

TAX BRIEFING

State aid and BEPS: countering the honey trap

Just as Winnie the Pooh is always on the lookout for ways to get more honey, most countries are always on the lookout for ways to get more money. While Pooh uses a variety of ways to get more honey, many of which result in a bee sting, countries are left with trying to encourage businesses to operate within their borders so that they can generate income by taxing those businesses.

Key tools for countries to use in this regard are tax policy and tax rulings. Ireland, for example, granted tax rulings to Apple in 1991 and 2007 offering favourable tax treatment in return for Apple incorporating two subsidiaries in Ireland.

Illegal state aid

In August 2016, the European Commission (the Commission) announced that tax rulings granted by Ireland regarding profit allocations to Apple's Irish branches amounted to illegal state aid (see *News brief "Apple state aid decision: Irish tax rulings found illegal"*, www.practicallaw.com/2-633-7660) (see box "State aid"). The sting, for both Ireland and Apple, is that Ireland has been ordered to recover €13 billion from Apple in lost tax revenue. Although this looks like a win for Ireland, it is facing a short-term gain but one with very severe long-term consequences. The Irish government therefore intends to fight the decision.

This was not the first time that the Commission has questioned an EU member state's tax policy; in October 2015, the Commission found that tax rulings given to Fiat by the Luxembourg tax authority and to Starbucks by the Netherlands tax authority were illegal state aid (see *News brief "Fiat and Starbucks: tax rulings found to be illegal state aid"*, www.practicallaw.com/7-620-4691). The Commission has been open about the fact that it is looking closely into tax rulings issued by member states to multinational entities.

US concerns

Many of the multinationals affected by the Commission's state aid investigations are US entities. The US Treasury Department has therefore responded by publishing a white paper that airs its concern about the

State aid

Broadly, state aid is anti-competitive behaviour by an EU member state that:

- Seeks to give a financial benefit to a select undertaking or group of undertakings.
- Threatens to distort, or actually distorts, competition.

Undoubtedly, the state aid provisions have the ability to capture tax policies and tax rulings but some are claiming that the European Commission is overreaching with its latest set of tax decisions relating to Apple, Fiat and Starbucks.

state aid investigations and expresses the hope that the EU and the US return to the system of international tax co-operation (www.treasury.gov/resource-center/tax-policy/treaties/Documents/White-Paper-State-Aid.pdf).

BEPS

As part of this co-operation and also the US's commitment to prevent tax avoidance by multinational organisations, the white paper points to the US's involvement with the G20 and the Organisation for Economic Co-operation and Development's (OECD) base erosion and profit shifting (BEPS) project. It states that the Commission's new interpretation of the state aid doctrine threatens to undermine the well-established basis of mutual co-operation and respect that many countries have worked hard to develop and preserve, particularly in connection with the BEPS project (see *News brief "The OECD's action plan on BEPS: a taxing problem"*, www.practicallaw.com/0-538-9745).

The BEPS project is the brainchild of the OECD and the G20. At its core, the project's aim is to fundamentally change the behaviour of multinational organisations with a view to realigning taxation with economic substance and value creation. The steps to achieving this goal are set out in a series of 15 action plans aimed at preventing tax avoidance caused by actions or structures that erode a country's taxable base or shift profits from one country to another country (typically, from a high tax country to a low tax country), or both.

The BEPS action plans are wide-ranging and cover, among other things: the use of hybrid entities and instruments; the taxation

of controlled foreign companies; interest deductibility; treaty abuse; the definition of a permanent establishment; and transfer pricing, which includes the much vaunted country-by-country reporting requirement (see *News brief "Country-by-country reporting for multinationals: EU transparency proposals"*, www.practicallaw.com/0-627-0585).

The BEPS action plans will mostly need to be implemented by the participating countries, of which there are many, which could mean that, although there may be a multinational consensus as to the general approach that needs to be taken, the actual BEPS rules may differ from country to country.

EU initiatives

In January 2016, the Commission published an anti-tax avoidance package (the package) with the aim of ensuring a co-ordinated EU-wide response to corporate tax avoidance (see *News brief "Corporate tax avoidance and BEPS: the EU grasps the nettle"*, www.practicallaw.com/3-623-5185). As part of the package, a draft anti-tax avoidance directive (the draft directive) has been developed. In its fact sheet about the package, the Commission states that the initiatives in the package reflect discussions in the Council of the EU, recommendations from the European Parliament and the outcomes of the BEPS project.

