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The Interplay between the State Aid Rules and other BEPS-Preventing Tools (SA.38375)

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According to EU law the prevailing divergences between the national tax systems shall not be corrected by unilateral measures that grant fiscal advantages to firms, which are affected by the disparities between tax systems[1]. Equally, the corrections implemented unilaterally that mean to neutralise the disparities between tax systems shall be aligned with the logic of international tax treaties, EU law and basic tax principles. The CJEU held that such corrections that restrict the free movement within the internal market are allowed only when applied to wholly artificial constructions. The State aid regime relies as well on a notion that defines the genuine nature of a transaction: the Market Economy Investor Principle, which in its turn is a corollary of the arm's length principle. ***If the final aim is the prevention of BEPS, can artificiality have distinct meanings in State aid law as opposed to the framework of free movement provisions?***

I. The State aid prohibition as applied to tax rulings

The CJEU established that any measure intended partially or wholly to exempt undertakings from charges arising from the normal application of the general tax system '*without there being any justification for this exemption on the basis of the nature or general scheme of this system*' constitutes State aid in the meaning of Article 107(1) TFEU. No distinction between measures by reference to their causes or aims can be made, only their effects matter for the purpose of establishing State aid[2].

Any differentiations that imply an advantage granted to specific undertakings must be aligned with the nature or general scheme of the tax system in the Member State concerned in order to escape the prohibition enshrined in Article 107(1) TFEU[3].

In the *FFT* SA.38375 case, the beneficiary is explicitly identified, not only identifiable, since the matter concerns discretionary administrative practices, which may give rise to measures that are caught by Article 107 TFEU, where the exercise of discretionary power goes beyond the simple management of tax revenue by reference to objective criteria[4]. In the present case, the justification of a derogation could refer to the objective differences between taxpayers, which may support the differentiated treatment of MNEs in comparison to non-associated companies. The question of objectivity of the criteria used in the assessment employed by the tax rulings is under dispute in the present case, as in several other similar cases[5].

II. The postulation of independency

The differences in the level of taxation applied by various jurisdictions accompanied by the in-built lack of independency existing frequently among entities within a MNE group may offer – in a global perspective – the opportunity of reducing the tax base. By selecting a specific method of calculation, the tax base can be reduced, though as *William Byrnes* observed in his recent post, the differences accounted in dollars would not necessarily be significant. Moreover, in order to obtain such a favourable position, the tax authorities in question must endorse the choice of method by issuing a tax ruling that supports the Advance Pricing Arrangement.

Lately, the struggle against profit shifting and tax base reduction has been pursued, not only by the European Commission, but also by the OECD/G20 via the BEPS project. The methods applicable on intra-group transfers rely on corrections aiming to reallocate the profit in order to align it with value creation.

Earnings and asset values may be used for measuring value creation within a multinational group. The main disadvantage of earnings as a measure of economic activity is that an entity's earnings may be relatively volatile and this volatility cannot be entirely controlled by a group. An accurate measure of an entity's economic activity can alternatively rely on the value of the assets that drive the creation of value for the group such as land and buildings, plant and equipment, intangible assets, and financial assets, which give rise to income other than equity holdings. Actions 9 and 10 of the BEPS Project instruct the development of rules preventing BEPS by controlling two types of behaviour:

- (i) Transfer of risks among, or allocation of excessive capital to, group members.
- (ii) Engagement in transactions, which would not, or would very seldom, occur between third parties[6].

All methods that apply the arm's length principle rely on the purely hypothetical idea of entities' independency in relation to each other and the rules mentioned above follow the same principle. However, some synergistic benefits or burdens may arise as a result of the membership in a MNE group, even without the deliberate concerted action of group members or the performance of any service or other function by group members. The existence of group synergies creates difficulties related to the comparability of intra-group and extra-group transactions. This comparability is as known key for the reliability of the methods adopted for the neutralisation of transfers that lack economic substance.

III. Not every one's CUP of tea

The CUP (comparable uncontrolled price) method[7] could be more suitable, where there is a comparable service provided by the associated enterprise to an independent enterprise under comparable circumstances. The method becomes nonetheless less reliable, if not all the characteristics of these uncontrolled transactions that significantly affect the price charged between independent enterprises are comparable.

