprising 75 of equity and 25 of debt; parentco puts the 100 into a CFC subsidiary as equity; and CFC then lends the 100 to a non-UK opco in the group. The idea is that there should be a CFC charge to cancel out interest deductions on the 25 that is indirectly financing the opco's non-UK activity.

Are the exemptions selective?

As usual where legislation is under attack, selectivity is the critical issue. Pursuing the three-step approach outlined above, the Commission has taken the view that (i) the relevant "reference system" here is the CFC regime (or possibly just "the specific provisions within the CFC regime determining artificial diversion for (deemed) non-trading finance profits" – a formulation that the UK would be happy with if the Commission did not then exclude Chapter 9), (ii) the exemptions in Chapter 9 represent a derogation from them, and (iii) the derogation cannot be justified.

It is true that Chapters 5 and 9 of Part 9A TIOPA protect only the UK tax base, leaving a UK-headed multinational free to use debt funding from subsidiaries in low-tax jurisdictions to finance non-UK members of the group. However, this is a natural concomitant of a territorial tax system which aims to tax offshore profits only where they have been artificially diverted from the parent jurisdiction. Indeed, the UK would say – with considerable justification – that the whole purpose of the two chapters taken together is to identify non-trading finance profits of this kind. So the reference system should be looked at more broadly, rather as the CJEU has done in the *Heitkamp* case considered below: in principle non-UK profits are outside the UK tax net, Chapters 5 and 9 taken together set certain limits on the principle (to catch profits which as a matter of economic reality have been shifted out of the UK) but there is no "derogation" and therefore no selectivity.

The Commission's preliminary decision makes much of the fact that Chapters 5 and 9 do not identify with scientific precision which profits have or have not been artificially diverted out of the UK. But this seems an unreasonable demand, especially in an area (cross-border taxation) where it is notoriously difficult to produce the perfect system. There will inevitably be rough edges, partly (as the UK has argued) for reasons of clarity and practicality for taxpayers and tax authority alike. To expect otherwise is, one might well say, another form of the "smoothing out" decried by Advocate General Saugmandsgaard Øe in *A-Brauerei*, discussed above.

Freedom of establishment

Another surprising feature of the Commission's investigation is that it pays no heed whatsoever to the CJEU's case law on freedom of establishment for CFCs, notably the seminal *Cadbury Schweppes* judgment from 2006. The CJEU has been very clear that companies can be set up in particular European jurisdictions merely to take advantage of lower tax rates and in *Cadbury Schweppes* it held that CFC rules can only be justified to the extent that they target "wholly artificial arrangements" that do not reflect economic reality. By that measure, far from being too liberal as the State Aid challenge might suggest, the UK's regime is (still) too restrictive. (One might say this encapsulates a basic difference between State Aid and the four freedoms: State Aid focuses on <u>positive</u> discrimination – the Commission is presumably saying that the specified non-trading finance profits of CFCs are given favourable treatment and instead should always trigger a full CFC charge − whereas the freedoms focus target <u>negative</u> discrimination, so UK multinationals would say that even taxing just 25% of relevant profits is a restriction on freedom of establishment.) This makes the State Aid/CFC issue unusually complex – and awkward for both taxpayers and HMRC.

It is to be hoped that the Commission will row back when it releases its final decision late this year or early next, perhaps citing the CJEU's reversal of the General Court in *Heitkamp* (see, again, the discussion below). It really does not seem appropriate to use the blunt tool of State Aid to undermine a set of rules which make sense in the context of the UK's wider regime for levying tax on company profits. To the extent these could be said to favour one set of undertakings over another, they do so by supporting the UK's territorial system. One reason for adopting this system may indeed have been to encourage major corporate groups to establish themselves (or, at least, to remain) in the UK. But that is a species of "tax competition" which is surely outside the ambit of State Aid.

<u>*Heitkamp* – an important defeat for the Commission?</u>

Competitive tax regimes may be the obvious target but it has become clear that the Commission believes the State Aid principle has an even broader remit in the tax sphere. Cases such as *Heitkamp* (C 203/16 P, heard together with an appeal on similar facts by a company called GFKL) suggest that, in the Commission's view at least, it has the potential to catch legislative measures that are commonplace in many Member States.

Heitkamp concerns a State Aid challenge to a provision of German law that is designed to support companies in financial difficulty. 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 financial distress (the “Restructuring Clause”).

In applying the three-stage test, the General Court identified the Forfeiture Rule as the correct system of reference, to the exclusion of the Carry Forward Rule. 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 the relevant 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.

Another critical Advocate General

When Advocate General Wahl delivered his opinion in *Heitkamp* in December 2017, he agreed with much of what the General Court had said. However, he disagreed with its identification of the system of reference.

The AG began his discussion of this crucial issue with some entertainingly direct remarks. He observed that in cases such as *World Duty Free* (considered below), the CJEU had said the reference system is the common or “normal” tax regime applicable in the Member State concerned. However: “As a criterion of assessment that statement is remarkably unhelpful”.

