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## EU Investigates Tax Rulings for Breach of State Aid Rules

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The European Commission is currently conducting in-depth investigations into whether national tax rulings breach the EU's competition rules. Whilst the spark for these investigations was the "Luxleaks" scandal, in December 2014 the Commission sought information from all Member States as part of a much larger campaign to attack what the Commission considers to be unfair tax competition. The latest development earlier this week was the launch of formal proceedings against Belgium in respect of its "excess profits" rulings for multinationals.

The Commission has chosen to tackle this issue using its State aid powers – rather than, for example, attempting tax harmonizing legislation or action via the OECD. This choice has major implications for companies involved. In particular, if the Commission concludes that State aid is present, it is tax paying companies and not the Member States that bear the consequences. Those consequences could include being required to pay substantial additional back taxes.

Companies will want to be confident that their arrangements with EU governments can survive State aid scrutiny. It is becoming ever clearer that comfort from the taxing State itself may no longer always be sufficient.

### What Types of Arrangements Are Being Investigated as Potentially Unlawful State Aid?

The Commission's investigations primarily focus is on advance pricing agreements made by the Irish, Luxemburg and Dutch governments confirming their acceptance of certain intra-group transfer pricing arrangements. The general transfer pricing rule is that the terms of such arrangements should comply with the "arm's length principle." This means that the terms of those arrangements should match the terms that would have applied between independent parties in a similar economic position. Detailed guidance on how this is to be assessed is set out in the OECD Transfer Pricing Guidelines. The Commission believes that the tax authorities failed to apply the guidelines correctly, resulting in a tax advantage for the relevant company. This advantage might arise, for example, where an off-market profit margin is approved for

an intra-group transaction between a taxpaying entity and a non-taxpaying entity.

The focus of the Gibraltar investigation is not on transfer pricing but rather on tax rulings confirming to Gibraltar companies that certain of their income would be treated as accrued or derived from outside Gibraltar, and hence exempt from Gibraltar tax. The Commission alleges that the rulings were given without performing an adequate evaluation and were based on insufficient information, and that this may constitute illegal State aid, notwithstanding the wide discretion of the Gibraltar tax authorities. It is noteworthy in this respect that while Gibraltar is part of the EU, the United Kingdom's crown dependencies (Jersey, Guernsey and the Isle of Man) and other overseas territories are not. Their tax rulings are therefore beyond the reach of EU law.

The most recent Belgian investigation concerns "excess profits" rules that allow multinationals to deduct a part of their profits that supposedly arises because as multinationals they benefit from intragroup synergies or economies of scale. In order to benefit from these rules, the company concerned required a tax ruling from the Belgian authorities. In this way it is similar to the Dutch, Luxemburg and Irish investigations.

In December 2014, the Commission asked all Member States to confirm whether under their national fiscal systems they provide tax rulings, and, if so, to provide a list of all companies that have received a tax ruling from 2010 to 2013. The Commission has also committed to proposing new legislation this spring to introduce the automatic exchange of information on cross-border tax rulings. These signal a potentially massive widening of the Commission's investigation; but may also signify that the Commission is prepared to consider a political settlement – involving Member State commitments as to future behavior in exchange for the Commission foregoing enforcement against earlier rulings.

### **What is State Aid and Why Does it Apply?**

Under the State aid rules contained in the EU treaties, which are directly effective in Member States, State aid is an advantage given by a Member State to specific companies (or specific sectors of the economy), which affects competition within the EU. This "advantage" is not restricted to beneficial tax treatment: it can either be measures granting positive benefits (such as direct subsidies) or measures which enable a business to mitigate costs it would otherwise have incurred.

State aid is illegal unless it is approved by the Commission or falls within an exempted category. None of the exemptions appear to apply to the current tax cases.

State aid requires an advantage to be selective or specific in some way. For this reason, State aid does not affect general taxation regimes such as the general rates of corporate tax imposed by Member States. These fall outside the EU's jurisdiction and are still a matter for Member States. There is nothing unlawful about a company arranging its affairs in a tax-efficient manner in order to benefit from lower rates of taxation in different Member States. However, the Commission stated that:

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**“[u]nder State aid rules, national authorities cannot take selective measures that allow certain companies to pay less in taxes than they should if the tax rules of the country were applied in a fair and non-discriminatory way.”<sup>1</sup>**

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Hence the focus on tax rulings for specific firms – not tax rates or policies as such.

