Fictional Interest Payments and Abuse of European Tax Law: New State Aid Challenges?

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In a little more than one week we saw a series of judgments and a European Commission decision that may again test the limits of the European Union's state aid system in its application to matters of direct taxation.
On March 7, 2019 the Commission started a formal state aid investigation into the tax deduction of fictitious interest payments in the Luxembourg *Huhtamäki* case. It essentially argues that non-existing interest payments cannot be deducted in order to reduce tax payable. At first sight, any non-tax-lawyer might reason that there is no reason to deduct something you never paid for anyway, so what is all the fuss about? Tax lawyers that grew up in countries with a corporate tax regime that closely links commercial and tax accounts are likely to have a similar response.

A quite straightforward explanation: suppose that one company provides an interest-free loan to another company, because they are both related (for instance, they may have a common owner). In some tax jurisdictions transactions between related parties will be corrected as to prevent any 'personal' relationship from interfering with the determination of taxable profit, which could even happen to stand-alone companies in relation to their shareholders. In such a case, the entity that is taking out the loan may be allowed to deduct a proper amount of interest from taxable profit even if it has not been paid, while the other entity should add the non-received interest to its profit to properly reflect what would have happened in a third-party relation. (Technically speaking, such deductions and additions to profit would be processed by means of an assumed capital contribution and an assumed profit distribution, but I will avoid referring to this for ease of reading.)

The above will not be true in every jurisdiction as several of them would not allow for the deduction of interest that has not been paid for corporate taxation purpose – often modeled after the German "Nutzungseinlagen" doctrine – as such a payment does not show up as a capital contribution in accounts. So, depending on the legal framework and prevailing doctrine in a country, the deduction (and taxation) of fictitious payments may or may not be acceptable as a general rule.

It is a pity that the Commission did not provide a few more details in its press release, so we will have to wait for the publication of the decision opening the formal state aid investigation to see whether or not it is aiming at all sorts of fictitious interest payments regardless of the reference framework.

What is likely to have played a role here is that the Commission saw a case of double non-taxation, as the entity providing the loan was based in Ireland where it was not taxed on its interest-free loan. So, while Luxembourg did allow for the deduction of fictitious interest in a ruling there was no such interest recognized and taxed at the other side. Whether or not the other country's doctrine would allow for taxing fictitious interest should not prevent a Member State from determining taxable profit properly in accordance with its national rules, should they generally allow for a deduction of fictitious interest (which the Commission will have to determine in respect of Luxembourg). As long as these rules are internally consistent and the interest rates used reflect what third parties would have agreed to, who is to blame for a difference between national tax systems?

This leads to another little conundrum: what prompted the Commission not to start parallel investigations in two Member States as Ireland failed to include (fictitious) interest in the taxable income? In other recent cases, the Commission argued vigorously for the recognition of a general principle of EU Law requiring Member States to ensure that group companies be taxed as unrelated parties (*quod non*). I could understand if the Commission already adopted a German-modeled doctrine in its line of thinking, but isn't that premature? Of course, we cannot end up with a finding of state aid in two countries at once with regard to the same transaction, so here we might need to consider the effects of disparities between legal doctrines that might not be attributable to either state.

This investigation was not the only thing that shook things up a little recently. In a series of Danish cases (Joined cases C-116/16 and C-117/16 and Joined cases C-115/16, C-118/16, C-119/16 and C-299/16 of February 26, 2019) the Court of Justice of the European Union (CJEU) confirmed the existence of a European anti-abuse principle applicable to situations where taxpayers try to rely on EU Law, even in cases where such rule does not exist under national law or bilateral provisions in tax treaties. This as such is not new. But here the CJEU clearly stated that in case of a fraudulent or abusive practice, national authorities and courts *are to refuse* a taxpayer's claim to entitlements normally offered under the relevant EU legal instruments.

This raises the question whether in situations in which taxpayers rely on, for instance, tax exemptions prescribed by the Parent-Subsidiary Directive or the Interest-Royalty Directive as in the cases at hand, state aid could be at play if Member States continue to allow for such exemptions in some (but not all) situations of abuse. The CJEU's choice of words seems to leave no discretion to national authorities to focus their investigative efforts on the most promising cases, although there is room to doubt whether they imply *ex officio* action to be taken by national courts in procedures brought before them.

It is still unclear whether Member States that already offered exemptions in their national law, prior to EU Directives ordering them to, would still be allowed to revert to their national standard and continue to do so. In case of abusive use of national exemptions, this is unlikely. As of 2019 most national general anti-avoidance rules (GAARs) in corporate tax systems of EU Member States have been adapted – either in text or in spirit – to accommodate a rather broad GAAR prescribed by the Anti-Tax Avoidance Directive (ATAD), so we might see some convergence here as well.

So where does all of this lead to? State aid investigations could be used to address Member State non-action with regard to particular abusive situations, especially now that both the European and national anti-abuse rules are getting more in line. At the same time, we should be careful not to use state aid investigations to enforce what some might deem to be 'best practices' where there are legitimate differences in doctrine and legislative concepts between Member States.

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