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ALERT MEMORANDUM

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# European Commission Probes Member States' Tax Rulings Systems

On September 11, 2013, the European Commission ("the Commission") launched a State aid investigation by sending requests for information to several Member States regarding their systems of tax rulings. The initial requests focus on three Member States: Ireland, Luxembourg and the Netherlands. Similar requests may well be addressed to other Member States in the future.

This preliminary investigation is conducted by the Commission's Directorate General for Competition and seeks to determine whether companies benefited from unlawful State aid through favourable tax rulings. These requests constitute a first step in the investigation that may result in the opening of a formal investigation if the initial information obtained were to strengthen the Commission's concern that certain national systems of tax rulings or the actual ruling adopted under such system breach EU State aid rules.

The investigation must be seen as part of the European Union's general fight against tax avoidance and evasion and appears to have been prompted by press reports identifying certain upfront arrangements that governments had concluded with certain companies on the tax treatment of revenues that seemed difficult to reconcile with the general tax rules. It also comes shortly after the OECD adopted an Action Plan on "base erosion and profit shifting"[1] (*i.e.*, international tax planning by some multinational enterprises designed to shift profits in ways that erode the taxable base of developed and developing countries to locations where they are subject to a more favourable tax treatment, thus leading to situations where income is not taxed anywhere), which the G20 endorsed on September 6, 2013.

The investigation may result in far-reaching consequences for beneficiaries of such rulings. This is because the Commission can, under the State aid rules, force Member States to retroactively reconsider and invalidate tax rulings that infringe the

[1] See OECD, *Action Plan on Base Erosion and Profit Shifting* of July 19, 2013, available at http://www.oecd.org/ctp/BEPSActionPlan.pdf; and OECD, *Addressing Base Erosion and Profit Shifting,* Report of February 12, 2013, available at http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/addressing-base-erosion-and-profit-shifting_9789264192744-en#page1.

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State aid rules, and to recover from beneficiaries of such ruling any tax benefit considered to amount to unlawful State aid. It is possible for the Commission to look back for a period of ten years prior to the commencement of its preliminary proceeding, even in circumstances where the rules or time limits under national tax laws for modifications of rulings or resulting tax assessments would normally prevent such action.

## I. WHY AND WHEN CAN TAX RULINGS BE CONSIDERED "STATE AID"

In principle, Member States have far-reaching and exclusive powers in adopting tax laws and in making policy choices as to what they wish to tax or not to tax. Nevertheless, they must respect the provisions of the Treaty on the Functioning of the European Union ("TFEU"), including Article 107 (1) TFEU, which prohibits *"any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods, in so far as it affects trade between Member States."*

Hence, measures taken to exempt a beneficiary from an otherwise existing obligation to pay taxes, can amount to State aid if (i) they provide the beneficiary with an "advantage" (compared with the situation under normal tax laws), (ii) that advantage is granted by the State or from State resources, and (iii) that advantage may affect trade between Member States and distort competition, as long as (iv) such a measure benefits "*certain undertakings or the production of certain goods*" (*i.e.*, if the measure is "specific").

The Commission is therefore likely to consider that a tax ruling constitutes State aid where it entails a loss of tax revenues for the Member State and confers a selective advantage to its recipient. In principle, an advantage will exist where the tax resulting from the application of the "normally applicable" tax system is higher than the tax payable under the tax ruling. The Commission notice on the application of the State aid rules to measures relating to direct business taxation (the "Tax Notice") explains that *"the measure must confer on recipients an advantage which relieves them of charges that are normally borne from their budgets. The advantage may be provided through a reduction in the firm's tax burden in various ways, including a reduction in the tax base (such as special deductions, special or accelerated depreciation arrangements or the entering of reserves on the balance sheet), a total or partial reduction in the amount of tax (such as exemption or a tax credit), deferment, cancellation or even special scheduling of tax debt."*[2]

In analysing tax rulings, the Commission must be expected to focus on the question of whether the ruling entails a selective advantage, *i.e*. whether it favours *"certain undertakings."* In that regard, the Tax Notice places particular emphasis on the

[2] Commission Notice on the application of State aid rules to measures relating to direct business taxation, JO 1998, C 384/3, par. 9.

