CPI's Europe Column Presents:

State Aid and Tax Rulings

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State aid is defined as an advantage in any form whatsoever conferred on a selective basis to undertakings by national public authorities. Therefore, subsidies granted to individuals or general measures open to all enterprises do not constitute State aid. Tax reliefs can be considered as state aid only when they give the recipient an advantage on a selective basis (for example to specific companies or industry sectors).

The Article 107(1) The Treaty on the Functioning of the European Union (TFEU) considers that "any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market.". A company that receives government support gains an advantage over its competitors and distorts market competition. TFEU generally prohibits state aid unless it is justified by reasons of general economic development. The European Commission is in charge of ensuring that State aid complies with EU rules.

The European Commission based on recent case-law[2] considers that a measure by which the public authorities grant certain companies a favourable tax treatment which places them in a more favourable financial position than other companies amounts to State aid. Since 2013, DG Competition has started investigating a particular category of such tax measures: the tax rulings issued by Member States that concern specific corporations (or group of corporations). A considerable number of the rulings relate to intra-group transfer pricing arrangements within multinational corporations. In principle, transfer pricing arrangements that reflect a reliable approximation of a market based outcome in line with the OECD's arm's length principle (i.e. between two companies that belong to the same group, the amount charged by the one related company to another in a transfer must be the same as if the two companies were not related/independent) are not problematic as they do not constitute State aid. This seems to be the case for rulings that cover intra-group transactions between two different Member States, where both companies carry out genuine economic activities on which they are taxed. A category of simple rulings, for example, confirms that a company has a branch that carries out economic activities, which means that the company will in principle be taxable in the jurisdiction of that branch.

However, in some cases, tax rulings may refer to the remuneration of financing companies that are part of a multinational group. The only activity of such financing companies is the passing-on of funds or intellectual property rights from one group company to another company within the same group. The Commission found that in such situations, it can be the case that the company taking the loan can typically deduct the full interest payment from its taxable income, while the group financing company receiving the interest payment is taxed only on this margin, which represents a fraction of the overall interest received on this loan. In addition, the Commission's market investigation concluded that there are rulings which endorse tax deductions for payments or charges between group companies, even where such payments are not actually made. In such situations tax rulings confer a selective economic advantage and therefore they constitute an illegal State aid.

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[2] See DG Competition working paper on State aid and tax rulings: Case C-105/14 Taricco and Others EU:C:2015:555, paragraph 61; Case C-6/12 P Oy EU:C:2013:525, paragraph 18; Joined Cases C-106/09 P and C-107/09 P Commission and Spain v Government of Gibraltar and United Kingdom, paragraphs 72 and 73; Joined Cases C-78/08 to C-80/08 Paint Graphos and Others EU:C:2009:417, paragraph 46; and Case C-387/92 Banco Exterior de España EU:C:1994:100, paragraph 14.

Following the investigation of tax rulings in the EU, the DG Competition opened 9 cases examining whether tax rulings constitute illegal State aid. 4 of these cases refer to tax rulings issued by the State of Luxembourg. 4 of these cases have to do with US headquartered multinational companies.

The first Commission's decisions were related to Fiat Finance and Trade, based in Luxembourg and Starbucks, based in the Netherlands. Fiat Finance and Trade provides financial services, such as intra-group loans, to other Fiat group car companies. The Commission concluded that the tax ruling issued by the Luxembourg authorities in 2012 gave a selective advantage to Fiat Finance and Trade which has unduly reduced its tax burden by €20 - €30 million. This was achieved (1) because the ruling lowered the calculated by the ruling capital base with respect to the actual company's capital and (2) by using lower than the market rates remuneration for intra-group financing.

