TAX RULINGS IN THE EUROPEAN UNION – STATE AID AS THE EUROPEAN COMMISION'S SWORD LEADING TO TRANSPARENCY RULINGS

Author
Beate Erwin

Tags
E.U. Commission
Germany
State Aid
Transparency
T.F.E.U.

The European Union's plan on putting an end to corporate tax breaks granted by means of letter rulings ran into German privacy concerns as E.U. Finance ministers met on June 19, 2015. The initiative, aimed at implementing an automatic exchange of letter rulings granted by E.U. Member States, will affect E.U. businesses as well as European operations of foreign multinationals, including those based in the United States. Examples of the latter are already under review by the E.U. Commission with regard to letter rulings issued by Ireland and the Netherlands, respectively, to local operations of Apple and Starbucks. Although the E.U. Commission, the executive body of the European Union, has no direct authority over national tax systems, it can investigate whether certain fiscal regimes, including those that issue advance private tax rulings, constitute an infringement of E.U. principles, in particular "unjustifiable" State Aid to companies. Such allegedly incompatible State Aid would comprise, *inter alia*, selective tax advantages granted by an E.U. Member State to companies with operations in its jurisdiction.

The Commission is very clear on its intent to use its powers and pursue its initiative vigorously. The financial press has widely reported a statement made by a spokesman for Competition Commissioner Margrethe Vestager that combating tax evasion and avoidance is a top priority of the Commission. In line with that concern, the Commission is taking a structured approach when using its State Aid enforcement powers to investigate selective tax advantages that distort fair competition.[1]

The following provides an overview on the legislative framework with respect to State Aid, developments and an outlook on the future of tax rulings in an environment of increased tax transparency.

WHAT IS STATE AID IN GENERAL?

Article 107 sec. 1 of the Treaty on the Function of the European Union ("T.F.E.U.") provides that any aid granted by a Member State or through state resources, in any form whatsoever, distorting or threatening to distort competition by favoring certain undertakings is incompatible with the internal market as far as it affects the trade between the Member States.[2] A measure qualifies as "State Aid" if the following conditions are met:

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1 *Out-law.com*, April 2015.

2 See: Matthias Scheifele, "State Aid, Transparency Measures and Reporting Standards in the EU," in Chapter 274 of *The Corporate Tax Practice Series: Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Reorganizations & Restructurings 2015*, ed. Louis S. Freeman (Practicing Law Institute).

- The relevant intervention is granted by a Member State or through State resources.[3]
- The intervention provides an economic advantage to the recipient.[4]
- The intervention affects or may affect competition and trade between the Member States.[5]
- The advantage is selective, *i.e.*, it is only granted to specific recipients.[6]

"A measure qualifies as 'State Aid' if the following conditions are met..."

Even if a measure fulfills those prerequisites, certain exemptions set forth under Article 107 sec. 2 or sec. 3 T.F.E.U. may apply to exempt the measure from State Aid status. For example, State Aid having a social character and being granted to individual consumers and State Aid eliminating damages caused by natural disasters are considered compatible with the internal market under such exemptions.[7] In addition, State Aid promoting economic[8] and cultural[9] development is not considered to be unlawful. Also allowable is State Aid promoting the execution of projects of common interest or projects to remedy serious disturbances in the economy[10] of a Member State,[11] as well as other categories of aid specified by decision of the Counsel on proposal from the Commission.[12]

If a Member State intends to implement a new State Aid measure, it must notify the Commission,[13] whereas existing State Aid measures are constantly reviewed by the Commission.[14] Procedural basis for the Commission's authority to review the status of State Aid is Council Regulation (EU) No. 734/2013[15] ("Procedural Regulation").[16] Pursuant to the Procedural Regulation, the Commission decides whether

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3 "Commission notice on the application of State aid rules to measures relating to direct business taxation," *Official Journal C 384* (December 10, 1998): p. 3, ¶10.

4 *Id.*, ¶9.

5 *Id.*, ¶10.

6 Jestaedt, §8 in *European State Aid Law*, ed. Martin Heidenhain (München: Verlag C.H. Beck, 2010).

7 Consolidated Version of the Treaty on the Functioning of the European Union art. 107(2), Oct. 26, 2010, 2012, *Official Journal C 326* [hereinafter "T.F.E.U."].

8 *Id.*, art. 107(3(a)).

9 *Id.*, art. 107(3(d)).

10 In particular, this exemption was of importance in context with the financial crises, see: Blumenberg, Jens, and Wulf Kring. "Europäisches Beihilferecht Und Besteuerung." *IFSt*, no. 473 (2011): 21(f).

