LOYENS & LOEFF

JUNE 2016
EDITION 107

The European Commission's 2016 Approach towards State Aid in Tax Matters

LOYENS & LOEFF

In this edition

- Introduction
- State aid in a nutshell
  - Procedure and recovery
  - The definition of state aid
- Selected issues
  - Tax rulings
  - Co-ops
  - Collective investment vehicles
  - Tax settlements
  - Other issues identified by the Commission
- Attribution to permanent establishments
- Concluding remarks

1. Introduction

The current European Commission (Commission) has the objective to close loopholes that enable multinationals to shift profits for tax avoidance purposes. To bring tax reform forward the Commission aims to use all tools at its disposal, including enforcement of state aid rules, aiming at establishing fair tax competition within the EU.[1] The ultimate example of this is the Commission's ongoing effort to assess the tax ruling practices of EU Member States, which led to the investigation of over 1000 individual tax rulings. Some of these investigations led the Commission to conclude that tax rulings issued had been unlawful, which ended up in a recovery order which obliges the relevant EU Member States to redress any special tax benefits enjoyed by a company retroactively.

In May 2016 the Commission published its Notice on the notion of State aid (the Notice).[2] The Notice reflects the Commission's position on how it intends to apply state aid rules to, for instance, tax incentives and tax rulings. The Notice also provides valuable insights with respect to how the Commission will handle cases involving tax rulings in future. In June 2016 an additional working paper was published.[3] These 2016 documents can provide useful guidance. However, it is important to stress that some positions taken by the Commission are yet to be tested in front of the EU's Courts.

Paragraph 2 of this edition of Quoted will provide a short overview of the state aid framework and its general definition. Paragraph 3 will focus on the most relevant issues the Commission singled out in respect of tax measures and which it discusses in more detail in the Notice. These are (i) tax rulings, including advance pricing agreements (APAs), (ii) cooperatives (co-ops), (iii) collective investment vehicles (CIVs), (iv) tax settlements, (v) depreciation and amortization rules, (vi) fixed basis regimes, like tonnage tax regimes, (vii) anti-abuse rules, (viii) excise duties and (ix) tax amnesties. Exempting permanent establishments (PEs) will be addressed in paragraph 4. Some concluding remarks will follow in paragraph 5.

Three recent recovery decisions involving tax rulings (Starbucks, FIAT and the Belgian Excess Profit rulings) have been published. To the extent the 2016 documents and those prior decisions lead to different or more nuanced outcomes, those will be signaled here as well.

2. State aid in a nutshell

State aid rules have been applicable in the European Union (EU) since 1958.[4] Its definition has been written to cover classic subsidies to begin with, but the Court of Justice of the EU (CJEU) made it clear that the state aid rules must also be applied to other kinds of government-funded benefits including tax benefits.

2.1 Procedure and recovery [5]

State aid rules prevent a Member State from granting financial benefits to a specified group of companies or a single company, as this may affect free and fair trade and competition between companies in the EU's internal market. Specifically, state aid rules aim to create a level playing field within each Member State. Should the Commission find out that specified tax benefits have been granted despite of the obligation to notify the Commission of any plans to do so ex-ante, it generally must order the recovery of tax benefits.

Even if all conditions of national law have been fulfilled in order to be eligible for certain incentives, or even if all the conditions agreed upon in a tax ruling or APA have been met, a violation of state aid rules may lead to the roll back of any tax incentives, which will then likely result in additional payments to the national government. Ideally such payments would be qualified as back taxes, as this may lead to possible foreign tax credits and the avoidance of foreign anti-avoidance rules, but in the end

1 Letter by Commissioner Vestager to US Secretary of the Treasury Lew of 29 February 2016.

2 See http://ec.europa.eu/competition/state_aid/modernisation/notice_of_aid_en.pdf. This Quoted only covers a select number of issues relevant to state aid in tax matters.

3 Background paper to the High Level Forum on State Aid of 3 June 2016.

4 Articles 107-109 Treaty on the Functioning of the European Union (TFEU) provide the core provisions on state aid. Somewhat similar provisions apply in the European Economic Area (EEA).

