Analysis

The EC's guidance on state aid

Speed read

The European Commission has published a final draft of its Communication on the application of TFEU art 107 on the notion of state aid. Specific tax issues considered include tax rulings, settlements, amnesties, depreciation, collective investment vehicles and excise duties. The guidance sets out the EC's view that, among other things: the arm's length principle forms part of the Commission's assessment of tax measures under art 107, regardless of whether that principle is part of the national legal system; tax settlements may well involve state aid; and, state aid impacts much more broadly on the tax system than just in relation to transfer pricing rulings

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The European Commission published a draft Communication on the application of art 107 of the Treaty on the Functioning of the European Union (TFEU) in January 2014. The final version of that Communication has been long awaited, particularly in the context of the widening of the scope of the Commission's investigations into tax ruling practices. The final draft was published on 19 May 2016 (98/C 384/03) (see www.bit.ly/1TsfBns), and largely follows the earlier draft, but with some additions.

The Communication is broad ranging and relates to the notion of aid under TFEU art 107 generally, including areas such as health care, education, and culture and heritage conservation. Specific sections appear in relation to tax, however, and this document also sets out the Commission's views on the arm's length test.

Guidance on specific tax situations

The Commission notice sets out its basic position that member states are 'free to decide on the economic policy which they consider most appropriate and … to spread the tax burden as they see fit across the various factors of production'. This comes, however, with the important proviso that 'nonetheless, member states must exercise this competence in accordance with Union law', noting particularly the application of state aid law and discrimination contrary to the fundamental freedoms.

Tax amnesties

Tax amnesties (for a specified, short period of time) may be considered to be general measures (and therefore not selective) if certain conditions are met. Those conditions are:

- the measure is 'effectively' open to any undertaking with outstanding tax liabilities, such undertaking being of any sector or size, without favouring a pre-defined group;
- the measure does not allow for any de facto selectivity in favour of certain undertakings or sectors; and
- the tax administration's activities are limited to administering the implementation of the tax, and there is no discretionary power in relation to the amnesty.

A tax amnesty measure which applies to a specific category of taxpayers following a court judgment may also be a general measure, provided it follows the country's objective of ensuring compliance with a general legal principle.

Tax rulings

Despite the Commission's investigations into tax rulings appearing to be the current focus of its attention, the guidance on tax rulings and settlements is just one of a number of tax issues addressed.

In general terms, the Commission comments that tax rulings (e.g. those on the application of bilateral tax treaties, the application of national fiscal provisions or the arm's length test) give legal certainty and predictability as to the application of tax rules. The Commission notes that this is 'best ensured if its administrative ruling practice is transparent and the rulings are published'.

Consistent with its previous statements, the Commission notes that the problem arises where the result of the tax ruling is not one which would result from the 'normal application of the ordinary tax system'. This thereby potentially gives a selective advantage, because the addressee of the tax ruling may have a lower tax liability than those in a similar legal and factual situation who don't have a tax ruling.

EU arm's length principle

The guidance reiterates its position in respect of the purported EU arm's length principle. It is worth setting out in full the key point made by the Commission:

'The [CJEU] has held that a reduction in the taxable base of an undertaking that results from a tax measure that enables a taxpayer to employ transfer prices in intra-group transactions that do not resemble prices which would be charged in conditions of free competition between independent undertakings negotiating under comparable circumstances at arm's length confers a selective advantage on that taxpayer, by virtue of the fact that its tax liability under the ordinary tax system is reduced as compared to independent companies which rely on their actually recorded profit to determine their taxable base.'

Authority cited for this proposition, as set out in the letters to each of the countries involved in the current investigations, is *Belgium and Forum 187 v The Commission* (Joined Cases C-182/03 and C-217/03). In this guidance, the footnote citing Belgium and Form 187 is slightly more extensive, and cites paras 96 and 97 of the case: 'the effect of the exclusion [is that] the transfer prices do not resemble those which would be charged in conditions of free competition'.

The Commission goes on to say that a tax ruling which endorses a transfer pricing methodology which results in something other than a 'reliable approximation of a market-based outcome in line with the arm's length principle' confers a selective advantage.

The Commission is clear that the arm's length principle forms part of its assessment of tax measures under art 107, regardless of whether the arm's length principle is part of the national legal system. The guidance goes on to state: 'The arm's length principle the Commission applies in assessing transfer pricing rulings under the state aid rules is therefore an application of art 107(1)'.

As to the content of that principle, the guidance notes that 'it may have regard to' the OECD's *Transfer Pricing Guidelines*, because they 'capture the international consensus on transfer pricing' and provide useful guidance. The Commission also

notes that if a transfer pricing (TP) arrangement complies with OECD guidance, it is 'unlikely' to give rise to state aid.

