Foreign Tax Treatment and ‘State Aid’ Scrutiny: The Next Step in Protecting the EU’s Internal Market?

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Raymond Luja (Maastricht University)

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In the aftermath of the surge in COVID-19 related government support to businesses and just days after UK Brexit negotiators announced not to extend the deadline for the ongoing negotiations with the European Union, the European Commission launched its “White Paper on levelling the playing field as regards foreign subsidies” on 17 June 2020. It was already announced as part of its “New Industrial Strategy for Europe” last March.

International tax lawyers, inside and outside of the EU, nowadays realise that anti-subsidy legislation can have a substantial impact on tax treatment, foreign and domestic. We have seen this in the past with EU State Aid rules and the WTO Agreement on Subsidies and Countervailing Measures.

While being open for foreign investment, the EU aims at guaranteeing that subsidies at large do not lead to unfair competition in its internal market. The Commission is worried about investments by state-owned enterprises and offshore investors, as well as subsidy races between public authorities. It concluded that current rules leave a gap, requiring the Commission to explore possibilities to address distortions by foreign subsidies.

First things first, why read any further if you are a tax lawyer or a tax manager? Simply because the definition of subsidies must necessarily be broad enough to ensure that restrictions imposed cannot be escaped by using the tax system instead. This is not new either, if we look back at state aid. What is new, however, is that the Commission now wants to be able to deal with subsidies by non-EU countries more effectively, which is understandable as such.

This already too extensive blog is not the time and place to cover all the details of the White Paper. Suffice it to say that, in the widest interpretation of the proposals, we could observe an extraterritorial effect to the Commission’s more recent attempts to deal with failures in profit allocation and at arm’s length pricing. This time however, it would focus on the actions of non-EU governments and tax authorities.

Three modules are being proposed in the White Paper. The first module would allow the Commission and possibly Member State authorities to investigate whether companies operating in the EU received foreign subsidies that distort the internal market. They may act against such subsidies to the extent they do not support certain economic activities or public policies the EU would be OK with. If one entity within a group of companies working internationally would be actually established within the EU, this investigation could already be triggered. Apart from subsidiaries, this might possibly be extended to cover permanent establishments as well that are or will be otherwise active in the EU.

Even though the White Paper is not that clear yet, targeted tax relief and fiscal investment incentives (not being generally available) would probably qualify, as would tax measures specifically facilitating foreign acquisitions, the postponement or waiver of collection of taxes from companies or even full tax exemptions restricted to particular entities (such as foreign government-owned enterprises or sovereign wealth funds competing or investing in the EU). At the same time, it is uncertain whether a general tax system that would provide for a lower level of tax on foreign (investment) income would be out of scope, if the country’s intention is to tax worldwide income.

Several factors may indicate a subsidy’s distortive effect, such as its size, it being granted to larger entities, market conditions and the (potential?) level of activity on the internal market. While ‘recovery’ is not being proposed as a sanction here, the possible methods of addressing distortive foreign subsidies come close. For instance, if it turns out that an “actual and irreversible” payback to the third country is not suitable or feasible (when would it?), redressive payments to the EU or its Member States might be put on the table. Lighter measures might be forced divestment of assets, prohibition of certain investments or acquisitions, or the need to publish R&D results from subsidized research. Fines and periodic penalty payments are being considered in case of non-compliance.

Other modules proposed would impose, inter alia, compulsory reporting to disclose any foreign subsidies received as part of a larger acquisition within the EU – where one takes control or is able to exercise material influence over the target – or when taking part in a public procurement procedure. This includes subsidies received within a relevant group of related companies three years prior to the bid or tender. If one wants to guarantee full disclosure and transparency, what would be the rationale to limit reporting to third-country subsidies anyway?

An actual legislative proposal is expected in 2021. The biggest challenge will not be to ensure the EU’s compliance with existing international obligations, but to actually define subsidies in a way that is sufficiently predictable for all those involved but still broad enough to be effective. It should be clearly limited to measures favouring certain undertakings or sectors of industry as to keep reporting obligations limited and to manage the workload of supervisory authorities. We should try to steer clear of turning such a selectivity test into a non-discrimination test, as happened under the EU’s intra-EU state aid definition.

On a side note, if (and that is a big ‘if’) we would copy the current ‘selective advantage’ test from EU state aid rules and then attach fines to non-reporting such foreign advantages, this might have some unforeseen effects. It would actually allow for revisiting the protection of legitimate expectations and the foreseeability of the presence of aid. They might finally be tested against human rights norms once we attach fines or penalty payments to non-compliance, something we avoided to do in an intra-EU situation. (Recovery was not meant to be a sanction under EU doctrine, even though it might feel as one to those unaware of the aid they allegedly received).

I hope the White Paper will get sufficient attention from foreign governments and international bodies as they are as much stakeholders in this as any of the companies it might affect. That said, the EU’s internal market will need additional rules to counter the effects of foreign governments intervening, either via their tax system, cheap loans, massive equity injections or otherwise. Even if it are just incidents today, there may be a clear danger to the EU’s internal market in future.

But… the EU and its Member States should be prepared to face similar treatment abroad. We may see EU companies put through a lot of additional administrative red tape in foreign acquisition and tendering procedures, whether there is something wrong or not. And the EU investigating and not acting against those foreign subsidies it is OK with, might well make other countries rethink their initial offer.

It is wishful thinking at this day and age to hope for international consensus to update multilateral trade rules dealing with subsidies, extending them to the digital economy and services, and to make procedures more speedily. So the EU’s proposed approach might be the more feasible one for the time being, provided that the definition of subsidies is managed well. Companies – foreign or not – need certainty. Should Member States indeed green-light the European Commission to go in this direction, they should also make sure to fund the next task force and the additional judges needed to make this work across the board. Otherwise the proposed anti-subsidy rules might be at risk of turning into a discretionary tool for political purposes that we only hear of in high-profile cases.