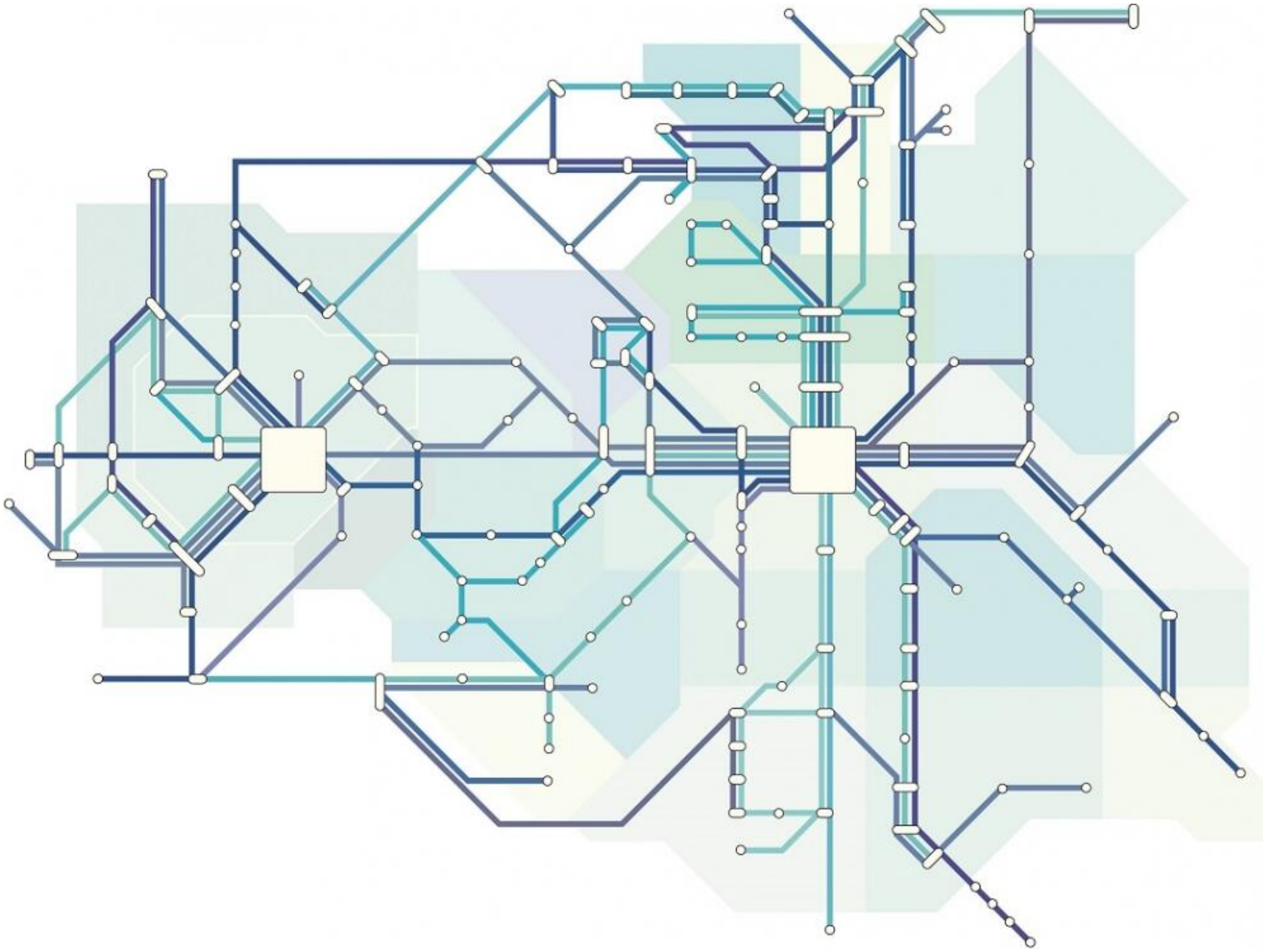
The State aid journey

International Tax   Large Corporate



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Kelly Stricklin-Coutinho provides an update on State aid – where we've been, where we are, and where we may be going

Key Points

What is the issue?

State aid and tax has dominated news relating to multinationals in the past few years.

What does it mean to me?

At the time of writing a Brexit withdrawal agreement has been published but it is as yet unclear whether the UK and EU will adopt the terms of the agreement, or whether the UK will leave the EU on 29 March 2019.

What can I take away?

If a withdrawal agreement is agreed, the Commission has plenty of time to conclude its position on these investigations and to order the UK to recover aid from taxpayers, and probably even to penalise the UK if it does not do so. It also allows the Commission plenty of time to develop its theory of the application of State aid law to tax still further.