In the *FFT* case, the Commission and the addressee of the negative decision disagree on the use of the TNMM method (Transactional Net Margin Method)[8]. The Commission considers that by allowing the use of the TNMM instead of the CUP and approving the choice of a lower capital and level of remuneration, the Member State granted unlawful aid to *FFT*. The fact that *Chrysler* – an entity member of the *Fiat-Chrysler* group – issued bonds itself could according to the Commission have provided a better point of reference for the pricing of intra-group loans.

> …depending on the facts and circumstances of the taxpayer, not all methods

> approximate a market outcome in a correct way. When accepting a calculation method of the taxable basis proposed by the taxpayer, the tax authorities should compare that method to the prudent behaviour of a hypothetical market operator, which would require a market conform remuneration of a subsidiary or a branch, which reflect normal conditions of competition. For example, a market operator would not accept that its revenues are based on a method which achieves the lowest possible outcome if the facts and circumstances of the case could justify the use of other, more appropriate methods[9].

It is obvious that the Commission applies the classic MEIP (market economy investor principle) in a new manner. Customarily, the comparison is made between a hypothetical figure – a prudent investor in the market economy – and the state that acts as a seller, buyer, creditor or shareholder in relation to an alleged State aid beneficiary. Selling at a lower price or buying at a higher price than the market conditions implies the existence of an advantage. In the *FFT* case, the state acted only as a tax authority that according to this new interpretation would be obliged to verify whether the entity in question adopted a prudent behaviour *vis-à-vis* some other member of the MNE group.

In *Westdeutsche Landesbank Girozentrale*, the General Court observed that the position of a public body and its role as owner of a business must not be confused. The line of argument based on an increase in tax revenue would be wholly irrelevant for a private investor[10]. This finding has not been overturned by subsequent case law. Therefore, the increase in tax revenue cannot constitute a valid reason, where the applicable paradigm is the MEIP. From a private investor perspective, rather the opposite may be true, since taxes represent costs for a business.

From the tax authority view, it is clear that a MNE's decision to establish itself in that Member State takes into consideration *inter alia* the level of taxation. Thus, it could be rational to endorse an APA that does not reflect the possibility to acquire the highest level of annual tax revenues, if in the long run such a choice deterred the MNEs to establish themselves or extend their activities in that jurisdiction. The MEIP is definitely not an appropriate tool for a State aid assessment in relation to tax rulings.

IV. The lack of economic substance

The lack of economic substance of a transaction, which has the effect of reducing the tax base may be neutralised in EU law by applying the State aid rules or the doctrine of abuse of economic freedoms (*Cadbury* case, see my post of 15 October 2015). In State aid law, the lack of economic substance is disclosed by applying the MEIP principle, if the concerned measure is comprised within the sphere of economic activities of the state.

On the other hand, if the measure is regulatory or administrative, the focus shall fall on the objectives pursued and the adequacy and proportionality of the measure in relation to those legitimate objectives. If a favourable exception granted to specific undertakings is not covered by those objectives, then an advantage caught by Article 107 TFEU may be arising[11]. A wholly artificial transaction, which has the effect of reducing the tax base of the group, would not necessarily entail a reduction of the tax revenues for the Member State that issues the tax ruling. In some cases, the grant of an economic advantage may be imputable to one Member State, while the resources are attributable to a different Member State (or non-Member State). Such measures shall be deemed not to constitute State aid.

The lack of economic substance of a transaction could be caught under the radar of CFC-rules of a different Member State than the addressee of the State aid decision and double taxation may occur, if the transaction is first neutralised under the CFC rules and then, in other (EU Member) states, the State aid recovery is ordered and implemented. However, if the MNEs operations do not exceed the territory of the Union, which is not the case concerning *Starbucks* SA.38374 and *FFT* SA.38375, and the tax ruling suspected to constitute State aid has not been notified, in EU law, the State aid law will enjoy primacy over any other considerations, since unlawful State aid must be recovered with no delay[12]. Therefore, no other Member State should be allowed to enforce CFC rules if the lower taxation element must be eliminated according to Article 108(3) read in conjunction with Article 107(1) TFEU.