11 T.F.E.U., art. 107(3(b)).

12 *Id.*, art. 107(3(e)).

13 *Id.*, art. 108(3).

14 *Id.*, art. 108(1).

15 Council Regulation 734/2013/EU of July 22, 2013 amending Regulation 659/1999/E.C. laying down detailed rules for the application of Article 93 of the E.C. Treaty, *Official Journal L 204* (July 31, 2013): p. 15 [hereinafter "Procedural Regulation"].

16 T.F.E.U. Article 109 authorizes the Council (on proposal from the Commission and after consulting the Parliament) to implement any appropriate regulation regarding the application of the State Aid provisions, which the Council utilized to adopt the Procedural Regulation.

a notified measure constituting State Aid is compatible with the internal market.[17] If the Commission finds that an existing State Aid measure is incompatible with the internal market, it decides whether the Member State granting the State Aid should amend or abolish the respective measure within a period of time determined by the Commission.[18] Illegal State Aid must be recovered from the recipient entity.[19]

STATE AID AND DIRECT BUSINESS TAXATION

Principles set forth under E.U. law supersede national laws of Member States ("Supremacy Principle"). The Supremacy Principle guarantees the superiority of European law over national laws. It is a fundamental principle of European law. The Supremacy Principle applies to all European acts with a binding force. Therefore, Member States may not apply a national rule that contradicts European law. This rule is not inscribed in the Treaties. Rather, it is based on European Court of Justice ("E.C.J.") decisions.[20]

One of these principles under E.U. law overriding domestic law is the incompatibility of State Aid with the internal market. The latter applies to aid "in any form whatsoever."[21] Given this broad definition of State Aid, national provisions regarding direct business taxation may be considered as State Aid if the preconditions of the T.F.E.U. are met. In 1998, the Commission clarified these requirements with respect to national tax provisions and adopted the Commission Notice on the application of State Aid rules to measures relating to direct business taxation.[22]

Measures in the area of direct business taxation may amount to unlawful State Aid if the following conditions are met:

- Economic Advantage

  First, the tax measure must grant an economic advantage. In the case of tax rulings, an advantage will in principle exist where the tax payable under the tax ruling is lower than the tax that would otherwise be paid under the normally applicable tax system. The general rule is that the allocation of profit between companies of the same corporate group must comply with the "arm's-length principle" as set forth in Article 9 of the O.E.C.D. Model Tax convention. In the case of transfer pricing agreements, this means that arrangements between companies of the same corporate group must not depart from arrangements that a prudent independent operator acting under normal market conditions would have accepted. The E.C.J. has confirmed that if the method of taxation for intra-group transfers does not comply with the arm's-length principle and leads to a lower taxable base than would result

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17 Procedural Regulation, art. 7.

18 T.F.E.U., art. 108(2).

19 Procedural Regulation, art. 14.

20 See *Van Gend & Loos v. Netherlands Internal Revenue Administration*, Case 26/62 [1963] CMLR 105, and *Costa v. E.N.E.L.*, Case 6/64 [1964] ECR 585, CMLR 425,593.

21 "Commission notice on the application of State aid rules to measures relating to direct business taxation," *Official Journal C 384* (December 10, 1998): p. 3, ¶2.

22 *Official Journal C 384* (December 10, 1998).

from correct implementation of that principle, a selective advantage is provided to the company concerned.[23]

- State Resource Based Financing

  Second, the advantage must be financed through State resources. In cases where a tax authority lowers the effective tax rate that would otherwise be payable, the resulting loss of revenue for the State is equivalent to the use of State resources.[24] This applies even if the tax relief might indirectly have a positive effect on overall budget revenue.[25] Furthermore, the State support may not just be provided by legislation but also through the practices of the tax authorities.[26]

- Distortion or Threat to Distort Trade and Competition Between Member States

  Third, the tax measure must distort or threaten to distort trade and competition between Member States. Where the beneficiary carries out an economic activity in the E.U., this criterion is easily met.

- Selective Character of the Tax Measure

  Finally, the tax measure must be specific or selective in that it benefits "certain undertakings or the production of certain goods." According to the Commission, "every decision of the administration that departs from the general tax rules to the benefit of individual undertakings in principle leads to a presumption of State Aid and must be analyzed in detail."[27] Thus, a tax ruling that merely interprets general tax rules or manages tax revenue based on objective criteria will generally not constitute State Aid, while a ruling that applies the authorities' discretion to apply a lower effective tax rate than would otherwise apply may amount to State Aid. In the case of transfer pricing agreements, a tax ruling that deviates from the arm's-length principle is likely to be considered as specific and hence qualify as State Aid under E.U. law.