This guidance appears to suggest a sliver of distance between the Commission's position and the OECD guidance. The Commission clearly considers OECD guidance authoritative, but it also appears to derive an arm's length principle from EU law.

The Commission also refers to TP methods in very brief form. It notes that a ruling is likely to be selective where it allows a taxpayer to use 'alternative, more indirect methods for calculating taxable profits, for example the use of fixed margins for a cost-plus or resale-minus method for determining an appropriate transfer pric[e], while more direct ones are available'.

Settlements

The guidance on settlements is brief but notes that tax settlements may well involve state aid, particularly where the 'amount of tax due has been reduced without clear justification … or in a disproportionate manner to the benefit of the taxpayer'. Clear justification appears to include, by way of example, optimising the recovery of debt.

The guidance refers to the following as specific circumstances in which a settlement may involve state aid:

- a 'disproportionate concession' is made to a taxpayer, which is more favourable compared to taxpayers in a similar legal or factual situation;
- the settlement is contrary to applicable tax provisions and results in a lower amount of tax 'outside a reasonable range'; and
- established facts should have led to a different assessment of the tax, but the amount of tax has been 'unlawfully reduced'.

It is not completely clear where domestic guidance, such as the litigation and settlement strategy (LSS), might fit with this position. Certainly, it is helpful to be able to point to compliance with the LSS, on the basis that it demonstrates a less discretionary approach to the settlement, which is more in line with the simple administration of the tax system.

Depreciation/amortisation rules

The EC comments that it is difficult to assess selectivity in relation to depreciation because of the requirement to establish a benchmark, from which a specific rate or depreciation method may derogate. The Commission notes that while in accounting terms the purpose is generally to 'reflect the economic depreciation of the assets with the aim of presenting a fair view', the fiscal process allows for different purposes.

However, where a tax authority has the discretion to set different periods or methods in respect of firms or sectors, 'there is obviously a presumption of selectivity'.

Fixed basis tax regime for specific tax activities

A fixed basis regime will not be considered selective if it seeks to avoid a disproportionate administrative burden on entities because of their size or sectoral activities, and does not have the effect of implying a lower tax burden than for comparable undertakings excluded from its scope.

Anti-abuse rules and excise duties

Both anti-abuse rules and excise duties receive the same treatment from the Commission. Anti-abuse rules may be selective if they provide for a derogation to specific undertakings, inconsistent with the logic of the rules. Excise duties, while harmonised, may be selective where an undertaking uses a product subject to reduced excise duty as an input or sells it on the market.

Specific entities: cooperative societies and collective investment funds

The Commission refers to genuine cooperative societies as operating differently to other economic operators, in particular commercial companies; and so they may not be in a comparable factual and legal situation and may, in certain circumstances, fall outside the scope of the state aid rules.

Likewise, the Commission addresses the taxation of undertakings for collective investment. The Commission refers to measures aimed at ensuring tax neutrality for investments in collective investment funds or companies. It states that they should not be viewed as selective where the measures do not favour certain undertakings or types of investments, but simply reduce or eliminate double economic taxation, where that is a principle of the tax system. 'Preferential treatment limited to well-defined investment vehicles', however, where they are preferred as against comparable competitors, may well be considered selective treatment.

The Commission does set what might appear to be base lines in respect of collective investment vehicles. It notes that the tax neutrality to which it refers does not mean that investment vehicles 'should be entirely exempt from any tax' or that fund managers should be exempt from tax on their management fees; nor does it allow for a more beneficial tax treatment of collective (as opposed to individual) investment. The Commission considers that disproportionate, and therefore a selective measure.

Final thoughts

This guidance deals with the topic of state aid more broadly than in relation to tax. As such, it covers a number of features of state aid which will be less relevant to taxpayers. (For example, it addresses whether the aid is imputable to the state, where in most tax situations there will be no dispute, or whether the recipient undertaking is engaged in an economic activity, which is often a key feature of state aid cases outside the context of tax, but rarely so in tax cases.)

However, the guidance also refers to key elements of state aid law which will be generally applicable, such as the principle of selectivity generally, and particularly selectivity stemming from discretionary administrative practices. The guidance also refers to some of the elements of the test in dispute in the appeals in the cases relating to Starbucks and Fiat, such as the distortion of competition.

What is clear from this Communication is that, in line with earlier EU case law, the issue of state aid impacts much more broadly on the tax system than just in relation to transfer pricing rulings. This document is therefore likely to be important guidance.

Where state aid is being considered as part of tax governance procedures, it would be well worth considering including the specific issues raised in the Communication. It may also be worth considering other aspects of current dealings with tax authorities as regards state aid compliance. Areas to be particularly careful of are those where the tax authority has discretion in relation to your particular case, and those where one taxpayer may be perceived to be receiving preferential treatment. ■

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