Fiscal State Aid: is there Method in the Madness?

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In my introductory chapters for the past couple of years ("*Fiscal State Aid: the Kraken Wakes*" and *Fiscal State Aid: Some limits Emerging at Last?*"), I have focused on the alarming unpredictability for taxpayers and tax authorities alike of the fearsome weapon that is fiscal State Aid. It has at times seemed uncontrollable, threatening to wreak havoc on well-established tax practices and principles. But with a lot of squinting it is perhaps possible to discern a thread of rationality at the heart of it and this year I should like to look anew at fiscal State Aid with this in mind.

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 recent 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, unless perhaps it is on "no deal" terms. The UK government has said that it will replicate the EU's State Aid rules after Brexit, with an independent decision-maker to ensure compliance − 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.

The scourge of multinationals

As I have noted in previous years, 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. Indeed Margrethe Vestager, the energetic EU Commissioner who is about to start her second five-year stint in charge of competition policy, can seem to be on something of a crusade against the tax (and other) practices of multinationals. A statement she released in September 2019 following decisions of the General Court in *Fiat* and *Starbucks* began as follows: "*All companies, big and small, should pay their fair share of tax. If Member States give certain multinational companies tax advantages not available to their rivals, this harms fair competition in the EU. It deprives the public purse and EU taxpayers of much needed funds to fight climate change, to build infrastructure, to invest in innovation.*"

There is a significant transatlantic dimension too: where the Commission has targeted tax rulings, the taxpayers have as often as not been US groups. To American eyes this can look rather like a tax grab by the EU and the issue even engaged the attention of President Trump, who dubbed Margrethe Vestager the "tax lady".

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. 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 assisted several UK groups with applications to the General Court to annul the Commission's decision regarding 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.

Convoluted cases but a discernible principle?

The next section of this article sets out the criteria for determining the existence of fiscal State Aid and it will become apparent in subsequent sections that in my view the practical application of those criteria is a matter of considerable obscurity.But I should disclose upfront the thread of rationality that I believe may run through the cases. The European courts would very likely deny this but, as will be discussed below under the heading "A Proposed Rationale: Deliberate Market Distortion", one way to distinguish the cases is to ask whether the legislation was passed or the ruling made with an intent to distort competition. If it was, you can expect the courts to strike it down.

Principles and Procedure

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.

Article 107(1) TFEU

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.

Application to Tax

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 or 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 affect trade between Member States?

A Member State's tax practices can breach the State Aid regime in two main ways: (a) through legislative measures that favour particular economic sectors, categories of undertakings or regions, thus constituting an "aid scheme"; or (b) in the form of discretionary tax rulings that favour individual undertakings ("individual aid").

In cases of alleged fiscal State Aid, the second and fourth elements in the list above are usually uncontroversial. Legislative tax measures and tax rulings are, by definition, provided by the state or financed out of state resources (whether at national or local level); and if they are selective, they will necessarily strengthen the position of one category over another and are likely to have 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 a benefit 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.

Clearance

Member States are meant 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. (In practice, it appears unlikely that the Commission would find fiscal State Aid to be compatible.) If serious doubts remain as to the compatibility of the measure, the Commission must open an in-depth investigation.

Investigations, Decisions and Appeals

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 alleged aid), by application to the EU courts for "annulment". An application can be made, for example, on grounds of error of law or manifest factual error, 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. This was shown most graphically in the *Apple* case: following a challenge made by the Commission in 2016 to a tax ruling issued by Ireland many years earlier, and after initially stiff resistance, Apple and Ireland were forced to accept that the alleged aid did indeed have to be repaid pending the eventual outcome of their appeals. Apple then paid €14.3bn into an escrow account established by Ireland. The *Apple* case is discussed further below, under "Rulings on Transfer Pricing".

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 Test

In determining whether a particular legislative measure is "selective", the Commission generally applies a three-step test (the "Selectivity Test"):

- First, it identifies the "system of reference" or "reference framework". 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.

Competitive Tax Regimes

The obvious target for a challenge based on fiscal State Aid is 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's "excess profits" regime

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.

Belgium's most recent invention is a replacement for the Coordination Centre concept in the form of a special exemption for "excess profits". This could be loosely described as a reverse transfer pricing rule: if a Belgian member of a multinational made more profit than it would have done as a standalone company, the "excess" was exempt from Belgian tax.