Tax rulings are "comfort letters" from national tax authorities giving specific companies clarity on how their corporate tax will be calculated, or on the use of special tax provisions such as transfer pricing arrangements ("Advance Pricing Agreements" or "A.P.A.'s"). As long as such letter rulings are used to provide guidance on the respective tax authority's interpretation of tax rules, they would not be considered harmful with respect to E.U. principles. However, if used to provide selective advantages to a specific company or group of companies, tax rulings may involve State Aid within the meaning of the E.U. rules, resulting in an infringement of E.U. law as outlined above.

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23 See: *Belgium and Forum 187 v. Commission*, Joined Cases C-182/03 & C-217/03, [2006] E.C.R. I-5479, ¶97.

24 "Commission notice on the application of State aid rules to measures relating to direct business taxation," *Official Journal C 384* (December 10, 1998): p. 3, ¶10.

25 E.U. Commission, "Report on the implementation of the Commission notice on the application of State aid rules to measures relating to direct business taxation," C(2004)434 at ¶19 (February 9, 2004).

26 "Commission notice on the application of State aid rules to measures relating to direct business taxation," *Official Journal C 384* (December 10, 1998): p. 3, ¶10.

27 *Id.*, ¶22.

If one of the tax measures in question constitutes State Aid, it could in principle benefit from an exemption under the T.F.E.U., but such exemptions generally apply to tax relief granted for a specific project, such as investing in disadvantaged areas or promoting culture and heritage conservation, and are limited to the costs of carrying out such projects. However, the Commission has indicated in its opening decisions that, at this stage of the investigations, no indication exists for the contested rulings to benefit from an exemption under the T.F.E.U.

CONSEQUENCES OF UNLAWFUL STATE AID

If an existing tax provision comprises State Aid within the meaning of Article 107 sec. 1 T.F.EU, and if no exemption within the scope of Article 107 sec. 2 or sec. 3 T.F.E.U. applies, the Member State is obliged, upon a decision of the Commission, to recover the unlawful State Aid from the beneficiary.

The Commission may only refrain from its decision regarding the recovery in two defined cases. If the recovery of unlawful State Aid is contrary to a general principle of the Community law, no recovery will be required.[28] Those general principals provide for an exemption when the recovery is absolutely impossible[29] or a legitimate expectation[30] argues against the recovery. However, these exemptions are rarely applicable. The recovery of unlawful State Aid can be applied to unlawful State Aid that was received within the prior ten-year period.[31] Recovery cannot go back further. Apart from theses exceptions and pursuant to Article 14 sec. 1 Procedural Regulation, Member States must take all necessary measures to recover unlawful State Aid from the beneficiary and to impose interest on the deferred payment.[32] Hence, consequences for the businesses at issue may be harsh.

WHO IS ON THE E.U. COMMISSION'S RADAR?

While the Commission is very clear that only selective tax rulings in the sense of the State Aid legislation are targeted, it is also very clear on its determination to establish a new set of rules in this respect.

E.U. Commissioner for Taxes Pierre Moscovici said in an interview with Euranet Plus that tax rulings are not illegal and that the Commission is not seeking to question the system itself. The Tax Commissioner went on to say that an exchange of information on tax rulings will simply force E.U. Member States to take a fair approach to tax competition, and as a result, companies will avoid tax abusive strategies.

According to Competition Commissioner Vestager, the European Commission will not be able to move quickly enough to tackle anti-competitive tax practices by the different Member States without "at least" a single corporate tax base and automatic exchange of information on the tax rulings (discussed in more detail below).

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28 Procedural Regulation, art.14(1(2)).

29 Sinnaeve, §32 in *European State Aid Law*, ed. Martin Heidenhain (München: Verlag C.H. Beck, 2010).

30 *Ibid*.

31 Procedural Regulation, art.15(1).

32 *Id.*, art. 14(2).

> If Member States do not provide the necessary information, we can give injunctions. We can launch infringement procedures and we can take them to court if we do not get the info we need to do our work. But for the Commission to work in a dedicated, fast and just manner, we need at least the automatic exchange of information on tax rulings and a common consolidated tax base. We might also have to prepare guidelines for Member States to explain in detail what is allowed and what is not. But for that we need more case law.

The European Commission has been investigating Member State practices in granting tax rulings since June 2013. To date, requests for data on rulings have been received by Austria, Belgium, Cyprus, the Czech Republic, Denmark, Finland, France, Germany, Great Britain, Hungary, Ireland, Italy, Lithuania, Luxembourg, Malta, the Netherlands, Poland, Rumania, Sweden, Slovakia, and Spain. According to the European Commission, no need was observed to ask Bulgaria, Greece, Croatia, Latvia, and Slovenia for tax rulings,[33] which some interpret as the "white list" of countries deemed compliant in this respect.