The Commission suspects that Ireland, the Netherlands and Luxembourg may have broken this rule by failing to properly apply the OECD Transfer Pricing Guidelines which, the Commission submits, provides the appropriate guidance for determining the arm's length position. The Commission argues the arm's length principle forms part of State aid law<sup>2</sup> on the basis of case law<sup>3</sup> and the possible discrimination between companies within the same group and independent companies, should this principle be breached.

The Commission suspects that Gibraltar broke this rule by allowing companies subject to the tax rulings in question to pay less tax than Gibraltar companies in comparable circumstances.

### **Recent General Court Rulings on Specificity May Undermine These State Aid Investigations**

The General Court recently annulled two State aid decisions concerning a Spanish tax law allowing companies taxable in Spain to amortise the goodwill from their shareholding in non-Spanish resident companies.<sup>4</sup>

The General Court found that the Spanish law did not confer a selective advantage for the purposes of State aid. The General Court stated that neither the mere departure from the general corporation tax regime nor the fact that the law provided advantages unavailable under the laws of other Member States was sufficient to render a measure selective. The General Court did not consider the advantage was selective in a State aid sense as it was generally available and was not aimed at any particular undertaking or category of undertakings but rather at a category of economic transactions. The Commission has recently appealed that decision to the Court of Justice.<sup>5</sup>

The Commission in the Ireland, Netherlands and Luxembourg investigations is comparing the alleged advantaged position of the companies under investigation against the treatment of a hypothetical independent company acting

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<sup>1</sup> Joaquín Almunia, former EU Competition Commissioner, 'Some highlights from EU competition enforcement' (Speech at the International Bar Association's 18th Annual Competition Conference, 19 September 2014) <[http://europa.eu/rapid/press-release\\_SPEECH-14-608\\_en.htm](http://europa.eu/rapid/press-release_SPEECH-14-608_en.htm)> accessed on 4 February 2015.

<sup>2</sup> See for example Commission decision of 11 June 2014 in case SA.38373 (2014/C) (ex 2014/NN) (ex 2014/CP), *Ireland – Alleged aid to Apple* [2014] OJ C369/32, paras 54 *et seq.*

<sup>3</sup> *Kingdom of Belgium and Forum 187 ASBL v Commission*, Joined Cases C-182/03 and C-217/03, EU:C:2006:416.

<sup>4</sup> *Autogrill España v Commission*, T-219/10, EU:T:2014:393, and *Banco Santander and Santusa Holding v Commission*, T-399/11, EU:T:2014:938.

<sup>5</sup> *Commission v Autogrill España*, C-20/15 P, and *Commission v Banco Santander and Santusa*, C-21/15 P.

under normal market conditions. However, in determining whether the relevant tax rulings conferred a selective advantage, the General Court’s judgments suggest the Commission will need to demonstrate that the companies under investigation and the independent companies transacting with third parties are in the same legal and factual circumstances and that therefore its comparison is appropriate.

The Commission has stated that the Spanish cases can be differentiated from the ongoing investigations as they concerned a general tax scheme, whereas the current investigations involve specific tax rulings granted to individual companies. The companies and Member States can be expected to say that rulings are a normal part of any general tax framework and that these companies received no special treatment that would not have been available to others. Indeed the widespread nature of comparable rulings, as indicated by press leaks disclosing Luxembourg tax arrangements for over 340 multinational groups, does suggest that rulings for the companies under investigation do not appear to be exceptional.

### **What Are the Consequences of Finding That the Relevant Tax Rulings Constitute State Aid?**

Where unlawful State aid has been granted, the State measures granting it will be declared void and unenforceable from the date on which they came into effect. The Commission has the power not only to require the relevant Member State to recover the aid (plus interest) granted over the last 10 years, but it can also determine the relevant amount based on its own assessment. Such an assessment is unlikely to be sympathetic to the recipients of the aid. In particular, the Commission will not take Member States’ tax competitiveness into account, although it will not be able to alter the prevailing tax rate.

The Commission can force Member States to sue recipients through the national courts if payment is not voluntarily made. Following an adverse decision, the only recourse open to the beneficiary is to pursue a challenge through the European Courts – a costly, time consuming and uncertain course of action, which does not automatically suspend the effect of the Commission’s decision in the interim.

### **Why Are Corporate Taxation Arrangements Being Examined Now Under State Aid Rules?**

Reforms that came into force in July last year have resulted in a dramatic fall in the number of State aid notifications made to the Commission. This has freed resources for a larger number of “*ex officio*” investigations. The Commission has signaled its willingness to use this capacity to pursue public policy objectives via State aid that are not driven purely by competition concerns. The motivation of the Commission to do this stems from two main sources.