In theory the idea was that a non-Belgian member of the relevant group, sitting at the other end of the transaction or transactions that gave rise to the supposed excess, would have made less profit than it should have done and would be taxed in its jurisdiction on an equivalent amount. But there was no requirement for the group to establish that this was in fact happening and doubtless in reality it wasn't. One might also assume that the method to be used to determine the arm's length pricing of the transactions was not calculated to maximise the hypothetical standalone profitability of the Belgian member of the group. Finally, the exemption could only be claimed on the basis of a clearance from the Belgian fisc and, while this was not it seems an express requirement in the legislation, in practice clearance was only given for newly established arrangements.

Thus the excess profits exemption could fairly be painted as a regime designed to encourage multinationals to add a Belgian member to the group and price intra-group transactions so as to maximise actual profit – and thus also the exempted profit – in that company. In short, a thinly disguised competitive tax regime.

Challenges from the Commission

The Commission announced in January 2016 that it regarded the exemption as providing a selective tax advantage that amounted to unlawful State Aid, and told Belgium to recover the exempted tax from the groups concerned. Belgium effectively conceded defeat by introducing retrospective legislation aimed at doing just that.

Despite this unpromising backdrop, the Commission decision was successfully challenged by affected taxpayers. In February 2019, the General Court found that the Commission had erred in identifying Belgium's "excess profit" system as an unlawful "aid scheme" because the Belgian tax authorities maintained (and did in practice exercise) a margin of discretion over the operation of the system and further "implementing measures" – the provision of clearance and agreement as to the hypothetical standalone profit – were required before taxpayers could benefit from the regime.

However, that is not the end of the story. The General Court did not endorse the taxpayers' arguments on the substantive issues and the Commission has renewed the attack. In September 2019, it announced that it was opening in-depth investigations into the tax rulings given to 39 multinational companies. Rather than characterising the Belgium system as an aid scheme, the Commission is now looking to assess the compatibility of each tax ruling on an individual basis.

This is hardly an efficient way to proceed from anyone's perspective, but the Commission can I think have high hopes of ultimate success.

Santander/World Duty Free

The CJEU has already shown that it 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 long-running saga involving some Spanish legislation.

The CJEU delivered judgment in *Santander* (C-20/15 P) and *World Duty Free* (C-21/15 P) at the end of 2016. The cases 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 (unless it also merged with that company, which in turn required a controlling stake rather than a mere 5% holding). Although Spanish companies in the second camp may not have minded, acquisitive companies in other jurisdictions objected to what they saw as an unfair advantage for Spanish acquirers.

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; rather, it was potentially available to all Spanish 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 acquire 5% of a foreign company and undertakings which acquire 5% of a Spanish company. In other words, it was enough to show unjustified discrimination on the basis of different transactions.

The need for this creative approach to selectivity is a good illustration of the difficulties caused by applying Article 107(1) in the tax sphere. It is reasonable to assume that the real offence was, as noted above, that Spanish acquirers received what one might describe as an export subsidy: when considering the purchase of a foreign company (or a stake in such a company), they could trump bidders from other countries because of the associated Spanish tax benefit. But it was presumably felt that potential acquirers in different jurisdictions were not in a "similar legal and factual position", which is a fundamental requirement for the second step in the Selectivity Test.

The General Court's second attempt

At any rate the General Court took the hint and, in November 2018, reversed itself by upholding the Commission's decisions in both cases. The General Court noted that, applying the CJEU's judgment, a measure may be selective even where the resulting difference in treatment "is based on the distinction between undertakings which choose to perform certain transactions and other undertakings which choose not to perform them". Selectivity was not restricted merely to situations where there were distinctions between undertakings "from the perspective of their specific characteristics".

It has been observed that *Santander* and *World Duty Free* essentially merged the Selectivity Test 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.

The CJEU judgment might also open up new possibilities for the Commission. Doubtless most tax systems include rules which tax different activity differently.

Sectoral Tax Regimes – Regulatory Capital

This second category is not perhaps such an obvious target for the Commission, as it may not involve a Member State using tax incentives to attract business to its jurisdiction or give its existing businesses assistance in competing for foreign opportunities. Nonetheless, it is not difficult to see how rules which give beneficial tax treatment to a particular sector can fall foul of the Selectivity Test.

This particular story began in January 2018, when the Commission 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 interest; these are often called "hybrid instruments" because they boost regulatory capital but for tax purposes preserve their character as debt. The argument was that the special tax rule provided State Aid to Dutch banks and insurers, because ordinary corporates could not get the same treatment.