In March 2014, the Commission adopted two injunctions ordering Luxembourg to deliver information requested by the Commission regarding tax rulings and intellectual property tax regimes. In June 2014, the Commission opened formal investigations into individual rulings issued by (i) Irish tax authorities on the calculation of taxable profit allocated to the Irish branches of Apple Sales International and of Apple Operations Europe, (ii) the Netherlands in relation to the calculation of the taxable basis in the Netherlands for manufacturing activities of Starbucks Manufacturing, and (iii) Luxembourg in relation to Fiat Finance and Trade.

"The European Commission will not be able...to tackle anti-competitive tax practices by the different Member States without 'at least' a single corporate tax base and automatic exchange of information on the tax rulings."

Regarding Ireland, the Commission stated that the results of its preliminary investigation into Apple's arrangements were that A.P.A.'s in Ireland may have given the company unfair advantages incompatible with E.U. State Aid laws. While the Irish Finance Minister, Michael Noonan, claimed that the European Commission does not have a very strong case, Competition Commissioner Vestager told Irish state broadcaster RTÉ that there are reasonable doubts about the legitimacy of the rulings. Regarding the Netherlands, the Commission's preliminary view into the agreement between the Dutch tax authorities and Starbucks was that the agreement amounted to unlawful State Aid; according to State Aid experts, the Commission may have gone too far on its conclusions in relation to Starbucks.

Regarding all three cases, the Commission stated:

> The Commission has reviewed the calculations used to set the taxable basis in those rulings and, based on a preliminary analysis, has concerns that they could underestimate the taxable profit and thereby grant an advantage to the respective companies by allowing them to pay less tax. The Commission notes that the three rulings concern only arrangements about the taxable basis. They do not relate to the applicable tax rate itself. Selective tax advantages may amount to State Aid. The Commission does not call into question the general tax regimes of the three Member States concerned.[34]

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33 See: "State aid: Commission orders Estonia and Poland to deliver missing information on tax practices; requests tax rulings from 15 Member States," *European Commission Press Release Database*, published June 8, 2015.

34 *Out-law.com*, June 12, 2014.

In October 2014, the Commission opened an investigation regarding rulings given to online retailer Amazon in Luxembourg. In January, the European Commission stated that corporation tax arrangements agreed between Luxembourg and Amazon in 2003 may have conferred such a "selective advantage" on Amazon.

In February this year, the Commission announced it was investigating Belgium's tax regime, which allows companies to reduce their tax liability on the basis of excess profits tax rulings.

In June 2015, the Commission issued two injunctions ordering Estonia and Poland to deliver requested information on their tax ruling practices within one month. In its press release, the Commission notes that in the case of non-compliance with these injunctions it may refer the Member State to the E.C.J.

WHERE DO WE STAND NOW AND WHAT IS NEXT?

"The E.U. Commission unveiled new proposals to help identify corporate tax avoidance by announcing a policy that would enhance information sharing between Member States."

The E.U. Commission unveiled new proposals to help identify corporate tax avoidance by announcing a policy that would enhance information sharing between Member States. The Tax Transparency Package was presented on March 18, 2015. It follows an earlier proposal for an exchange of information on tax rulings released in December 2014 and aims to ensure that Member States have the information they need to protect their respective tax bases.

The Commission has proposed the setting up of an automatic exchange of information between countries on cross-border tax rulings. Member States will be required to exchange information automatically on private tax rulings and A.P.A.'s. The exchange would be made within a strict timeline: every three months, all Member States would be obliged to report all rulings issued during that period to all other Member States and the Commission. This report would be sent via a secure email system and would contain a pre-defined standard set of information. The recipient Member States would have the right to request more detailed information that is relevant to the administration of its tax laws. Each year, Member States would provide statistics to the Commission on the volume of information exchanged.

In addition to this quarterly exchange of information, an obligation is imposed with regard to rulings issued during the ten-year period prior to the effective date of the proposed Directive, discussed below. This obligation applies only to rulings that remain valid on that date.

The instrument under which all such exchange would occur is Directive 2011/16/EU on Administrative Cooperation in the Field of Taxation ("D.A.C.").