5 EU Regulation 2015/1589 covers state aid investigation and recovery procedure (Official Journal of the EU, L 248/9 of 24 September 2015)

it is up to the EU Member State involved to determine the legal basis for recovery of the benefit. Protection of legitimate expectations raised by national tax authorities or governments is nearly non-existent in an EU context, as only the European Commission would normally be in a position to create such expectations.

In this edition of Quoted we will focus on unlawfully granted aid, i.e. tax incentives and tax rulings that meet the criteria for state aid (see paragraph 2.2.) and that have not been sent to the European Commission for prior approval where needed. In case of unlawfully granted aid, the Commission is empowered to order its immediate suspension if that would be necessary to prevent further harm to fair EU trade and competition, meaning that it could order a tax scheme or ruling to be inapplicable forthwith. This is still rare in tax cases but not unheard of. After a formal investigation the Commission may order the recovery of unlawful tax benefits over a period of 10 years.[6] In addition, interest will be due in order to compensate for the financial benefit of not having had to pay taxes from the start. Any recovered amount will end up in the hands of the government that provided for the unlawfully granted state aid.

In case of a recovery order an appeal would be possible at the EU's General Court and then at the CJEU. Such an appeal will not normally lead to suspension of recovery. To the extent the Commission orders a Member State to calculate the benefit that needs to be recovered, such calculations may also become the subject of a procedure in a national court.

Upon recovery, companies may not argue that they had tax planning alternatives that they would have used had they been aware of any state aid risks. The CJEU pointed out that they should normally be able to determine whether the proper procedure has been followed, which would have enabled them to avoid any state aid from the start. While this doctrine is not beyond reproach, suffice it to say that the CJEU also held that bankruptcy can be the logical consequence of recovery as it would help to restore the status-quo on the EU's internal market.

2.2 The definition of state aid

In order for state aid rules to apply four criteria need all to be met. Their actual application in the field of taxation will be addressed in more detail in paragraph 3, when we discuss the tax related issues identified by the Commission.

a. An advantage

A financial benefit needs to be present. Whether or not such a benefit exists will normally have to be determined by comparison to the normal tax regime applicable in a Member State. That said, some rules that are considered part of the national tax regime may lead to a benefit by themselves as we will see in paragraph 3. A benefit will also exist in case a government tries to create a level playing field, for instance by lowering the tax burden in a particular sector of industry to the tax burden applicable to its competitor in another Member State, as it is still the national tax system that is the benchmark.

It is not relevant whether the national legislator intended that an advantage was given. The fact that tax authorities actually granted an advantage, knowingly or unknowingly, will normally be decisive. As for the advantage it is not restricted to just the process of determining the tax due. Also the process of collection of taxes may lead to advantages, for instance in case taxes are being waived or when tax authorities would allow for the postponement of paying tax contrary to normal procedures, at least without an appropriate interest charge. In these situations the behavior of the tax authorities may have to be compared to that of similar creditors, in order to determine whether or not the actions by the tax authorities would be in line with what market operators would do when trying to collect a debt from a debtor.

In the context of fiscal state aid, an advantage may occur in any tax. Even though the Commission's current focus is on corporate taxation, advantages may occur also with regard to dividend withholding taxes, value added taxes (VAT), wage or payroll taxes and alike.

An advantage can be granted both directly as well as indirectly. State aid rules only apply to entities that carry out an economic activity from an EU perspective,

6 As this period starts to run upon actions taken by the Commission vis-à-vis a Member State, like asking questions, the actual recovery period may be longer than 10 years.

regardless of their domestic legal status. It may therefore cover public or limited companies, partnerships, self-employed persons but also non-profit entities, investment funds and alike.[7] Persons who receive a benefit in their non-commercial capacity, like private persons and employees, will not themselves be subject to state aid rules. That said, tax benefits that target employees in a particular sector of economy or that would trigger private investors to invest in certain companies may lead to indirect state aid. I.e. the investor or employee receiving a benefit would then be the intermediary whose actions would benefit a company (like easier/cheaper access to capital or avoiding a wage increase because of the tax reduction already offered).