discretionary powers of tax authorities, in particular where the exercise of discretionary power goes beyond the simple management of tax revenue by reference to objective criteria. The Tax Notice hence states that *"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 analysed in detail."*[3] Therefore, as long as a tax ruling only contains an interpretation of a general rule, in particular to remove uncertainties resulting from ambiguities in such tax rules, or more generally so as to provide to its recipient with legal certainty and predictability on the application of general tax rules in areas where there is uncertainty, it will generally not constitute a specific advantage and hence not be State aid within the meaning of Article 107(1) TFEU. The situation is different where the tax authorities use their discretion to depart from the general rules, or to interpret them in manner inconsistent with the general objectives or logic of the general tax rules.[4]

## II. WHY WOULD STATE AID RESULTING FROM TAX RULINGS BE DIFFICULT TO AUTHORIZE UNDER THE STATE AID RULES

The TFEU provides for a number of cases in which the Commission can authorize State aid that is notified to it. However, such authorization usually requires that the State aid is needed to ensure that the beneficiary undertakes some socially "desirable" measure as a quid pro quo for the aid, such as investing in disadvantaged areas, improving environmental protection or engaging in research and development activities. While it is not impossible that a specific benefit granted under a tax ruling qualifies for approval, in most cases tax rulings are not specifically linked to such socially desirable activities and the amount of the benefit is not linked to the costs associated with such activities. In most cases, tax ruling benefits would therefore be considered "operating aid", which cannot normally be authorized.

## III. PROCEDURAL CONSEQUENCES

Pursuant to Article 108(3) TFEU Member States are under an obligation to notify to the Commission any plan to grant or alter new State aid, including in the form of tax measures. More importantly, such State aid measures must not be implemented before they receive the Commission's approval ("Stand-still obligation"). Member States (and competitors) can rely on that procedural provision alone to refuse to grant any benefit considered to amount to State aid, because Article 108(3) TFEU has "direct effect" and

[3] *Ibid.*, par. 22.

[4] The Commission will in practice also consider the transparency of a measure and of the process used to adopt it, even though this is, strictly speaking, not legally relevant for the determination of the existence of aid. Tax authorities attempting to keep rulings or the underlying interpretation of the general tax rules secret and intransparent are likely to increase the Commission's concerns.

can thus be invoked by Member States' governments and before national courts without any need for implementing decisions by the Commission or the Member States.

In addition, if the Commission were to find that a tax ruling constitutes a State aid, which has been implemented in violation of the Stand-still obligation and which does not qualify for approval under any of the exemptions provided for in the Treaty (*e.g.,* because it cannot be qualified as an aid to research and development, or as an environmental or regional aid), it will require the Member State to recover the aid from the beneficiary. In the case of State aid in the form of tax measures, the sum to be recovered amounts to the difference between the sum that the company should have paid if the general rule had been applied and the tax actually paid. Compound interest is added to this basic amount.[5]

The Commission will not order recovery if the beneficiary can invoke legitimate expectations in the legality of the State aid. But such legitimate expectations can only result from action taken by the Commission, and cannot result from anything the Member State did or said. Statements or actions of the national tax authorities will therefore not normally be relevant.

In principle, the Commission orders the Member States to effect the recovery in accordance with the applicable procedural rules of the Member State in question. However, and importantly, the EU Courts have consistently held that the national rules must not make it unduly difficult or impossible to effect recovery within the time limit the Commission specifies in its decision (usually four months). This requires the Member States, including the tax administration and national courts, to interpret national law consistent with this EU law requirement, which in many cases means to disregard time limits for recovery or modification of tax assessments.

## IV. RETROACTIVE INVESTIGATIONS

The Commission is authorized to investigate State aid that has already been granted. Moreover, it is authorized to order the recovery of aid that has been granted in the past, if the Stand-still obligation was not respected (*i.e.*, if the measure was not notified and approved by the Commission before the benefit was granted).

Nevertheless, there is a ten-year period of limitation.[6] Any aid that was granted ten years before the Commission begins its investigation into a measure is deemed to be existing aid (which can only be the subject of forward looking measures). Each

[5] *Ibid*., par. 35.

[6] Council Regulation (EC) No 659/1999 of March 22, 1999 laying down detailed rules for the application of Article 97 of the EC Treaty, JO 1999, L 83/1, Art. 15.

investigative measure by the Commission interrupts the ten year period (*i.e.*, each investigative measure causes the ten-year period to start afresh).

The Commission is therefore authorized under the State aid rules to investigate and take decisions as regards tax rulings (and resulting tax assessments) which have been issued up to ten years ago.

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If you have any questions with respect to the issues addressed herein, please contact any of your regular contacts listed at http://www.cgsh.com/.

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