STATE AID AND TAXATION

The European Commission's decisions on tax rulings in the broader State aid perspective

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CONTENTS

With the recent investigations into tax rulings granted to Huhtamäki in Luxembourg and Nike in the Netherlands, the Commission continues its scrutiny of tax measures applied to multinational companies. This unprecedented approach of the Commission to tackle the 'unequal' application of the State aid rules to tax measures has been heavily criticised. This is particularly the case for the Commission's interpretation of the arm's length principle implying that the corporate income tax paid by multinational groups must be comparable to standalone companies for the purpose of the State aid assessment. This interpretation triggers the crucial question on how the Commission's decisions fit within the well-established framework following from the case law of the European Courts regarding the application of the State aid rules in the area of tax measures.

BROADER CONTEXT STATE AID SCRUTINY TAX RULINGS

While the Commission's focus on tax rulings is relatively recent (2013), the general application of the State aid rules to national tax measures is a long-settled practice. In fact, as early as 1974, the Court of Justice of the EU (CJEU) clarified that the Commission's competences in the field of State aid also cover the area of direct business taxation. In 1998, the Commission adopted a Notice on the application of the State aid rules to measures relating to direct business taxation, which was replaced in 2016.

State aid rules prohibit fiscal measures that give a selective advantage to the beneficiary. As a rule, fiscal measures that are not of a general nature and that unjustifiably discriminate between taxpayers in a similar factual and legal situation constitute State aid. According to the CJEU case law, the selective nature of tax measures must be assessed on the basis of a three-step test.

	1	2	3
	Identify the reference system	*Assess if the measure deviates from the reference system*	*Justify by the nature and the design of the reference system*
SCOPE OF ASSESSMENT	Identify the consistent set of rules that apply to all undertakings falling within its scope: 'the reference system'. The reference system forms the benchmark to assess presence of a selective advantage.	If a particular measure deviates from the reference system, it introduces differences between economic operators who, in view of the objectives inherent to the system, are in a comparable legal and factual situation.	If the measure deviates from the reference system, this deviation must be justified by either the nature or the design of the reference system. If a measure (which is selective a priori) is justified, the selectivity test will not be satisfied and the measure does not qualify as State aid.
EXAMPLES	In the case of business taxation, the general corporate income tax system is considered as the reference system. Some special-purpose taxes differentiating certain products or activities that are subject to the tax from others whose situation is different as regards the intrinsic objective pursued, such as environmental and health taxes imposed to discourage certain products or activities. These taxes are not a derogation but are considered as the reference system.	In Paint Graphos, for instance, the CJEU found that the exception for taxable income of cooperative societies of producers and workers derogated from the reference system, namely the corporate income tax system.	In A-Brauerei, the CJEU ruled that while a national tax exemption for the acquisition of intangible assets by companies owning at least 95% of the shares constituted an exemption of the reference system, such derogation was justified by the nature and the design of the reference system, which aimed preventing double taxation.

Although the above three-step analysis has not always been closely followed by the European Courts (i.e. Gibraltar, British Aggregates, Heiser), it has consistently been applied in the recent judgments in the Spanish goodwill-cases. More recently, it was confirmed by the CJEU's Grand Chamber with regard to the German tax exemption for the acquisition of intangible assets by companies owning at least 95% of the shares (A-Brauerei).

THE THREE-STEP SELECTIVITY TEST APPLIED TO TAX RULINGS

The Commission's application of the three-step selectivity test to tax rulings has been severely criticised. The McDonald's case demonstrates that correctly applying the test is decisive for the outcome of the State aid assessment. In this final decision, the Commission has recognised that its initial doubts about the existence of State aid were related to the erroneous assumption that Luxembourg misapplied the provisions of the reference system in favour of McDonald's. The Commission concluded that the double non-taxation of certain profits was the result of differing interpretations of the double taxation treaty by Luxembourg and the US. Consequently, the Commission closed the investigation by concluding that Luxembourg did not grant State aid in the form of a selective tax advantage to McDonald's.

ASSESSMENT TRANSFER PRICING RULINGS

With respect to the assessment of tax rulings endorsing a transfer pricing methodology to determine a corporate group entity's taxable profit, the Commission's application of the three-step test results in two closely-linked issues. These issues relate to the definition of the reference system, andare crucial for the outcome of the State aid assessment:

1. the broad definition of the reference system and its objectives; and
2. the assumption that there is a uniform European ALP

1. The broad definition of the reference system and its objectives

The Commission has adopted a very wide definition of the reference system, namely the national system for corporate income tax, which applies to all corporations, including standalone firms and groups of companies. In essence, the objective of the corporate income tax regime is to tax the profits of all corporations in a non-discriminatory way.