The level of advantage may have to be determined at the level of an economic entity (a group of companies as a whole, to the extent they engage in the same economic activity together), which may go beyond the legal entity that would normally be identified for tax purposes.

b) Granted by a Member State or out of state resources

Tax benefits by definition will be granted by some kind of public body. "State" aid rules not only apply to the national or federal government, but also to any lower level of government. This criterion does imply that the government had some active involvement in granting the aid. This excludes the granting of tax exemptions or lower tax rates that may result from a clear and precise obligation of European Law, for instance in the area of VAT.

c) Selectivity

State aid rules do not intend to prevent Member States from providing an attractive tax regime to all companies. They only apply in case benefits are restricted to a single company or to a select group of companies, which might be companies within one particular sector of industry. Even if the amount of beneficiaries within one sector would cover several thousand companies, it would not take away the selective nature of a measure. Sometimes the special characteristics leading up to selectivity are rather broad. For example, in one case the CJEU held that a tax regime specifically targeted to benefit the offshore-industry as such already led to selectivity. Tax benefits restricted to companies located in a particular part of a Member State may also be considered to be (regionally) selective, although local governments that have taxing rights of their own may have different general tax regimes from one municipality or province to the next.

d) It (threatens to) distort(s) trade and competition within the EU

This criterion is why the EU gets involved in state aid in the first place. A very light test will be applied here; it is safe to assume that this criterion will be met in nearly all cases where a benefit has been granted. Some exceptions may apply in case of absolute legally guaranteed monopolies and very local activities which are unlikely to attract any (future) competitors from the EU.

The European Commission has issued a 'de minimis' regulation which decrees that aid up to € 200.000 per 3 fiscal years will be deemed not to have a noticeable impact,[8] and hence be excluded from the scope of state aid procedure. As any kind of aid by any level of government needs to be taken into account here, including subsidies, state guarantees and alike, reliance on this criterion to avoid state aid rules is not recommended in respect to most tax schemes.

3. Selected issues

With the basic definition of state aid in mind, this paragraph will address some of the tax issues the Commission discussed in detail. Fiscal state aid can take many forms and go far beyond the issues discussed here.

3.1 Tax rulings

While acknowledging that tax rulings (including APAs) may be a useful instrument to provide legal certainty to taxpayers, the Commission emphasizes that a ruling may not endorse a result that would be contrary to the normal application of the tax system. To the extent rulings involve transfer prices, there should be "a reliable approximation of a market-based outcome".

7 Hereinafter 'companies' is meant to refer to any entity that is economically active within the EU.

8 Regulation 1407/2013, OJ L 352/1 of 24 December 2013.

The Commission takes the position that EU state aid law provides for its own at arm's length principle which applies regardless of whether and how this principle is incorporated in the applicable national tax law. It reasons that unequal treatment of (multinational) group companies versus standalone companies is prohibited as they are in a similar legal and factual situation from a state aid point of view. This point of view is very controversial and will have to be tested in front of the EU Courts, as the Commission seems to disregard that the normal tax system and its existing (and not the ideal) anti-avoidance framework should be the proper benchmark for analysis.
Here there is a major contrast with tax law where anti-avoidance rules, including the application of an at arm's length test to intra-group transactions, have been introduced exactly because of the inherent legal and factual difference between standalone companies and group companies. Taking the reported profits of the latter for granted might lead to profit shifting in the absence of such rules.

In the Notice the Commission does point out that a transfer pricing arrangement that complies with the OECD Transfer Pricing guidelines is unlikely to give rise to state aid, but only if the guidance on the choice of the most appropriate method is being followed and the end result still produces a reliable approximation of market prices. Those conditions effectively reduce the impact of the OECD rules as the Commission's primary test will be that of a 'reliable approximation' even if this would mean going beyond what current OECD guidelines provide for. In the preceding Belgian Excess Profit decision the Commission used far clearer language to put the OECD guidelines aside.