State aid, tax and Brexit

State aid and tax has dominated news relating to multinationals in the past few years, and for UK based tax practitioners never more so than in relation to the European Commission's investigations into the group finance exemption set out in the UK's Controlled Foreign Company rules. That decision is keenly awaited, but the timing of the decision alongside Brexit creates uncertainty.

State aid and taxation: the landscape

Rationale for State aid Rules

In establishing an internal market in the EU, specific provision was made to prevent government bodies (whether central or local) from intervening in markets by assisting certain entities in the market, giving them an advantage over other market operators. Subsidising certain entities by way of government action concerns the distortion of competition within the internal market generally, but also concerns competition between Member States to subsidise (i.e. preventing a subsidy race between Member States). Regulating subsidy also concerns ensuring that inefficient suppliers are not given an advantage compared with more efficient suppliers. The principles are firmly rooted in ensuring competitive conditions, which means that the issues around competition and its application to tax will be of greater, rather than less interest as the UK navigates its future outside the EU.

Prohibition on aid

It is a long established principle that State aid law applies to taxes. The prohibition against State aid is contained in Article 107 of the Treaty on the Functioning of the European Union. The prohibition in Article 107 bans:

- Any aid in any form whatsoever
- Granted by a Member State or through State resources
- Which distorts or threatens to distort competition
- Which favours certain undertakings (known as 'selectivity')
- And has an effect on trade between Member States.

The test is cumulative, so for a measure to be prohibited, each of these criteria must be met. The TFEU goes on to state (at Article 108) that all aid must be notified to the European Commission prior to it being granted (or altered), in order that they may take a decision as to the status of the measure. Where the Commission decides that a matter is a prohibited State aid (either where the aid has been notified to it or where it has discovered the alleged aid of its own initiative), the Commission must order the Member State to recover the aid from the recipient. Penalties may be imposed on Member States which do not recover prohibited aid.

Exemptions from State aid law are set out in regulations and there is a de minimis amount of aid which may be provided. For a small number of taxes, particularly locally set charges such as business rates and Community Infrastructure Levy, the de minimis amount and the exemptions may prove useful to place taxpayers in a position where they do not receive prohibited State aid. However, the de minimis amount is low and the exemptions are based on public policy justifications, so neither will be of use in the context of the challenge on CFCs.

Those who unlawfully receive State aid will find themselves subject to a number of possible risks of challenge:

- The European Commission may challenge the decisions as set out above.
- Competitors have standing to challenge, by way of judicial review, the treatment their competitor has received. Other challenges in English courts

may also be possible.
- Government reports to the Commission aid granted in its territory, and the relevant government department may, to that end, audit the possible grant of aid.

Although the latter two are important features of State aid law outside the context of tax, they are unlikely to be relevant for tax measures for practical reasons.

Appeals against the Commission’s decisions are heard by the EU’s General Court, which considers matters of law and fact and finally by the European Court of Justice (the CJEU) which rules on law alone.

Recent investigations

The Commission has developed its position on how State aid applies to tax from its traditional position as regards reliefs and exemptions, where perhaps the granting of an aid was more classically conceived. What is different in the European Commission’s recent investigations is that where previously State aid law had been applied to particular reliefs, exemptions or geographical areas, the European Commission has concerned itself with wider issues of taxation, such as tax competition and non-taxation. Many of the investigations have concerned the mechanism of tax rulings, although the Commission has been quick to say that it supports the use of tax rulings, an unsurprising position given that tax rulings tend to provide legal certainty to all parties, and legal certainty is an important principle of EU law. The Commission is concerned, rather, with the result procured by tax rulings in certain contexts. In addition to tax rulings, the Commission has stated its interest in dealing with non-taxation. The focus then is on the outcome of tax measures rather than on the mechanism which produces the result.

At the time of writing, decisions are awaited in various contexts. Although the Commission decided that Ireland had provided State aid to Apple and the Irish government recovered the ordered amount from Apple, held in escrow pending the appeal, the EU courts have not yet ruled on the Apple case. Appeals are outstanding in the majority of the rest of the cases (with some hearings having taken place already) but one decision which has attracted attention is the Commission’s decision in respect of McDonalds that there was in fact no prohibited State aid.

In high level terms, the Commission decided that the double non-taxation of McDonald's profits in Luxembourg was not a prohibited State aid because the double non-taxation derived from a mismatch between Luxembourg and US tax laws, rather than special treatment by Luxembourg. The notion that the EU cannot deal with a mismatch between two countries' tax systems is familiar to those dealing with matters concerning the fundamental freedoms of movement. The Commission goes further, however, and says in its press release (IP/18/5831) that as the decisions did not derogate from national law or the Luxembourg – US Double Tax Treaty there is no aid.