Mindful perhaps of *lèse-majesté*, the AG then made it clear that he did not blame the CJEU for failing to give useful guidance. In the case of positive benefits of the sort primarily targeted by the State Aid regime (for example a straight subsidy), it is usually easy enough to identify the “normal situation”. That is not so in the tax sphere and, according to the AG, even the Commission struggles to produce a coherent rationale: apparently “the Commission was unable to explain on what basis it determines the reference system”.

The AG did however detect in the case law a principle of sorts: “a broad approach is to be favoured in determining the reference system”, indeed the approach should be one which “takes into account all relevant legislative provisions as a whole, or the broadest possible reference point”; and in support of this he cited again the CJEU’s judgment in *World Duty Free*, where “the relevant benchmark was not the rules governing investments abroad, but rather the Spanish corporate tax system as a whole”.
Pursuing this approach, the AG concluded that the Commission and the General Court had been wrong to exclude the Carry Forward Rule from the correct system of reference; and once that error is rectified, the Restructuring Clause “becomes an intrinsic part of the reference system itself” rather than “an obvious derogation from it” – it puts the taxpayer back in the position of being able to carry forward losses, notwithstanding the change in its ownership.

Confirmation from the CJEU

The CJEU endorsed the AG's conclusion: the Commission and the General Court had erred in their analysis of selectivity by choosing the wrong system of reference. That system could not consist of "provisions that have been artificially taken from a broader legislative framework". In focusing solely on the Forfeiture Rule as the reference system and excluding the Carry Forward Rule, "manifestly the General Court defined [the framework] too narrowly".

It would be wrong, though, to give the impression that *Heitkamp* contains nothing but good news. Thus the Advocate General seemed content that a strict approach should be taken to justification, the last step in the standard three-step method of determining selectivity; indeed he noted that "to my knowledge, the Court has yet to accept the reasons relied upon by Member States under the third step of the assessment of selectivity". And it would have been more reassuring if – in line with the "general availability" test favoured by the Advocate General in *A-Brauerei* –the AG and the CJEU had been able to say simply that the Restructuring Clause was a "general" measure, not a "selective" one, because any company could find itself in financial distress. Many Member States 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.

Santander/World Duty Free

Certainly, the CJEU does not like beneficial tax regimes which, while arguably open to any undertaking in the relevant jurisdiction, are available only if another party is or is not based in the same jurisdiction. This is clear from a few cases involving Spanish legislation.

At the end of 2016, the CJEU delivered judgment in *Santander* (C-20/15 P) and *World Duty Free* (C-21/15 P). These concerned a 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 overturned this decision and referred the cases back to the General Court. 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.

Then in July 2018, in the "Spanish tax lease system" case (C-128/16 P, concerning a tax benefit available when buying ships constructed by Spanish shipyards), the CJEU again sided with the Commission and against the General Court, which it said had (*inter alia*) repeated its error from the earlier cases.

It has been observed that *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"? The question is not easily answered but on one point the Commission and the CJEU leave little room for doubt: this is always a matter for the EU rather than individual Member States.

Regulatory Capital

The Commission has now opened another front in its State Aid campaign. In January 2018, it sent a letter to The Netherlands querying the special tax treatment of "contingent convertibles" designed to constitute capital for regulatory purposes while preserving the issuer's ability to deduct the coupons. The argument is that this provides State Aid to Dutch banks and insurers, because ordinary corporates cannot get the same treatment.

The challenge was not made public at the time, but could be divined from the subsequent reaction of the Dutch government when in late June it put forward a proposal to abolish deductibility on these "AT1" and "RT1" instruments with effect from 1 January 2019. Publication of the 2019 Finance Bill three months later confirmed the proposal and made it quite clear that there would be no grandfathering for existing instruments.

This development has caused dismay in other Member States, such as the UK, which have similar rules. Banks and insurers would no doubt say that if it were not for regulatory capital requirements that do not apply to any other sector, they would issue normal debt and so be entitled to the deductions anyway. Are they then in a "comparable legal and factual situation"?

Of course the Dutch response is not the only possible one for governments that do not want to litigate. Member States could take the view that – with interest deductibility now heavily constrained by various BEPS-related rules anyway – the ability to issue hybrid instruments carrying deductible interest could be extended to all corporates.

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 tight 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 *inter alia* tax rulings issued by Ireland (to Apple), the Netherlands (to

Starbucks) and Luxembourg (to Fiat and Amazon); and it has recently opened a new investigation targeting another ruling given by the Netherlands (to IKEA).

The most eye-watering claim relates to Apple: in August 2016, the Commission ordered Ireland to recover around €13bn, plus interest. In October 2017, the Commission referred Ireland to the CJEU for failing to do so and Ireland has now collected €14.3bn from Apple which is to be held in an escrow account pending the outcome of the appeal.