The inevitable consequence of the Commission's broad definition of the reference system is that transfer pricing rulings endorsing a method that results in a different outcome for a corporate group than a stand-alone company are viewed as a discriminatory derogation from the reference system (second step). This approach seems to be in line with the CJEU's case law on fiscal measures as confirmed in the recent rulings in the cases on the Spanish goodwill scheme and A-Brauerei. However, if the reference system were to be defined more narrowly, e.g. as the common system applicable to transfer pricing (potentially including the – at times not binding – OECD Transfer Pricing Guidelines), it would be far more difficult to establish deviations from the reference system under the second step, since all corporate groups would be taxed on the same basis. Despite support from the relevant corporate groups and Member States for a more narrowly defined reference system, the Commission's approach has not changed.

The broad definition of the reference system has actually been applied in all the cases concerning tax rulings. For instance, in Huhtamäki, the Commission found the deemed interest deductions to constitute a derogation from the reference system, since it allowed Huhtamäki to achieve an effective tax rate that is significantly lower than the rate applicable to standalone companies. Likewise, in Nike the

Commission's preliminary findings are that there is a derogation from the reference system because of the higher royalty payments by Nike in comparison to those negotiated on market terms between standalone companies. Comparable scenarios can be found in the Commission's decisions in Starbucks and Amazon. which both have appeals pending before the General Court. We do not expect a final verdict on the correct definition of the reference system in the short term, as it is likely that the General Court's judgments will be appealed by either the Commission or the company concerned.

2. The assumption of a uniform European ALP designed to avoid discrimination

Taking into account that the general objective of the reference system is to tax all companies subject to this system, corporate groups must select a transfer pricing method that reflects a market-based outcome. The Commission views the OECD Guidelines as useful guidance and it has repeatedly stated that "if a transfer pricing arrangement complies with the OECD Transfer Pricing Guidelines, a tax ruling endorsing that arrangement is unlikely to give rise to State aid".

However, in its decisions, the Commission interprets the ALP as a uniform European principle meant to ensure an equal tax treatment of all the firms subject to the reference system. The Commission's restrictive interpretation of the ALP is illustrated in the Fiat, Apple and the Excess Profit case. In these cases, the Commission considered in essence that due to the incorrect allocation of profits and the endorsed transfer pricing methodology (including a number of adjustments) the respective taxable base of these multinationals was artificially lowered and did not reflect a market-based outcome. Arguably, this view is inconsistent with the OECD Guidelines, which acknowledge that the ALP is a method aimed at estimation, which shows that a precise result is not possible to achieve. Moreover, the Commission's interpretation of the ALP limits the margin of discretion of multinationals and tax authorities to achieve the result pursued by the reference system, namely taxing the income of all firms on equal terms. After all, the essence and the objective of the common national practice concerning transfer pricing tax rulings is achieving legal certainty on taxation on equal terms taking into account the particularities of corporate groups. It remains to be seen whether the Commission's interpretation of the ALP will be followed by the European courts.

RECOVERY OF UNLAWFUL STATE AID

The conclusion that a tax ruling is State aid may have severe financial consequences. In addition to prohibiting the maintenance of the ruling, the finding that State aid has been granted without prior notification to the Commission will normally require the Member State to recover the amount of aid granted over the ten preceding years, plus interest.

LEGITIMATE EXPECTATIONS

The question is whether a recovery order can be successfully countered by a claim of legitimate expectations raised by the tax authority that the tax ruling is compatible with the State aid rules. It follows the case law of the European Courts that such a claim is rarely accepted, since companies benefitting from State aid are considered to be responsible themselves for ensuring compliance with the notification obligation (see e.g. Alcan). In one of the Spanish goodwill-cases, the General Court ruled that the beneficiaries of the measure at issue could legitimately take the view that that measure did not constitute State aid, because, in its answer to a parliamentary question, the Commission had provided clear assurances that the measure did not fall within the scope of the rules on State aid.

NEW RECOVERY REGIME FISCAL AID

With regard to the recovery of unlawful State aid resulting from Dutch tax measures, including tax rulings issued by the Dutch tax authority, a specific recovery regime has been introduced on 1 July 2018 by means of the new Recovery Act State aid. This act provides a legal basis for the recovery of unlawful State aid ordered by the Commission, a national court or the tax authority via an additional tax assessment (see our Update on the entry into force of the Recovery Act State aid (in Dutch only)).

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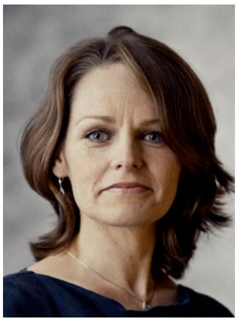

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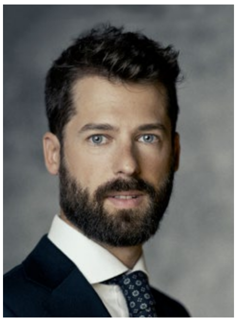

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