In the Belgian decision the Commission pointed out that downwards adjustments of profits, without a corresponding pickup abroad, would run afoul of the Commission's at arm's length standard.[9] Then again, it seems that this consideration must be read in the context of the Belgian regime that did not allow for any downwards adjustment at the time apart from a special rule which was deemed state aid. In countries where (up- and) downwards adjustments are part of the normal process of establishing a stand-alone profit this consideration may not apply, but the EU's Courts may have to shed some light on this. This particular consideration was not repeated in the (binding) Notice, but the (non-binding) June 2016 working paper shows that the Commission will still pay attention to a practice of allowing deductions for payments between group companies that were 'not actually made'.

In summary, the Commission points out that tax rulings are particularly likely to confer a selective advantage in case (i) they misapply national tax law, resulting in a lower tax, (ii) the ruling is not available to undertakings in a similar legal and factual situation, or (iii) a ruling is more favorable towards one company than to others, in particular when endorsing a too advantageous transfer price or by allowing the use of a more indirect method to determine taxable profit where more direct ones are available (like third-party prices, so-called CUPs). To the extent indirect methods need to be used, in its working paper the Commission's staff points out that traditional methods (like cost-plus or resale-minus) are to be preferred over transactional profit methods (like TNMM or a transactional profit split) using the OECD Guidelines as guidance.

As for (ii) it should be clarified that limited access to advance tax rulings as such does not lead to a selective advantage if the rulings that do get issued do not provide a financial benefit.

As the Commission's resources are limited it is committed to focus on cases showing a 'manifest' breach of its at arm's length principle. Still, its working paper indicates a continued willingness to engage in in-depth testing of, for instance, margins for financing companies and rulings confirming a CUP without (adequate) comparables being presented. When a TNMM is used (in line with OECD recommendations), particular attention will still be paid to adequate performance indicators being used as to best capture the commercial value of activities performed.

3.2 Co-ops

The Commission reiterates a 2011 CJEU judgement that points out that those cooperatives that are in a similar legal and factual situation as regular commercial

9 Decision SA.37667 of 11 January 2016, Paragraphs 150 and 177-179.

companies may not be excluded from the normal tax system just because of their legal form. The CJEU did recognize that traditional cooperatives may be in need of a special tax regime to deal with their characteristics. Preferential tax treatment of cooperatives might escape application of state aid rules if those cooperatives have a relationship with their members that go beyond a purely commercial relationship and members need to be actively involved in running the co-ops business, apart from equitable entitlement of members to profits made. In case a cooperative does not have these and other special characteristics, the fact that a cooperative may be held to distribute all profit to its members forthwith might justify taxation at member level (here the Commission seems somewhat more lenient than the CJEU).

This section is of particular importance for tax planning structures involving cooperatives, where the cooperative itself does not carry out a trade or business and where – if acting as an investment vehicle or holding company – the actual presence and real, active involvement of multiple members is missing.

3.3 Collective investment vehicles

The Commission indicates that tax measures that try to create tax neutrality between direct investments and investments via CIVs should not be considered selective per se, as the nature and general scheme of the tax system might justify a regime providing for fiscal transparency allowing the results of the CIV to be taxed in the hand of its participants instead. Tax measures that would go beyond creating transparency and would make investment via a CIV more attractive than direct investment could still be at odds with state aid rules, as would measures restricted to specific types of (specialized) investment funds like national venture funds.[10]

This section is mainly of relevance to CIVs in Member States who either allow investment funds to reinvest pre-tax profits, where such option would be absent in case of direct investment, as well as to those in Member States that have more than one fund regime within their territory.

3.4 Tax settlements

While the Commission does acknowledge the relevance of tax settlements allowing tax authorities to avoid extensive legal disputes in domestic courts, it still is on the lookout for settlements that provide a disproportional benefit to taxpayers. A settlement may not lead to a more favorable treatment of companies compared to other companies in a similar legal and factual situation. Nor may it lead to a contra legem settlement leading to a lower tax “outside a reasonable range”.