The challenge was not made public at the time. But it could be divined from the reaction of the Dutch government when, in late June 2018, it put forward a proposal to abolish deductibility on these "AT1" instruments (issued by banks) and "RT1" instruments (issued by insurers) with effect from 1 January 2019. Publication of the 2019 Dutch Finance Bill three months later confirmed the proposal and made it 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"? In the UK specifically, banks may also feel aggrieved that they are taxed at a significantly higher rate than other businesses and deductibility for AT1 debt hardly compensates.

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 <u>all</u> corporates. Indeed, the UK has in theory moved in that direction, introducing a new, non-specific, regime for "hybrid capital instruments" with effect from April 2019.

This replaces the more generous rules under the UK's regulatory capital securities regime, which was expressly available only to banks and insurers. However, the UK's experience offers a cautionary tale. In its eagerness to avoid openly discriminatory rules while seeking to ensure that in practice only banks and insurers use it, the UK might find it has the worst of both worlds. The UK Revenue is tying itself in knots in the attempt to explain how the new rules preserve deductibility, while it is not inconceivable that – assuming State Aid continues to be a relevant concept after Brexit – they could be found to be *de facto* selective and for that reason unlawful.

At any rate, it will be interesting to see whether the Commission persists with a challenge to the openly "selective" rules for regulatory capital previously operated in the Netherlands, the UK and indeed many other Member States.

Standard Tax Rules – Commission Overreach?

Special 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. Two recent German cases show just how far this can go.

Heitkamp

The first of these cases is *Heitkamp* (C 203/16 P, heard together with an appeal on similar facts by a company called GFKL). It suggests that, in the Commission's view at least, State Aid has the potential to catch legislative measures that are commonplace in many Member States.

Heitkamp concerned 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 loss-making 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 Selectivity 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 coherence of the tax system) and therefore did not justify the derogation.

An unhappy 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*, 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 didn't blame the CJEU for failing to give useful guidance. When considering 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 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. The Advocate General seemed content that a strict approach should be taken to justification, the last step under the Selectivity Test; 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".

A-Brauerei

However, the second German case in fact provides an example of exactly that: in *A-Brauerei* (Case C-374/17), the CJEU found that the exemption under review was not "selective" because it was justified.

Another disgruntled AG

Before discussing the outcome of the case, though, I should again like to look at the opinion of the Advocate General (on this occasion Saugmandsgaard Øe) as this too showed real discontent with the operation of State Aid in the tax sphere; indeed, the AG questioned whether the standard three-step Selectivity Test is in fact the right approach at all.

A German court had requested a ruling on an exemption from land transfer tax 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 argued 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. On that basis, the exemption is a derogation and, said the Commission, selectivity is established.

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

The notion that such an inoffensive exemption should constitute unlawful State Aid is remarkable and the AG clearly had no sympathy whatsoever for the Commission's conclusion.

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. They received no support when the case came before the CJEU and it is not clear that they are compatible with the CJEU's decision in *World Duty Free*.

However, his trenchant criticisms of the way in which State Aid principles are applied to tax legislation and rulings are certainly noteworthy. The AG 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 not 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 dissatisfaction in the opinions of other Advocates General, citing Advocate General Wahl's – clearly correct – observations in *Heitkamp* 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).

CJEU decision

I am sorry to report that the CJEU effectively ignored the AG's criticisms when it delivered its judgment three months later (December 2018). It stuck with the "reference framework" approach and agreed with the Commission that in this instance it was Germany's regime for taxing the transfer of (German) real estate. It then noted that the merger exemption was a derogation from that regime and was available only where the two companies had for at least five years prior to the merger been linked by a shareholding of 95% or more, so it was well on the way to a finding of selectivity too. The Court barely touched on the requirement for the potential to distort competition and affect trade between Member States.

Perhaps I should not complain too much, since the CJEU did at least answer the plea I made at the end of last year's article: as noted above, it finally decided a case on the basis of "justification" – the derogation was not in fact selective because it was justified.

However, the justification was that land transfer tax can be assumed to have been paid when the relevant group acquired the property, such that imposing a second charge on a merger of companies within the group would amount to double taxation. This is hardly the expansion of the justification concept that I was calling for, analogous to the CJEU's belated discovery of the "balanced allocation of taxing powers" as a check on its own activism in applying the four freedoms to Member States' tax legislation.

