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EU Tax Rulings For Companies Threatened By State Aid Law

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At the beginning of November, the International Consortium of Investigative Journalists disclosed the results of its investigation into corporate taxation in Luxembourg (Leaked Documents Expose Global Companies' Secret Tax Deals in Luxembourg).[1] ICIJ claims that billions of euros in taxes for cash-strapped governments in Europe have been forgone and Luxembourg might have given favorable tax treatment to more than 300 multinational companies.

In an unusual move, the new European Commissioner for Competition Margrethe Vestager responded on the same day by issuing a public statement to confirm that the commission is already investigating whether certain tax rulings adopted by some member states are in compliance with EU state aid rules.

With particular regard to Luxembourg, there are already two EU probes open and they intend to take a close look at the published documents. This could lead to the opening of more state aid investigations and more multinational companies might be caught by investigations into selective tax breaks by governments throughout Europe.

Background

According to the documents made public by ICIJ, hundreds of multinational companies have been able to substantially reduce their tax exposure by forming Luxembourg entities that earn large profits through transfer pricing and other tax structuring, after receiving favorable tax rulings from the national authorities. Tax rulings are decisions through which national authorities confirm the conformity with legal rules of company-specific tax structures presented by multinational companies and their tax advisers.

Most legal and media commentary focuses on the legality of the rulings from a tax law perspective and the role played by tax advisers. However, international companies that have benefited from tax rulings issued in Luxembourg or elsewhere in the European Union face more than tax law risks — they also risk the enforcement of EU competition law and in particular, EU state aid control.

Indeed, aside from the risks resulting from the potential opening of an in-depth proceeding by the commission, if the tax rulings are declared to be incompatible state aid within the meaning of Article 107(1) of the Treaty on the Functioning of the European Union (TFEU), the companies benefiting from them run into the risk of having to return the full amount of the aid — plus the applicable interest during the time when the tax ruling was applicable.

Vestager, during her hearing at the European Parliament on Oct. 2, 2014, already indicated that one of her first enforcement priorities would be to assess the legality under EU competition rules of any "tax deals" offered to multinational companies by national tax authorities. In view of the above, the commission is likely to open further state aid investigations affecting additional companies.

EU State Aid Law

State aid law is one of the pillars of EU competition law. It prevents EU member states from interfering in the economy by granting distortive aid, in any form, to companies operating in the EU market. According to Article 107(1) TFEU, a state measure is considered to be incompatible when the following four conditions are present:

- the measure is imputable to the state (i.e. enacted by the state itself or an agency) and financed through state resources;
- the measure confers an economic advantage to the company or group of companies to which it is directed;
- the advantage is selective, that is, only available to that specific company or group of companies to which it is directed; and
- the measure distorts or threatens to distort competition and has a negative effect on trade between EU member states.

Under Article 108 TFEU, member states need to notify and obtain the commission's approval before implementing any aid measure.[2] If the aid is implemented without such a notification or before having obtained the commission's approval, the aid measure is considered to be unlawful and the commission will open an investigation.

If it comes to the conclusion that the aid is not compatible with the internal market, it will issue a negative decision. In that scenario, the pertinent member state will have to recover the aid granted, including the applicable interest from the time the aid was at the disposal of the beneficiary until the date of its recovery, in accordance with the procedure laid down in Article 108(2) TFEU.[3]

This prohibition applies to any form of state aid, not just direct monetary contributions but also any other kind of advantages, including selective tax measures. Tax exemptions or fiscal advantages granted by national tax agencies may amount to incompatible state aid within the meaning of Article 107(1) TFEU, and hence are improper, if they distort or threaten to distort competition by favoring certain companies or group of companies and affect interstate trade.

EU Probes into National Tax Rulings

Tax measures have long been the focus of EU state aid probes. However, individual tax rulings did not catch the attention of the EU competition authority until earlier this year, when the commission opened formal investigations into the tax rulings practices of several EU member states. The commission opened three in-depth investigations under Article 108(2) TFEU against Ireland, Luxembourg and the Netherlands for alleged state aid involved in individual tax rulings with several multinational companies in June, followed by another case against Luxembourg in October. These four cases are registered under case numbers SA.38373, SA.38374, SA.38375 and SA.38944.[4]

According to the commission, tax rulings can amount to incompatible state aid under EU state aid law, if they grant a selective advantage to a specific company or group of companies. This is the case, in particular, when a tax ruling validates a company-specific financing arrangement or tax structure that results in a very low effective tax rate in the country granting the ruling. This, in turn, creates an incentive to employ transfer pricing strategies to shift risks, activities and ultimately profits to the country that grants the ruling.