First, following the financial crisis, there is the wider public concern with “aggressive” tax planning, including by large multinational groups. The previous Competition Commissioner Joaquín Almunia, in response to those concerns, emphasized the priority with which the Commission is treating corporate taxation in the enforcement of State aid rules, before he left stating:

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“[t]hese investigations are part of the broader drive in Europe and other parts of the world aimed to get big corporations to pay their fair share of taxes. I don’t need to add that this is all the more important in a time of tight public budgets.”<sup>6</sup>

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<sup>6</sup> Joaquín Almunia, ‘Some highlights from EU competition enforcement.’

This pressure has intensified within the Commission as Jean-Claude Juncker, President of the Commission and former Prime Minister of Luxembourg, has been forced into rejecting criticism of his role in establishing the tax practices of Luxembourg, and emphasizing the continued fight against tax evasion.

The second factor is the longstanding political frustration within the Eurozone about tax competition between Member States. The British, Dutch, Irish and Luxemburg, among others, have long resisted efforts of tax harmonization at EU level. This has been exacerbated by events during the financial crisis, as Member States with higher corporate tax rates, such as Germany, contributed to bail-outs of Member States with lower corporate tax rates, for instance Ireland. Some Member States now apply low corporate tax rates, thus gaining a significant competitive advantage when attracting business (and the benefits it brings to a Member State's economy) at the expense of other Member States, including those which have contributed to bail-out funds. This logic does not apply to Luxembourg or the Netherlands, neither of which have been subject to a Eurozone bailout.

It is expected that this will remain a priority area for the Commission and that further investigations will follow under the leadership of Competition Commissioner Margrethe Vestager, who said in a speech to the European Parliament "*I am going to continue the work that Joaquín Almunia started in order to throw light on some of these arrangements,*" and in an article with Pierre Moscovici, the new Commissioner for Economic and Financial Affairs, Taxation and Customs, noted in the context of tax rulings that "*unfair tax competition could create a race to the bottom, in which countries feel compelled to give handouts to multinationals in the form of tax breaks.*"

The Commission is also currently seeking information from eight Member States<sup>7</sup> regarding their "patent box" arrangements, which set favourable tax rates for profits derived from intellectual property registered in EU Member States. The Commission may initiate formal State aid investigations into these arrangements and has already suggested that the UK patent box is in breach of the EU's (non-binding) Code of Conduct on Business Taxation.

## **What Does This Mean For Businesses?**

The Commission's activities will clearly be of interest to any company that has individual tax settlements with a Member State. In particular, based on the Commission's letters to Luxembourg, Ireland and the Netherlands published to date, the advance pricing agreement rulings most vulnerable to attack are likely those:

- based on subjective criteria (for example, employment considerations), even where those criteria are only implied, and which would not be available to other companies in a similar legal and factual situation;
- which appear aimed at arriving at a certain tax base or securing a fixed tax payment divorced from the underlying economic activity;
- where the economic analysis put forward did not comply with prevailing standards (and in particular, the OECD Transfer Pricing Guidelines), to the extent where the use of a transfer pricing method accepted under OECD Guidelines may still be considered unjustified if a different method, preferred by the OECD and the Commission, is available;
- which are a product of negotiation with the tax authority instead of the application of transfer pricing methodology;
- which fail to take into account due remuneration for the surrender of profit-making potential;
- where the tax authority has given the impression that it has merely "rubber stamped" a request from the taxpayer (the Commission noted that the Luxemburg tax authority approved Amazon's ruling request within eleven working days);

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<sup>7</sup> Belgium, Cyprus, France, Malta, Hungary, Luxembourg, the Netherlands and the United Kingdom.

- based on assumptions for which insufficient evidence was presented or where the tax authority was not provided with the necessary information to produce a credible tax ruling; and/or
- which are indefinite in duration and are allowed to continue without revision or for a particularly long period (in this context, the Commission notes that the maximum across EU Member States is generally not more than five years).

While the Commission has made it clear that tax ruling systems do not constitute State aid *per se* (which is fortunate given 22 Member States currently allow for tax rulings), it would be prudent for any company in discussions with tax authorities regarding rulings or transfer pricing to take the State aid issues raised by the Commission into account. As the on-going investigations suggest, while arrangements may be blessed by a Member State, they may not be the only arbiters of what is lawful.

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