Similarly, the Commission's investigation in the case of Starbucks concluded that a tax ruling issued by the Dutch authorities in 2008 gave a selective advantage to the company by artificially lowering its tax contributions. Specifically, the ruling allowed the company to shift its taxable profits to Alki (a UK-based company in the Starbucks group) through a system of royalties for coffee-roasting know-how. Nevertheless, Alki is neither liable to pay corporate tax in the UK, nor in the Netherlands. At the same time, the Commission found, the ruling also allowed the company to reduce its tax base by inflating the price it pays for green coffee beans to its Swiss subsidiary.

The loopholes in the international tax system make the relationship between state aid and tax rulings even more problematic when US headquartered corporations are considered. For example, in the cases of Apple and Amazon, the Commission reported that part of their EU profits were transferred (making the use of tax rulings) to intra-group limited partnership companies with no employees which are not taxed either in the EU, or in the US, where intellectual property is mostly created and where these funds can be taxed (at higher rate than the ones applied in EU Member States) only when they are repatriated. The fact that these funds i) remain outside US; ii) are transferred outside the jurisdiction of EU Member States taking the advantage of specific tax rulings, creates a confusion on where they should be taxed and how.

While the European Commission concluded that these practices violate State aid law and repayments should take place to correct the resulted distortion of competition, the US Treasury in its white paper underlines that any repayments ordered by the Commission could be considered foreign income taxes that are creditable against U.S. taxes owed by the companies in the United States. If so, the companies' U.S. tax liability would be reduced dollar for dollar by these recoveries when their offshore earnings are repatriated (or treated as repatriated as part of possible U.S. tax reform).

There are some further challenges with respect to the Commission's approach on State aid and tax rulings. First, to assess whether a tax ruling that facilitates intra-group transfers confers a selective economic advantage to certain undertakings, we need to compare the terms and conditions of the intra-group transfer (or the profitability of the subsidiary under investigation) with comparable transactions in similar circumstances by independent companies. There are many practical difficulties associated with running such comparisons, as in some cases it is not easy to find the economically relevant characteristics that are sufficiently similar. In the majority of the 9 cases opened by the Commission, national tax authorities run different comparisons from the ones that the Commission considered appropriate and as a result they reached different conclusions.

Moreover, the separating line between a tax measure that provides a selective advantage (and therefore it constitutes a State aid) and a tax measure that provides a non-selective advantage is not always very clear and a comprehensive case-by-case analysis might be required. A good example is the Spanish goodwill cases.[3] According to the tax measure under investigation, if a Spanish company would arrange for a takeover of a domestic company it would not be allowed to amortize goodwill for tax purposes. In case it would acquire at least 5 % of a foreign company, the Spanish company would be allowed to deduct such costs and lower its taxable base accordingly. This measure had as a goal to stimulate Spanish companies to engage in international takeovers and grow. The Commission concluded that the tax measure is selective, since it only applies to companies investing abroad and the 5 % threshold is lower than the general reference system for the amortization of goodwill. At the appeal, the EU's General Court reversed the decision by judging that the measure is not selective as the derogation is available to all undertakings and therefore it does not constitute a State aid. At the European Court of Justice (ECJ) the judging was reversed again as the court concluded that the Commission's opinion on the selectivity of the measure was the correct one. Specifically, the ECJ ruled that "irrespective of its form or the legislative means used, should have the effect of placing the recipient undertakings in a position that is more favourable than that of other undertakings, although all those undertakings are in a comparable factual and legal situation in the light of the objective pursued by the tax system concerned". That interpretation suggests that the measure can be selective even if it is broad in scope with a large number of potential beneficiaries.

Undoubtedly, the Commission's approach requires a close coordination with tax authorities on the type of tax rulings maybe problematic. At the same time, multinational companies should be well informed and perform frequent tests over the tax measures that are relevant to their operation to make sure that they comply with the EU law. While a case-by-case approach is the appropriate way to move forward with the evaluation of such cases, more clarity over the main characteristics of tax measures that can constitute State aid can contribute to the better functioning of markets and encourage corporate investments and innovations.

[3] Joined Cases C-20/15P Commission v World Duty Free Group and C-21/15P Commission v Banco Santander and Santusa.