Tax rulings that result in a reduced effective tax rate for a particular taxpayer, as compared to the generally applicable tax laws of the country granting the ruling, could be considered as a specific advantage within the meaning of Article 107(1) TFEU, and therefore prohibited under the EU state aid rules because they place their recipient in a better fiscal position as compared to other enterprises in a similar legal and factual situation.

In assessing whether the national rulings were "selective," the commission will also have to take into consideration the case of the European courts and in particular, the recent judgment of the General Court of the EU (Judgment in Cases T-219/10 Autogrill Espana SA v. Commission and T-399/11 Banco Santander SA and Santusa Holding SL v. Commission) where tax breaks for shareholdings in foreign companies were found not to be selective and hence not to break EU state aid rules. The court said that the finding of the selectivity of a measure must be based, inter alia, on a "difference of treatment between categories of undertakings under the legislation of the same member state, not a difference in treatment between companies of a member state and those of other member States."

Broader Implications

These probes concern only the competition law analysis referred to above (i.e., whether the individual tax ruling amounts to state aid, and if so, whether this aid shall be declared compatible with Article 107(1) TFEU). In this investigation, the commission will thus not question the general tax regime of Luxembourg or of any other member states. However, the ICIJ publication has already sparked political turmoil and the European Parliament has called for action in this area, such as the introduction of a common consolidated corporate tax break.[5] Commission President Jean-Claude Juncker has already indicated his intention to propose separate legislation to enable EU member states to exchange information on individual tax rulings.

Earlier this year, the commission requested that Luxembourg provide complete information on its tax rulings practices. Luxembourg refused to provide the details on the tax arrangements, and the commission decided to begin infringement procedures. Now, as a result of the leak, the commission will have access to significant documentation and to a list of additional companies that might have benefited from tax rulings potentially subject to state aid rules.

A significant question is whether the commission can use the leaked documents to start new state aid investigations. In principle this may not be a problem, especially in the presence of legal precedents where courts ruled that leaked data can be used in tax investigations, even if they have been purchased by the authorities from insiders.

Implications for Companies

Companies should closely monitor the commission's investigations on tax rulings from Ireland, Luxembourg and the Netherlands, as well as any further developments in this area. In particular, multinational corporations with affiliates in one of these countries, or in other EU jurisdictions where they have received a tax ruling that reduces their effective tax rate, should seek legal advice to verify the compatibility of their own tax ruling under EU state aid law and assess any legal risks deriving from the inclusion in the ICIJ publication, including potential third-party actions. If a ruling is later found to be an illegal state aid, the addressee of the ruling risks the obligation to repay all the taxes that were not paid during the period in which the ruling was in place.

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[1] Commonly referred to as "Lux Leaks."

[2] See Council Regulation No 659/1999 of March 22, 1999, laying down detailed rules for the application of Article 108 of the Treaty on the Functioning of the European Union of the EC Treaty, (Procedural Regulation), published in the Official Journal L 83/1, 27.03.1999, p. 1-9; and the Commission Regulation (EC) No 794/2004 of 21 April 2004 implementing Council Regulation (EC) No 659/1999 laying down detailed rules for the application of Article 93 of the EC Treaty (the Implemented Regulation) as amended, published in the Official Journal L 140, 30.04.2004, p. 1-134.

[3] Under Article 14(3) of the Procedural Regulation, "recovery shall be effected without delay and in accordance with the procedures under the national law of the Member State concerned, provided that they allow for the immediate and effective execution of the Commission decision." According to Article 14(2) of the Procedural Regulation, the aid to be recovered pursuant to a recovery decision shall include interest at an appropriate level to be fixed by the commission. The Implementing Regulation establishes that the interest rate shall be applied on a compound basis until the date of the recovery of the aid. See also Commission Notice on recovery (2007), "Towards an effective implementation of Commission decisions ordering Member States to recover unlawful and incompatible State aid."

[4] Only the following decisions to open a formal investigation procedure under Article 4(4) of the Procedural Regulation have been published so far: State aid SA.38373 (2014/C) (ex 2014/NN) (ex 2014/CP) — Ireland; State aid SA.38374 (2014/C) (ex 2014/NN) (ex 2014/CP) — Netherlands; and State aid SA. 38375 (2014/NN) (ex 2014/CP) — Luxembourg.

[5] "Lux leaks": MEPs push for plenary debate with Council and Commission on tax avoidance, Nov. 12, 2014 (see here). See also ECON Committee meeting of Nov. 11, 2014.