Conversely, if the alleged State aid taking the form of tax rulings is notified and the Commission finds that the advantage must be considered lawful under EU law, the other Member States may not be entitled to use the CFC rules to neutralise such a measure. The interactions between State aid applicable on tax rulings and other measures adopted by different jurisdictions in order to align taxable profit with value creation would be nonetheless more difficult to predict. The final report of 5 October 2015, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments*, mentions that:

> Although countries outside the European Union are not required to comply with [State aid] obligations, the need for a consistent international approach outlined above means that any approach which cannot be fully implemented by the 28 EU Member States is unlikely to be effective in tackling the global issue of base erosion and profit shifting.

Tax rulings may constitute State aid, when the discretion of the tax authorities exceeds the simple management of tax revenue by reference to objective criteria. However, the interpretation and application of those criteria in practice will give rise to different outcomes. In opposition with the opinion of the Commission, I do not consider that only the outcome that ensures the highest level of revenues in a given fiscal year can be accepted as being conform to those objective criteria. The measure of legality, should be the accurate, coherent and non-discriminatory application of those criteria from a long-term perspective.

The most important finding exposed by the present post is nonetheless the fact that the criterion of state resources will not be satisfied, if the issuer of a tax ruling provides fiscal advantages that have the effect of reducing the tax revenues of other states, situation which generally would meet the definition of a tax haven. Since one of the four cumulative criteria would not be fulfilled, no State aid can be deemed to exist and the application of other BEPS instruments would provide the appropriate solution. In all other cases, the State aid law shall enjoy priority meaning that any unlawful aid must be recovered, thus the irregularity produced will be corrected by offsetting the advantage.

1.[Case 173/73, *Italy v. Commission*, EU:C:1974:71[17].]?

2.[Case C 75/97, *Belgium v Commission*, EU:C:1999:311 [33] and [41]. See also Case C-56/93, *Belgium v Commission*, EU:C:1996:64 [73].]?

3.[C-452/10 P, *BNP Paribas*, EU:C:2012:366 [121].]?

4.[Case C-241/94, *France v Commission*, EU:C:1996:353 [23-4].]?

5.[SA.34914, SA.38373, SA.38374, SA.38944. See more (click here).]?

6.[OECD/G20 Base Erosion and Profit Shifting Project, *Aligning Transfer Pricing Outcomes with Value Creation*, 5 October 2015, p 13.]?

7.[Under the CUP method, the arm's length price for commodity transactions may be determined by reference to comparable uncontrolled transactions and by reference to comparable uncontrolled arrangements represented by the quoted price.]?

8.[The method compares the net profit of an entity part of an intra-group transaction with an appropriate comparable entity making adjustments based on the actual circumstances of the transaction in order to obtain the arm's length net profit margin. The latter is applied to an item of profit to approximate the amount of taxable profit. Equity was selected as the net profit indicator, in which context an approximated arm's length margin on equity was predicted through the CAPM financial model. According to financial theory, a prudent investor diversifies its risk by investing in several securities instead of investing in only one security. The next assumption is that an efficient market would only remunerate the non-diversifiable risk component for each asset.]?

9.[Commission Decision, State aid SA. 38375 (2014/NN) (ex 2014/CP) Brussels, 11.06.2014 [62], p. 22. See also Joined Cases C-182/03 and C-217/03, *Forum 187 ASBL*, EU:C:2006:416 [94-5]. 'In order to decide whether a method of assessment of taxable income [such as TNMM] confers an advantage on [certain undertakings], it is necessary […] to compare that regime with the ordinary tax system, based on the difference between profits and outgoings of an undertaking carrying on its activities in conditions of free competition'.]?

10.[Joined Cases T-228/99 and T-233/99, *Westdeutsche Landesbank Girozentrale*, EU:T:2003:57 [317].]?

11.[L. Rubini, *The Definition of Subsidy and State aid*, Oxford 2009. p. 287.]?

12.[Case C-222/04, *Cassa di Risparmio di Firenze*, EU:C:2006:8 [150-2].]?

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