The Tax Transparency Package includes a second proposal that relates to initiatives to "advance the tax transparency agenda" of the Commission. These initiatives are:

- New transparency requirements for companies, including the public disclosure of some tax information by multinational companies;
- A review of the Code of Conduct on Business Taxation;
- An attempt to develop a reliable estimate of the level of tax evasion and avoidance across Member States; and
- The repeal of the Savings Tax Directive (*i.e.*, the legal framework on

automatic information exchange on financial accounts, including savings related income), which the Commission believes has been "overtaken by more ambitious EU legislation." Repealing the Saving Tax Directive is intended to create a streamlined framework for the automatic exchange of financial information and prevent any legal uncertainty or extra administration for tax authorities and businesses.

This proposal was endorsed by Finance Ministers at their informal E.C.O.F.I.N. meeting in Riga in April of this year, and technical negotiations in this respect are progressing in the Council.

To implement such legislation, unanimity is required. While it has been stressed in press releases that work on the initiative of an automatic exchange of tax rulings is in progress, some pushback has been encountered: Germany, Estonia, and Poland have addressed fiscal secrecy as a main concern in providing tax rulings. However, on July 15, 2015, the German government reportedly approved two bills authorizing the automatic exchange of tax information with other E.U. Member States and third countries. The exchange would be effective in 2017.

Additionally, in the E.C.O.F.I.N. meeting on June 19, 2015, Germany, Poland and Slovenia addressed concerns about the ten-year timeframe, *i.e.*, tax rulings dating back ten years. Tax Commissioner Moscovici denied that retroactivity exists. His position is based on the fact that retroactivity refers to rulings that have continuing effect. Hence, the proposal is not retroactive.

The Commission has stressed in press releases that work on the initiative of an automatic exchange of tax rulings is in progress. With respect to the confidentiality issues, it stated that, Member States could not invoke professional secrecy[35] for refusing to provide information requested by the Commission.

It is envisaged to enter into force as of January 1, 2016.

On June 17, 2015, an action plan was adopted to make corporate taxation fairer, more efficient and more transparent. The action plan set out key actions to tackle corporate tax avoidance including:

- A relaunch of the Common Consolidated Corporate Tax Base ("C.C.C.T.B."), its 2011 proposal on a framework to ensure taxation of profits where they are generated;
- Creating a better business environment;
- Measures ensuring effective taxation such as harmonizing corporate tax rates across the E.U.;
- Measures increasing transparency, building on the Transparency Package adopted in March 2015 (see above); and
- Improving E.U. coordination.[36]

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35 Commission Communication C(2003) 4582, *Official Journal C 297* (December 9, 2003): 0006 – 0009.

36 See: "Commission presents Action Plan for Fair and Efficient Corporate Taxation in the EU," European Commission Press Release Database, published on June 17, 2015; see also "Action Plan on Corporate Taxation," European Commission Taxation and Customs Union, published June 2015.

The transparency-related measures include a list of third countries and territories blacklisted by Member States. The list is available online.[37]

CONCLUSION

The details of the proposed automatic exchange of information on tax rulings are currently under negotiation. A unanimous decision may take longer than expected and could affect the scheduled implementation date of January 1, 2016. Apart from the issues outlined above with respect to secrecy and the ten-year lookback period, more fundamental issues arise, such as granting the Commission direct access to practices of the tax administrations of each Member State. The concern is that such access is beyond the institutional role of the Commission.

Nonetheless, the political pressure should not be underestimated and may be increased by the European Parliament, which is currently investigating tax rulings.[38] Depending on its findings, the European Parliament may approve the D.A.C., or propose even stricter provisions, notwithstanding the Parliament's consultative role in issues such as these.

Finally, the Tax Transparency Package proposed by the Commission is only one part of a wider set of connected initiatives aiming at increased overall levels of tax transparency. In particular, the Tax Transparency Package must be viewed in conjunction with Action 13 of the O.E.C.D.'s B.E.P.S. project, which requires companies to report taxes paid via the country-by-country reporting template and to maintain a Master File and Local Files. Businesses with E.U. operations are advised to closely monitor these developments. A significantly changed tax landscape is clearly ahead.

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37 See: "Tax good governance in the world as seen by EU countries," European Commission Taxation and Customs Union.

38 In February 2015, the European parliament set up a Special Committee on Tax Rulings and Other Measures Similar in Nature or Effect ("TAXE Committee") to look into tax rulings and "other measures similar in nature and effect" going back to January 1, 1991. With 45 members and the same number of substitutes, the TAXE Committee's role is primarily to investigate the compatibility of tax rulings with the rules of State Aid and tax law. The TAXE Committee will then draft a report, including recommendations on how to improve transparency and cooperation between Member States, to the benefit of the internal market, European companies and citizens. It will review the way that the European Commission treats State aid in Member States and the extent to which those Member States are transparent on their tax rulings, and make recommendations for the future.