This part is by far the most vague. Given the ambiguity of the Commission’s language it is not clear at this time whether a settlement covering several legal issues will have to be scrutinized on the merits item by item or as a whole. The Commission does implicitly seem to allow that a settlement may lead to a give and take if several issues are to be settled, as long as the outcome is not disproportionately in the favor of the taxpayer. If a part of the settlement would violate applicable laws, the question is whether this is due to a different interpretation of the facts or of the law. The reference to a “reasonable range” at least seems to exclude situations where, objectively speaking, both parties could not have had a difference of opinion on the legal consequences of a fact pattern they agree to.

3.5 Other issues identified by the Commission

In the Notice the Commission addresses some other tax issues as well.

a) Early or accelerated depreciation of certain assets used by certain undertakings or sectors of industry might lead to selective aid as would any discretion in allowing more favorable depreciation by the tax authorities. The Commission does not question the accelerated depreciation of leased assets as such, as long as qualifying lease contracts can be concluded by any company, small or large, in any sector of the economy.

10 In a 2010 case involving REITs the Commission was satisfied with a 90% distribution of profits instead of 100% from the perspective of transparency.

b) Fixed basis tax regimes may sometimes be acceptable for administrative expediency as long as "on average" the fixed basis should result in a tax burden that is equal to that of other companies and the fixed basis as such should not benefit particular companies that are eligible for such basis. Many fixed basis regimes are likely to fail this test and hence are deemed to receive an advantage.

   Apart from special rules dealing with the value of agricultural lands and their transfer for agricultural purposes, the fixed base regime most frequently dealt with are tonnage tax regimes. As stimulating international maritime transport by EU-registered vessels is one of the EU's main goals, the Commission has rather frequently approved of tonnage tax regimes (conditionally) provided that ring-fencing measures were in place as to avoid any spillover between maritime and non-maritime activities within one entity. This includes safeguards to ensure an appropriate allocation of costs related to maritime shipping that should not be deductible separately from the tonnage tax regime.

c) Anti-abuse rules may not include specific derogations that would make them inoperable in situations where they are meant to be applied by design. Essentially, an anti-abuse rule should not allow for escapes that would be contrary to its purpose. The most recent example of this, still subject to appeal, is that of rules blocking the carry-forward of losses after a takeover.[11]
   One Member State allowed an exception to this rule in case the company was in financial distress and a takeover would be needed to get it viable again. Here the issue was raised why normal, viable companies would not be granted the same treatment after a takeover.

d) Excise duties are harmonized at EU level for the most part. Reducing such a duty without the authorization necessary could lead to state aid for both the company selling the product as well as the company buying the product for further processing.

   In respect of VAT similar problems may occur, even though the Commission does not refer to VAT in the Notice directly. Member States that would allow certain entities to deduct input VAT without a proper basis in EU law could end up in a state aid procedure as could cases where the reduced VAT rate is applied to goods or services that should be subject to the regular VAT rate according to EU rules. For the time being, however, the Commission is more inclined to use infringement procedures to rectify situations like these.

e) Tax amnesties should not be designed to benefit only a predetermined group of companies or to be at the discretion of tax authorities, as this would likely result in selectivity.

4. Attribution to permanent establishments

In a recently opened case the Commission takes the preliminary view that a ruling confirming the attribution of profit to a PE abroad, where no such PE is recognized in the other state, is not in line with the object and purpose of double taxation treaties justifying an exemption. Attributing profits to such a PE may hence result in state aid.[12] Although the Commission now seems willing to accept that an exemption may be given even in the absence of effective taxation abroad, it will test whether the treaty conditions for such an exemption have been met. It does, however, argue that if the other state is not taxing the income due to the absence of a PE under its domestic law, no exemption should have been offered. In this ongoing case, the Commission seems troubled by the fact that PE income might be exempt as national terminology and treaty terminology may differ, which may lead to a mismatch between contracting states resulting in double non-taxation.