A Proposed Rationale: Deliberate Market Distortion

The cumulative detail from these cases can be overwhelming. Certainly, some of the distinctions drawn by the Courts in applying the Selectivity Test – in particular, determining the "reference framework" – make the further reaches of scholastic philosophy look like models of clarity and consistency by comparison.

I draw three conclusions from this.

First, what is now Article 107(1) TFEU was surely not drafted with tax in mind and it simply does not work very well in this context, where Member States commonly operate discriminatory rules that benefit particular undertakings through a transfer of state resources (or through the reduced extraction of resources from the undertakings).

The second, related, point picks up the observations of Advocate General Saugmandsgaard Øe in *A-Brauerei*. The Commission is much too enthusiastic in its application of the State Aid principle to tax matters and the Courts do not provide a sufficient brake on that enthusiasm. But unless and until the CJEU develops a broader concept of "justification", this seems unlikely to change.

The third conclusion is just a little more encouraging. Beneath all the complexity — and, dare I say it, occasional casuistry — one can perhaps detect a central characteristic which distinguishes the cases the Commission has won from those it has lost. The feature common to *Heitkamp* and *A-Brauerei* is that in neither case could anyone seriously think the relevant rule was introduced for competitive advantage, or to assist particular types of business.

The Courts would not acknowledge that motive is relevant. Indeed, when *World Duty Free* returned to the General Court in September 2018 this was expressly rejected (at paragraph 175); and of course if one looks at the wording of Article 107(1) the focus is on effects, not intentions. But in the tax sphere it is simply too easy to fall foul of the "objective" conditions. I would suggest, therefore, that asking whether a particular rule (or ruling) was <u>intended</u> to produce market distortions is as good a way as any of predicting the ultimate outcome.

UK CFC Exemption: Competitive Feature or Logical Result?

The UK also believes in competing on tax (though, like Ireland, would say it achieves this primarily through a low tax rate). It amended its most obviously alluring 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. A little over 10 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, as the UK Revenue would put it, "artificially diverted" from the UK. The Commission began looking into the regime shortly after the overhaul, requesting information from the UK on the reformed rules in April 2013.

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"). Chapter 5 captures relevant financing income of the CFC if, in particular, (i) it is funded from "UK connected capital", or (ii) there are UK "significant people functions" involved in generating that income. However, if these threshold conditions are not triggered (or are switched off - see immediately below), Chapter 5 is then subject to a number of exemptions that are set out in Chapter 9 of Part 9A (the "finance exemptions").

Exemptions for "non-trading finance profits"

At the time of the Commission's challenge, Chapter 9 operated by (broadly) switching off the rules in Chapter 5 so long as the requirements for the application of one of the finance exemptions were satisfied.

The main finance exemptions themselves have not materially changed since their introduction. Assuming that the threshold conditions have indeed been switched off, 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"). On the same assumption, 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 of 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 Selectivity Test, the Commission took 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 finance exemptions 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, the UK argues that 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 some 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: 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.

Commission decision

The Commission published its final decision in April 2019. This found that one of the two routes into the finance exemptions was in fact justified. There was no unlawful State Aid if the relevant financing income of the CFC was funded from "UK connected capital", so long as there were no UK "significant people functions" involved in generating that income. In this scenario, the UK rule is a justified proxy to avoid complex and disproportionately burdensome intra-group tracing exercises.

However, where there were UK "significant people functions" involved in generating the relevant financing income of the CFC, the finance exemptions were not justified (and so constituted State Aid). This was because, in the Commission's view, the exercise required to assess the extent to which the financing income of a company derives from UK activities is not particularly burdensome or complex.

The Commission rejected the argument that the Chapter 9 exemptions were necessary to safeguard freedom of establishment and comply with the seminal *Cadbury Schweppes* judgment from 2006, on the grounds that taxing a CFC's profits attributable to UK "specific people functions" followed established principles for profit attribution. The Commission decided that there had been no infringement of the fundamental freedoms and rejected an argument based on legitimate expectation.

Freedom of establishment

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 positive 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 negative 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 the UK Revenue.

Appeal

The UK and 17 of the affected taxpayers have since lodged appeals with the General Court, so the saga will doubtless run on for several years to come; the lead appellants will be the UK and (for rather random reasons) ITV, the country's leading independent broadcaster. Meanwhile, the UK Revenue has put in train arrangements for the recovery of the alleged aid from taxpayers which relied on Chapter 9 to switch off Chapter 5 for financing income the generation of which involved UK significant people functions – that is, the route into the finance exemptions which is still subject to challenge from the Commission.