Rulings on Transfer Pricing

The main focus of these investigations has been the transfer pricing endorsed by the rulings. Thus the Commission contends that they allowed for intra-group pricing that departed from the conditions that would have prevailed between independent operators; in other words, the pricing does not comply with the arm's-length principle.

One of Apple's arguments is that, in its case at least, this is not a relevant question: it says that the arm's-length principle as developed by the OECD was not part of Irish law and therefore Ireland's ruling could not have provided a selective advantage. In response, the Commission claims that the arm's length principle is inherently part of Article 107(1) of the Treaty. The Commission's approach to this principle also features in the *Fiat* and *Starbucks* cases and since these were heard by the CJEU in late June 2018, we could, before long, have substantive judicial guidance.

Of course, national tax administrations have, for many years 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; Amazon is appealing against this decision, seeking to have it annulled on the basis of flawed selectivity analysis and citing the principles of legal certainty and sound administration. Meanwhile, the Internal Revenue Service 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.

Tax mismatches

Two other noteworthy investigations concern rulings given by the Luxembourg fisc to McDonald's and ENGIE (previously GDF Suez). Each of them could be seen as an attempt by the Commission to broaden its attack on tax rulings, though one has now been abandoned.

McDonald's

The Commission opened a formal investigation in December 2015 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, and were then transferred internally to Luxco's US branch.

However, on 19 September 2018 the Commission announced that it would end the investigation. It accepted that the double non-taxation resulted from a mismatch between the national laws of

Luxembourg and the US, as applied by the Luxembourg/US tax treaty; Luxembourg was not giving McDonald's special treatment - any company could have taken advantage of the tax treaty in the same way –and therefore there was no State Aid.

A week later, in a wide-ranging speech on competition policy at Georgetown Law School in Washington DC, Commissioner Vestager confirmed the thinking. The Commission didn't like the tax result, but couldn't formally challenge it: "That doesn't mean that nothing was wrong. … But competition enforcers can't intervene just because something's not right. We act if - and only if - it turns out that a company or government has broken the rules." And the pressure has not been in vain: Luxembourg has said it will change underlying domestic law in a way that prevents a similar arrangement in future.

ENGIE

Meanwhile, the ENGIE dispute rumbles on. The Commission launched its investigation in September 2016, targeting tax rulings given by Luxembourg to ENGIE in respect of certain intercompany zero-interest convertible loans. It claimed that 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 tax rules in Luxembourg. The rulings allowed the borrowers to make claim deductions for interest that accrued but was not paid, while the conversion feature meant the lenders treated the loans as equity and (as in many other jurisdictions) equity returns were exempt from taxation under Luxembourg law.

The Commission has said that the Luxembourg fisc "failed to invoke established accounting principles", though there seems little doubt that the accounting used by debtor and creditor complied fully with the applicable principles; and it claimed that the fisc could be providing State Aid merely by failing to challenge the relevant transactions under its general anti-abuse rule - unabashed by the fact that, at the time, Luxembourg had only invoked its GAAR once in the 60 or more years since its introduction.

Then in June 2018, the Commission released its conclusion: the rulings artificially lowered ENGIE's tax burden without valid justification, so Luxembourg must recover tax of €120m.

The *McDonald's* and ENGIE investigations are a reminder that State Aid enquiries into tax rulings are not limited to 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.

Conclusion

The application of the EU State Aid regime to tax rulings and legislation is making waves as never before. Where these are simply subsidies in disguise, they are a legitimate target. But the European Commission appears to be on a crusade to introduce a degree of tax harmonisation that is at odds with the preservation of direct tax as a matter within the competence of Member States.

There are obvious, and in my view well-founded, objections to the way in which State Aid principles are being applied in the tax sphere.

Seeking retroactive recovery of unpaid taxes strikes a serious blow to the principle of certainty in law. This is perhaps particularly acute in the case of the Commission's investigations into tax rulings. All nine of these commenced in the last five years, so it is unlikely that the risk of a State Aid challenge was evaluated when relevant transactions were entered into.

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 €14bn windfall, Ireland has appealed 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".

Challenges to tax legislation are bedevilled by another sort of uncertainty. They revolve around the question of "selectivity" and, within that, the determination of the appropriate "reference system". Yet in a tax context that determination can seem, at best, an exercise in arcane distinctions worthy of a scholastic philosopher and at worst, little better than a lottery: the opinions given in the *Heitkamp* case and, most recently, *A-Brauerei* make remarkable reading and it is striking how often the General Court has been reversed by the CJEU.

It is also unsatisfactory that selectivity can never in practice be justified; we need a change in judicial approach comparable to the CJEU's belated recognition of the "balanced allocation of taxing powers" as a justification for tax rules that restrict the four freedoms.

As I noted at the start of this piece, the first signs of a rethink may be beginning to appear. It cannot come soon enough.

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