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October 2014

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European State Aid: A Trap for the Unwary Tax Director

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On 7 October 2014, the European Commission (the "**Commission**") opened an in-depth investigation into certain tax arrangements entered into by multinationals operating in the European Union (the "**EU**"). Such arrangements could constitute, according to the Commission, a selective advantage in the (under)estimation of the taxable income of multinationals.

This is the latest action of the Commission against these kinds of practices this year. On 11 June 2014, it opened three in-depth investigations towards several U.S. multinationals for their transfer pricing arrangements with, respectively, Ireland, the Netherlands, and Luxembourg.

While such multinationals may have thought that their tax position was secured by the tax rulings they were granted, they may have to refund the advantages they received if such tax rulings were to be considered as unlawful State aid under applicable EU State aid legislation.

I. State Aid and Tax Rulings

State aid is defined as an advantage granted on a selective basis to undertakings by national public authorities, which distorts competition and is thus likely to affect trade between EU Member States. (For more details on the EU State aid rules, see the focus hereinafter.)

While EU Member States are, generally speaking, allowed to offer companies a myriad of tax breaks to bolster economic activity, the Commission has authority to review specific tax arrangements, such as transfer pricing rulings, to determine whether they have been granted in breach of EU State aid legislation. Favorable tax rulings may therefore in certain instances constitute unlawful State aid.

In this respect, the Commission considers that tax rulings should not have the effect of granting certain undertakings lower taxation than other undertakings in a similar legal and factual situation. Tax authorities, by accepting that multinational companies depart from market conditions (determined by reference to the arm's length principle) in setting the commercial conditions of intra-group transactions through a discretionary practice of tax rulings, may renounce taxable revenues in their jurisdiction and thereby forego State resources. Where a ruling concerns transfer pricing arrangements between related companies within a corporate group, that arrangement should not vary substantially from the arrangement or remuneration that a prudent independent operator acting under normal market conditions would have accepted. Otherwise, the (favorable) method used by the tax authorities may give rise to an advantage granted to a specific undertaking, which may constitute unlawful State aid.

In this context, the European Court of Justice 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 taxable income lower than the one which would result from a correct implementation of that principle, it provides a selective advantage to the company concerned.

II. Consequences for Corporate Taxpayers Targeted by EU State Aid Procedures

As noted above, the EU Treaty prohibits State aid unless proved to be compatible with the internal market. To ensure that such prohibition is effectively complied with, the Commission is endowed with strong investigative and far reaching decision making powers. Companies and consumers are also important players in this field as they may trigger investigations by lodging complaints with the Commission.

The Commission is obliged to open a formal investigation when serious doubts exist as to the compatibility with EU State aid rules of the measure at stake, and the opening of an in-depth investigation does not automatically mean that there is State aid to be recovered.

Once the formal investigation starts, the concerned EU Member State as well as interested parties can submit observations to the Commission within a certain time limit (usually one month from the publication of the summary decision in the EU Official Journal).

At the end of the investigation, usually not longer than 18 months, the Commission may require the concerned EU Member State to recover any illegal State aid granted (with interest) from the beneficiaries. Should an EU Member State not comply, the Commission may refer the matter to the European Court of Justice.

The EU Member State, the beneficiary, and others directly affected by the decision can appeal the Commission's decision before the European Court of Justice.

Focus on the EU State Aid Rules

Article 107(1) of the Treaty on the Functioning of the European Union (the "TFEU") provides that State aid is, in principle, incompatible with the EU common market. Under Article 108 TFEU, the Commission is given the task to control State aid. EU Member States notify in advance of any plan to grant State aid. State aid which is implemented without advance notification, or implemented before the Commission has granted its approval thereof, is "unlawful aid." Beneficiaries of unlawful aid may be led to reimburse the aid to the concerned EU Member State, either by way of a decision of the Commission addressed to the EU Member State to obtain reimbursement or through Court action before a national judge. Under the current procedural rules, the Commission is under the obligation to order the recovery from the beneficiaries of any unlawful aid which is deemed to be incompatible with the EU common market.

The principle of incompatibility of State aid set out in Article 107(1) TFEU does not amount to a full scale prohibition. Articles 107(2) and 107(3) TFEU specify a number of cases in which State aid may be considered acceptable by the Commission ("exemptions"). The Commission has discretionary power to decide whether a proposed aid measure qualifies for exemption or whether the concerned EU Member State shall alter or abolish the aid. In exercising its discretionary power, the Commission has published various criteria it uses when deciding whether aid measures notified to it qualify for exemption under Articles 107(2) and 107(3) TFEU regulations, communications, frameworks, guidelines, and letters to EU Member States.

Under EU law, the concept of State aid is extremely broad and encompasses virtually any direct or indirect transfer of public resources (including potential use of those resources in the case of guarantees) which constitutes an economic advantage that the undertaking would not have received in the normal course of business, which is selective in that it is granted to one or several undertakings, but not across the board on a given market: it affects the balance between the beneficiary firm and its competitors and has a potential effect on trade between EU Member States.

As noted above, EU State aid rules are based on the idea of ex ante authorization, following prior notification by the concerned EU Member State. State aid procedures involve the concerned EU Member State, and the beneficiary of the aid is deemed to be simply an interested party, as are any other concerned operators such as complainants.

As for the tax rulings granted to various U.S. multinationals, the Commission explained that, after a preliminary assessment, the special arrangements in question seem to have all four characters of State aid:

(i) the arrangements are specifically addressed to a company via a ruling that departs from the internationally accepted administrative practice, i.e. the arm's length principle (selectivity);

(ii) they seem to underestimate the value of the transactions among companies of the same group, therefore reducing the profit those transactions generate, i.e. the tax base for corporate tax purposes compared to the one of companies that do not carry out intra-group transactions (advantage);

(iii) less tax to pay means less resources for the state (aid granted via state resources); and

(iv) the firms concerned are globally active actors, therefore an aid in their favor is likely to distort competition (effects on competition).

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