In the Commission's view, therefore, the groundwork has been done to allow member states to quickly adopt and implement the proposed measures in the package. Indeed, 31 December 2018 is set as the implementation deadline for most of the proposals, which leads to some interesting questions for the

UK's impending Brexit negotiations (*see box "Impact of Brexit"*).

Interaction of BEPS, state aid and the Directive

There are obvious philosophical crossovers between BEPS, state aid and the draft directive. The draft directive is clearly inspired by BEPS and the Commission has almost certainly taken inspiration from BEPS in the way that it has extended the scope of state aid. The development of state aid is not, however, on a par with the draft directive. Whereas the draft directive takes BEPS and simply uses the EU's powers to force uniform application, state aid is rather a different beast.

State aid is outside of the carefully negotiated BEPS parameters; it is therefore questionable whether it is the appropriate tool with which to tackle perceived BEPS-style abuses. Instead of an internationally agreed approach to BEPS, with buy-in across the globe, using state aid in this way leads to a very EU-centric set of precedents that could damage the international consensus that has been built around BEPS and leave member states in a worse commercial position than their non-EU counterparts.

BEPS accepts that each country has, and will continue to have, a different tax code. In contrast, the state aid tax decisions appear to be a back-door method to achieve uniformity across the EU with regards to tax. The Commission has put forward a proposal for a common EU consolidated corporate tax base a number of times, and it appears that state aid is being used as a vehicle to achieve further consolidation (www.practicallaw.com/9-617-5372).

BEPS seeks to affect all taxpayers and potential taxpayers in each jurisdiction. State aid is much more targeted as, typically, each decision is specific to the circumstances of that taxpayer and ultimately applies only to that taxpayer, although broad principles may be extracted from decisions. The Commission is apparently reviewing all tax rulings granted across the EU, but with limited time and resources, it may be more likely to pursue high-value or high-profile

Impact of Brexit

Brexit should not affect the Organisation for Economic Co-operation and Development's (OECD) base erosion and profit shifting (BEPS) project, as BEPS is not an EU development but is driven by the OECD. The UK is already at the forefront of BEPS implementation, indeed, the UK has even developed an interim, or pre-BEPS, regime through the diverted profits tax (*see News brief "Diverted profits tax: the next step down the road", www.practicallaw.com/8-610-3069*). Although seen by many as out of step with the BEPS project due to its unilateral approach, it is a clear statement of intent by the UK government to take proactive steps to prevent erosion of its tax base.

The future of state aid controls in the UK is more complex. At first glance, the UK leaving the EU would mean that the UK becomes free to provide state aid to whomever it wishes. Indeed, during the Brexit campaign, Brexiteers pointed to the Port Talbot steelworks as an example of EU rules preventing the UK from aiding the steel industry. Whether state aid becomes an unregulated tool in the UK's armoury post-Brexit will depend on what the UK's exit from the EU looks like. If any route with access to the single market is agreed, some form of state aid regulation seems likely. Given that Brexit is being negotiated by a political party known for its support of free market ideas, state aid may prove to be an easy bargaining chip to lose.

Even if the UK turns its back on the EU entirely and relies instead on the World Trade Organization (WTO) rules, the UK will still be bound by the WTO's rules on subsidies. Although not as broad as the state aid rules and without the same mechanism of enforcement, the UK would still not have autonomy.

state aid challenges. This appears to be a fundamentally unfair, scattergun approach.

BEPS is forward-looking and seeks to change future conduct. State aid, by its nature, looks backwards. The Commission has a ten-year limitation period on the recovery of illegal state aid, which is typically beyond the period of most statutes of limitation. A company can get caught by a state aid challenge even if it has since changed its practices. Given the extent and speed of BEPS-related changes, pursuing these state aid cases appears to be adding an extra layer of complexity to the tax avoidance debate, which may not be at all helpful.

The increased emphasis on transparency, including the transfer of tax rulings between countries, together with the implementation of BEPS, is likely to mean that the scope for state aid to challenge future arrangements is limited, unless the EU ends up with a regime that goes further than is required by the BEPS action plans. However, state aid has clearly not had its day as there are still many years' worth of tax rulings for the Commission to sift through.

Actions for multinationals

A corporate group with EU operations should review its position, especially if it is currently operating under an EU tax ruling or has done so in the past ten years.

Companies considering an investment into, or acquisition in, a member state should:

- Take BEPS into account when considering financing arrangements, structure, and the ongoing operation and management of any investment.
- Consider the implications of the state aid tax decisions when undertaking tax due diligence. Particular care should be taken when drafting the tax indemnity provisions to ensure that potential losses arising from adverse state aid tax decisions are covered. After all, no-one wants to get stung.

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