JONES DAY

COMMENTARY

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State Aid in Disguise—EC Investigates UK Tax Regime

IN SHORT

The Background: The European Commission has opened an in-depth investigation into a specific provision of the UK-controlled foreign company rules.

The Issue: The Commission will investigate whether the UK's so-called Group Financing Exemption unfairly allows these multinationals to pay less UK tax, in breach of EU state aid rules.

Looking Ahead: The investigation is part of a broader trend of cases in which the Commission has targeted provisions in Member States' tax legislation that it feels are capable of constituting unfair and improperly advantageous fiscal arrangements; but this one raises new political issues given the UK's "Brexit" vote.

SKIP TO THE FULL VERSION

The European Commission ("Commission") has launched an in-depth antitrust investigation into a UK tax regime that provides for a highly specific exemption to the UK's Controlled Foreign Company ("CFC") legislation, which the Commission believes may allow multinational companies to benefit from an unlawful, selective tax advantage in breach of European Union ("EU") state aid rules.

The UK's Controlled Foreign Company Regime

The general purpose of the UK's CFC rules is to preclude UK companies from using a subsidiary, based in a low- or no-tax jurisdiction, to avoid taxation in the UK on income that would have been taxed or taxable there or in another higher-taxed jurisdiction. Under these rules, the UK tax authorities can effectively reallocate all (or the relevant proportionate share of) profits of such an offshore subsidiary back to the UK parent company, where it can then be subject to normal UK tax.

However, since 2013, the UK's CFC rules have included an exception for certain types of group financing income (interest payments received from intragroup loans) of multinational groups active in the UK—the Group Financing Exemption ("GFE").

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The GFE in Light of EU State Aid Rules

The Commission's state aid investigation does not call into question the UK's right to introduce CFC rules or to determine the appropriate level of taxation. The OECD's Base Erosion and Profit Shifting ("BEPS") initiative, to be implemented in EU law via an Anti-Tax Avoidance Directive ("ATAD") passed by the ECOFIN Council in June 2016, mandates that such rules be put in place throughout the EU. However, the role of EU state aid control is to ensure Member States do not give certain companies a better tax treatment than other companies. In this respect, tax rules may constitute illegal state aid if they provide more favorable tax treatment to specific taxpayers or industries that deviates from standard domestic tax rules or regimes. Preferential tax treatment accorded to a given category of taxpayers can still be justified under EU state aid law, but only to the extent that it is motivated by objective reasons and is consistent with the overall purpose and goals of the relevant fiscal rules.

The Commission's decision expresses doubt as to whether the GFE is consistent with the overall objectives of the UK's CFC rules. In addition, the ATAD does not provide for this sort of specific exception.

If the Commission were to conclude that the tax scheme at hand is unlawful state aid, EU law would require the UK to recover the amount of that aid which any and all multinational companies would have been found to have received by way of this tax exemption.

Prior Commission State Aid Investigations on Tax Exemption Schemes

Since June 2013, the Commission has commenced investigations of individual tax rulings and stepped up its efforts with regard to other tax schemes of Member States under EU state aid rules, e.g., advantages under Belgium's "excess profit" scheme to at least 35 multinational groups from the EU, the United States, and elsewhere. The condition of selectivity is the key condition in such types of cases, but its scope and meaning is still highly disputed amongst the Commission, the General Court, and the ECJ, and its practical application is also still quite unclear.

Given the parties involved, the investigation is likely to become politically sensitive and raise contentious issues, notably in connection with the ongoing "Brexit" negotiations, going well beyond pure state aid matters. Three issues appear to be paramount in this case. First, the Commission's ability to compel the UK to recover any unlawful aid after the UK has left the EU (which could occur by the time a decision is reached). Second, the UK's economic freedom to devise tax regimes that it believes are in the best interests of the UK, in particular following its departure from the EU. Third, there is potential for a real divergence between the EU's state aid approach and EU tax policy initiatives and perhaps even decisions by the Court of Justice in the field of taxation.

THREE KEY TAKEAWAYS

1. State aid can be found in tax measures if the tax regime in question accords a selective advantage to multinational companies only, or even if such measures are deemed "selective" as between the treatment of different sorts of income within the same regime as applied to one and the same taxpayer.
2. The investigation may be ongoing after March 2019, when the UK is due to leave the EU, resulting in a novel question of what happens then and whether any infringement decision could be enforced.
3. The investigation might bring into sharper focus the tension between antitrust law and tax setting powers and thereby impact the Commission's other pending cases in this area.

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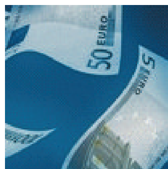

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