5. Concluding remarks

This edition of Quoted only provides some highlights of recent state aid developments. Even though some of the positions taken by the Commission are still the subject of appeal at the EU's Courts, the issues the Commission

11 General Court T-287/11 Heitkamp and T-620/11 GFKL of 4 February 2016.

12 Opening Decision SA.38945 of 3 December 2015, Paragraphs 87-90 (McDonalds).

discussed in-depth provide useful insights of its line of thought. Should the Commission start investigations with its own guidelines in mind, possible public exposure may be as detrimental to companies as the actual outcome of an investigation into a particular tax ruling (or the outcome of a subsequent appeal to the CJEU).

As far as (corporate) tax rulings are concerned – the Commission's current priority – it should be reiterated that the Commission seems willing to take the next step and use state aid rules as a backup option to national anti-avoidance rules, should those not ensure that multinational groups are taxed similar to independent companies. In that process it is creating its own definition of at arm's length transfer pricing, which may go beyond current state aid practice. The Commission also questions unilateral tax exemptions where tax treaties require effective taxation abroad. Its approach may have a severe impact on the fiscal sovereignty of Member States in case their anti-abuse legislation would be generally applicable but still inadequate, without selectivity being present per se. The CJEU still has to rule on the validity of the Commission's line of argumentation towards the arm's length principle and exemption of PEs.

In the meantime, it is recommended to ensure that any tax ruling is being backed up by a proper legal analysis and proper case-specific transfer pricing benchmarks, where needed. Making sure that substantial transfer pricing documentation is available will be of the utmost importance as to minimize exposure to (public) state aid investigations in future. Any choice of method needs to be explained adequately, in particular the use of a TNMM or profit split.

To conclude, the 2016 Notice should not impact positions taken earlier in respect of audits/state aid analyses with respect to taxes filed prior to its upcoming official publication. To the extent this notice already reflects the Commission's core considerations in recent, unpublished decisions, it may provide relevant guidance albeit subject to possible amendment or withdrawal once the EU's Courts had their say.

About Loyens & Loeff

Loyens & Loeff N.V. is an independent full service firm of civil lawyers, tax advisors and notaries, where civil law and tax services are provided on an integrated basis. The civil lawyers and notaries on the one hand and the tax advisors on the other hand have an equal position within the firm. This size and purpose make Loyens & Loeff N.V. unique in the Benelux countries and Switzerland.

The practice is primarily focused on the business sector (national and international) and the public sector. Loyens & Loeff N.V. is seen as a firm with extensive knowledge and experience in the area of, inter alia, tax law, corporate law, mergers and acquisitions, stock exchange listings, privatisations, banking and securities law, commercial real estate, employment law, administrative law, technology, media and procedural law, EU and competition, construction law, energy law, insolvency, environmental law, pensions law and spatial planning.

loyensloeff.com

Quoted

Quoted is a periodical newsletter for contacts of Loyens & Loeff N.V. Quoted has been published since October 2001.

The authors of this issue are prof. dr. Raymond Luja (raymond.luja@loyensloeff.com) and drs. Peter Adriaansen (peter.adriaansen@loyensloeff.com).

Editors

R.P.C. Cornelisse
E.H.J. Hendrix
A.N. Krol
C.W.M. Lieverse
W.C.M. Martens
W.J. Oostwouder
A.G. Wennekes
D.F.M.M. Zaman

You can of course also approach your own contact person within Loyens & Loeff N.V.

Although this publication has been compiled with great care, Loyens & Loeff N.V. and all other entities, partnerships, persons and practices trading under the name 'Loyens & Loeff', cannot accept any liability for the consequences of making use of this issue without their cooperation. The information provided is intended as general information and cannot be regarded as advice.

LOYENS & LOEFF

LOYENSLOEFF.COM

As a leading firm, Loyens & Loeff is the logical choice as a legal and tax partner if you do business in or from the Netherlands, Belgium, Luxembourg or Switzerland, our home markets. You can count on personal advice from any of our 900 advisers based in one of our offices in the Benelux and Switzerland or in key financial centres around the world. Thanks to our full-service practice, specific sector experience and thorough understanding of the market, our advisers comprehend exactly what you need.

Amsterdam, Brussels, Hong Kong, London, Luxembourg, New York, Paris, Rotterdam, Singapore, Tokyo, Zurich