It is worth noting that the Finance Act 2019 has already repealed, with effect from 1 January 2019, this ability to disregard UK significant people functions for the purposes of the finance exemptions. A cynic might say this demonstrates somewhat less than complete confidence in the arguments the UK is making in its appeal, though the UK could reasonably retort that the repeal was simply a pragmatic move which recognised the inherent uncertainty when litigating fiscal State Aid.

Deliberate Market Distortion?

The challenge to the UK's CFC regime might be summarised in two propositions. On the one hand, the UK's fundamental defence has clear merit: the finance exemptions are indeed a natural concomitant of a territorial regime. However, the judges might conclude that the exemptions were not entirely innocent and that they aimed to persuade companies to become – or at least, to remain – parented in the UK.

If they do, my proposed rationale underlying fiscal State Aid would suggest that the case is likely to go against the UK. Only a very brave commentator would predict the Court's reasoning, but it might essentially say that even under a territorial regime, profit attributable to UK activity – albeit arising in a non-resident subsidiary (the CFC) − ought to be taxed in the UK.

Tax Rulings as a Form of State Aid

While the 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 as to the calculation of their tax liabilities. Although not problematic in themselves, tax rulings can constitute unlawful State Aid (in the form of "individual 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 attracted 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 IKEA) and Luxembourg (to Fiat and Amazon).

Rulings on Transfer Pricing

Transfer pricing has been the most common focus of these investigations. The Commission contends that the rulings in question 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.

Apple

The most eye-watering claim relates to Apple. In August 2016 the Commission ordered Ireland to recover around €13bn, plus interest, and fourteen months later the Commission referred Ireland to the CJEU for failing to do so. As noted above, Ireland has now collected €14.3bn from Apple which it is holding in an escrow account pending the outcome of the appeal.

Apple had used a variation of the "double Irish" tax structure, under which companies that were incorporated in Ireland but managed in the US could effectively be stateless for tax purposes. I imagine it may therefore point to the outcome of the McDonald's investigation (see below) and argue that it too was doing no more than taking advantage of a mismatch in national tax regimes. Apple is also arguing that transfer pricing is simply not a relevant issue in its case; 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.

The Commission of course disagrees, arguing that transfer pricing is indeed in point and that the arm's-length principle is inherently part of Article 107(1) of the Treaty (the provision which sets out the prohibition on State Aid). And it contends that even if the companies were not resident in Ireland and therefore could not be taxed by Ireland on their global profits, non-resident companies were still subject to corporation tax on profits attributable to their activities in Ireland. Apple's Irish subsidiaries, it argued, had not applied the arm's length principle when allocating profits to these Irish activities.

The General Court heard Apple's case in September 2019 and judgment is expected shortly.

Fiat and *Starbucks*

It is important to note that the application of the arm's-length principle remains a national competency of Member States, and the Commission has acknowledged that Member States have a margin of appreciation in applying their transfer pricing regime. The significance of but also the limitation on that margin were brought into focus by two very recent decisions of the General Court.

In *Starbucks*, the taxpayer was a Dutch member of the group which bought and roasted coffee beans then supplied them (and other consumables) to other EMEA members of the group. It paid a deductible royalty to yet another group company and this was the specific focus of the Commission's challenge. An advance pricing agreement ("APA") had been concluded between the Dutch tax authorities and Starbucks that allowed Starbucks to calculate its pricing using the "transactional net margin method" ("TNMM"). The Commission decided that the methodology proposed under the APA did not result in a market-based outcome in line with the arm's length principle.

The General Court said that the Commission had to show the pricing was clearly out of kilter – taking account of the margin of appreciation – and that it gave the taxpayer a selective advantage over other similarly placed companies. It held that, even though there were methodological errors in the APA, the Commission had failed to demonstrate that the pricing method used resulted in Starbucks gaining an economic advantage. This combination of the burden of proof and the margin of appreciation will obviously place a limit on the Commission's ability to question transfer pricing rulings.

In contrast, in *Fiat* the same pricing method was found to have granted the taxpayer an economic advantage.

The taxpayer was a member of the group which provided intra-group financial services. Fiat had allocated profits to the taxpayer through the TNMM in line with a tax ruling made by the Luxembourg fisc.