At the time of writing, the only document available on the McDonald's decision is the press release. It is therefore difficult to unpack this important point of precisely what reliance the Commission places on International Tax law. The CJEU's reliance on international tax measures in the context of EU law has been varied in cases on the freedoms of movement, and the Commission's reliance on international tax standards in the context of State aid and tax rulings has been the subject of criticism (in particular as to the scope of the arm's length principle).

UK CFC investigations

The Commission characterises the finance company exemption in the CFC rules as a 'scheme that exempts certain transactions by multinational groups from the application of UK rules targeting tax avoidance.' The Commission emphasises the importance of CFC rules generally as an effective and important tax avoidance measure (which is unsurprising given the provisions in the Anti-Tax Avoidance Directives).

The Commission identifies two main features. First, it notes that a multinational active in the UK can finance a foreign subsidiary via its non-UK finance company and the result of the exemption is that it pays little to no tax because the offshore subsidiary pays little or no tax on the financing income and the financing income is not apportioned to the UK because of the exemption. Second, it notes that other artificially shifted income is apportioned to UK parent companies and taxed in the UK.

Some issues with the Commission's position

Reliance on international tax law

It is as yet not possible to know the extent of the Commission's reliance on international tax law so the application of that principle in the context of the CFC investigations cannot be fully fleshed out. It may well be helpful for taxpayers affected.

EU law emphasis on commercial purpose

The interaction of international tax principles and EU tax principles is also a developing position. For example, some governments in the EU (including the UK) have taken the position (in some cases relying on their interpretation of international tax norms of the arm's length principle) that the arm's length principle is to be interpreted to mean that commercial circumstances which justify terms to which third parties would not agree are irrelevant when seeking to satisfy the arm's length test.

The CJEU has recently taken exactly the opposite position in a case concerning the provision of a guarantee without consideration by a parent company to its subsidiary (Case C-382/16 Hornbach-Baumarkt). The CJEU decided in that case that the provision of such a guarantee, which took account of the relationship between the parent and subsidiary, where the taxpayer 'is given an opportunity, without being subject to undue administrative constraints, to provide evidence of any commercial justification that there may have been for that transaction…' will be a proportionate legislative provision, in line with EU law. The CJEU went on to say that there may be commercial reasons for a parent company to behave on non-arm's-length terms, that there is no argument advanced as to the risk of tax avoidance and that no wholly artificial arrangement has been identified.

Plainly, Hornbach-Baumarkt is relevant to cases applying the arm's length principle. In that context, it will be interesting to see how the Commission squares its reliance on an apparently stricter interpretation of the arm's length principle with the CJEU's more generous iteration of the arm's length principle in the context of the freedoms of movement.

These arguments as to commercial justifications for departing from an anti-avoidance rule resulting in a proportionate outcome in EU law apply in the context of CFCs also. The CJEU in Hornbach-Baumarkt establishes that in order for an anti-avoidance measure to be proportionate and in line with EU law, it must allow for consideration of the commercial factors of a relationship which justify departure from the norm. The commercial purpose in establishing a multinational’s finance company in a lower tax jurisdiction is a matter of evidence, and there are a number of ways to demonstrate commercial purpose for such a decision.

Brexit

At the time of writing a withdrawal agreement has been published but it is as yet unclear whether the UK and EU will adopt the terms of the agreement, or whether the UK will leave the EU on 29 March 2019.

If the UK leaves the EU on 29 March 2019, State aid law will be adopted in the UK and the Competition and Markets Authority (the CMA) will take over enforcement of State aid law from the Commission, although BEIS will deal with State aid policy. Law will be adopted (TFEU and regulations) but there is no proposal to adopt the extensive guidance the European Commission has produced which covers a range of topics including tax (such as tax rulings and tax settlements). The CMA proposes to publish its own guidance.
The impact of that on the CFC investigations is unclear; there is no reason to believe the CMA will simply drop the Commission’s investigations, although no formal provision has been made for the handover of the investigations. Indeed, the UK’s approach to those investigations may be important while the UK attempts to agree a new trading relationship with the EU.

The Commission, operating on a supra-national level, and the CMA, regulating the UK’s markets, will also start from different policy perspectives. A supranational body may be more interested in its power to influence international issues such as non-taxation, for example, whereas a national body (particularly one concerned with its national tax policy’s impact on trade relationships) may start from a different perspective.

If the terms of the Withdrawal Agreement are adopted, then the result is that there will be two years of EU law continuing to apply in the UK, including State aid law, and the rules regarding infraction proceedings. After that two year period the European Commission would have jurisdiction (in both cases) for a further four years in which it could bring proceedings on issues arising before EU law ceased to apply in the UK. That time period gives the Commission plenty of time to conclude its position on these investigations and to order the UK to recover aid from taxpayers, and probably even to penalise the UK if it does not do so. It also allows the Commission plenty of time to develop its theory of the application of State aid law to tax still further.