The General Court found that the Commission was correct in finding that the TNMM approach approved in the ruling could not result in an arm's length outcome. Applying the pricing method established a taxable profit base for Fiat that was significantly lower than for comparable companies in Luxembourg. As a result, the taxpayer gained a selective advantage through its application of the ruling.

The Commission may have won in *Fiat* in part because it is easier to find comparables for financing transactions than for other more bespoke commercial arrangements. The availability of such comparables may have helped the General Court conclude that the tax ruling fell outside the "margin of appreciation" of the relevant Member State.

Amazon

National tax administrations have of course taken an interest in multinationals' cross-border pricing arrangements for many years, and in this respect there is an intriguing angle to the *Amazon* case. The Commission 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. The IRS claimed more than four times as much as the Commission has said should be repaid by Amazon to Luxembourg. However, it lost both at first instance and in a subsequent appeal decided in August 2019.

One might say that in *Starbucks* too the more obvious target was the absence of US tax on the royalty, rather than the ability of the Dutch company to obtain a deduction for paying it. But the *Amazon* case suggests that the US courts may be a rather tougher proposition than their counterparts in 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 the relevant 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 the profits were then transferred internally to Luxco's US branch.

However, in 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. (Returning for a moment to my "market distortion" thesis, one might say that the treaty was not seen as a problem because it was a tool to regulate cross-border taxation rather than to alter the behaviour of taxpayers.)

A week later, in a wide-ranging speech on competition policy at Georgetown Law School in Washington D.C. (which I also quote from at the start of this article), 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, a dispute involving ENGIE (previously GDF Suez) 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 tax authority "failed to invoke established accounting principles", though there seems to be little doubt that the accounting used by debtor and creditor complied fully with the applicable principles; and it claimed that the tax authority 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. Both Luxembourg and ENGIE have since lodged an action for annulment of the Commission's decision with the General Court.

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" (BEPS).

Adjustments to Interest Expense - Huhtamäki

The most recent front in the Commission's campaign against "competitive" tax rulings was opened in March 2019, with the commencement of an in-depth investigation into the tax treatment of Huhtamäki in Luxembourg. The target is another form of the interest imputation under attack in *ENGIE*, albeit one that did not generate a tax mismatch within the same jurisdiction. The relevant Luxembourg rule simply imputed interest expense on interest-free debt.

The group lender to Huhtamäki was an Irish company and at the time Ireland did not have a standard transfer pricing regime, so the lender did not pay tax on a deemed interest receipt to match the deemed interest expense in Luxembourg.

The Commission is arguing that the unilateral downward adjustment resulting from the deemed expense represents a derogation from the principle of taxing all commercial profits of a company, adding that the arm's-length principle is not sufficient justification for the derogation. The downward adjustment therefore constitutes unlawful State Aid.

Luxembourg has responded by saying that the tax ruling is unobjectionable because the basis for imputing interest expense is rooted in transfer pricing principles that have been set out in the tax legislation since 2015; in other words, there was no "individual aid". It remains to be seen what final decision the Commission will reach. In any event, any potential impact and recovery of State Aid will be limited to Huhtamäki only as this is a standalone case. Attacking the legislation itself as an "aid scheme" would require a new investigation – the reverse, one might say, of what has happened in relation to Belgium's "excess profits" regime.

Conclusion

The application of the EU State Aid regime to tax rulings and legislation continues to make waves. There are obvious, and in my view well-founded, objections to the way in which the prohibition on State Aid operates in the tax sphere. However, while several Advocates General have made clear their disquiet, there is little sign that the General Court and CJEU are paying heed and no sign at all that the Commission will be deterred from what many see as a crusade to promote tax harmonisation.

One key objection is that 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 of these commenced in the last six years, so it is unlikely that the risk of a State Aid challenge was evaluated when relevant transactions were entered into.

It also seems an inefficient use of the Commission's resources to chase after individual aid cases; the Belgian "excess profits" saga is a prime example.

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”. It is hard to deny that the application of State Aid principles to taxation is generally fraught with difficulty and uncertainty, given the inherent tendency of tax regimes to discriminate between different undertakings by reference to their location or activities and to finance this through state resources (collecting less tax in specified circumstances).

There is a policy question too. 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.

I will end by returning to my central thesis. The practical application of the State Aid concept in the tax arena is shrouded in obscurity. Until the CJEU provides clearer judicial guidance, examining cases through the lens of deliberate market distortion may be as good a way as any of achieving some semblance of rationality and predictability.

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