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Editorial XL

Can Tax Treaties Confer State Aid?

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We all know the ECJ's mantra that Member States are free to design their laws in matters of direct taxation but that in doing so they must comply with the obligations imposed by the TFEU. Much to their surprise, tax treaty practitioners learned almost twenty years ago from the ECJ's decision in *Saint-Gobain* that this principle extends to tax treaties and that a Member State should comply with the TFEU-rules on the fundamental freedoms when it exercises the taxing rights which it derives from a distributive rule included in a tax treaty. The ECJ made it clear that this applies irrespective of whether a Member State entered into a tax treaty with another Member State or with a third State.[1] Union law experts were less surprised. Indeed, if there is a conflict between rules of international law (treaty law) and obligations imposed by the TFEU on Member States, the matter is resolved in favour of EU law. This rule, which is laid down in Article 351 TFEU, applies to all treaties with no exception for tax treaties. [2] A logical consequence of this rule is that treaties, including tax treaties, must also respect the TFEU rules on the prohibition of state aid (Article 107 TFEU). In its decision of 2014 involving an advantage conferred by Romania following an arbitral award under a bilateral investment treaty between Romania and Sweden, the Commission made it clear that *'the voluntary agreement […] to enter into [the treaty] created the conditions for the selective advantage'*[3] and the Commission's opening decision of 2016 in *Mc Donalds* confirms that tax treaties are not immune to a state aid investigation, not even a tax treaty with a third State (the 1996 Luxembourg/US tax treaty).[4] Very recently, the ECJ decided that the fact that a Member State is required under international public law (a treaty between Spain and the Holy See) to provide a tax benefit, does not preclude the treaty measure from being State aid[5]. I do not intend to comment on the *Mc Donalds*-case here and patiently await the outcome of the Commission's ongoing investigation. Instead I want to make more general observations on whether and to what extent a tax treaty may be a tool to grant state aid to undertakings. I will limit the discussion to the treaty rules that confer advantages to taxpayers, i.e. the distributive provisions (Articles 6–21 OECD Model) and the relief provision (Article 23 OECD Model).[6]

These provisions easily meet four of the five conditions set out by Article 107 TFEU for there to be state aid that is not compatible with the TFEU. They restrict a Member State's domestic taxing rights (either as State of source of the profit or as State of the taxpayer's residence). Hence, they confer an economic advantage to the taxpayer which he would not have received without the treaty. As the Member State forgives tax revenues which, absent the treaty, it would have received, these measures are imputable to the Member State and financed through State resources. And since tax treaties apply to cross-border trade and investment, they affect trade between Member States and can potentially distort competition within the internal market. The difficult question is whether the treaty provision offers a selective advantage to the taxpayer who enjoys the benefit of that provision and, if so, whether that selective measure can be justified by acceptable justifications that are inherent to the tax system. Determining whether a treaty provision confers a selective advantage involves the application of a

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1 ECJ 24 Sept. 1999, C-307/97 *Saint Gobain*, § 56 et seq.

2 There is an exception for treaties with 3rd countries that predate 1 Jan. 1958 or the accession of a country to the EU. If such treaties are not compatible with the TFEU, they must be renegotiated.

3 EC Decision 2015/1470 of 30 Mar. 2015, State Aid SA. 38517 (2014/C) (ex 2014/NN) – Romania – Implementation of Arbitral award *Micula v. Romania* of 11 Dec. 2013, § 118.

4 EC Decision to initiate formal investigation procedure SA.38945 (2015/C) of 6 June 2016.

5 ECJ, 27 June 2017, C-74/16, *Congregacion de Escuelas Pias Provincia Betania*.

6 Also rules that deny advantages to taxpayers (i.e. anti-abuse and limitation on benefits-rules) may confer state aid to taxpayers. That may in particular be the case where those rules do not comprehensively define all taxpayers that come within the scope of the potential abusers (compare to General Court 4 Dec. 2016, T-287/11 *Heitkamp,* § 125–138) or leave discretionary powers to tax authorities to decide which taxpayers (do not) come within the scope of the rule such as the proposed LOB-clause under BEPS Action 6 (compare to ECJ 18 July 2013, C-6/12 *POy*, § 25–26). *See also* the Commission's Notice on Aid 2016 (2016/C 262/01) § 183 (Official Journal of 19 July 2016). I do not intend to discuss those rules here.

discrimination-test. One needs to determine the reference system and to find out whether the measure derogates from that system insofar as taxpayers that are legally and factually comparable in light of the purpose of the reference system are treated unequally and hence suffer a discriminatory treatment.[7] I shall try to illustrate this by two examples, one involving relief offered by the source State of the income and one involving relief offered by the State of residence of the taxpayer.

The first example concerns interest arising in Member State B and beneficially owned by a resident of Member State N. Article 11 of the B/N treaty follows the OECD Model as a result of which withholding tax in B is reduced to 10% (instead of 30% under B's domestic law). However, in addition interest beneficially owned by banks resident of N is fully exempt from withholding tax in B.

Different reference systems can be selected and the selection is driven by the group of taxpayers that claims to be discriminated against.

If B's domestic banks claim that N's banks receive state aid because the latter do not pay tax in B on interest sourced in B, while the former pay Corporate Income Tax (CIT) at the rate of 35% on such interest, the reference system is obviously B's domestic CIT system. The question then arises whether resident and non-residents banks are comparable from the perspective of B's domestic CIT system. Under the ECJ's case law on the fundamental freedoms, it is settled that they are not comparable, unless the Member State has decided to exercise its tax jurisdiction on both.[8] After the ECJ's judgment in *Regione Sardegna*, the approach should be the same in state aid cases where a Member State exercises its taxing jurisdiction on both residents and non-resident but does so in a different manner, i.e. like in the case at hand where B decides not to tax non-resident banks, while it subjects domestic banks to tax.[9] If the conclusion that banks resident of B and banks resident of N are comparable in light of the objective pursued by B's domestic CIT system is correct, one must determine whether N's resident banks are treated more favourably than B's resident banks. Whether this is the case depends upon whether the comparison is to be made with B's rules on withholding tax on interest payments to residents or B's CIT system applicable to residents as a whole. This question is relevant where B's resident banks are exempt from withholding tax in B on interest arising in B, but pay 35% CIT on their net profit. In cases involving alleged violations of the fundamental freedoms, the ECJ has held that the appropriate comparison is with the Member State's entire direct tax system, not only with its rules on withholding tax.[10] If we may extrapolate this case law on the fundamental freedoms to the state aid area – and after the ECJ's decisions in *Regione Sardegna*[11] and *World Duty Free Group,*[12] there seem to be good arguments to do so – State B confers a prima facie selective advantage (i.e. a form of import subsidy) to banks resident of N. This clearly demonstrates that the state aid review may – unlike the fundamental freedoms – be suitable to eradicate cases of reverse discrimination (i.e. discrimination of a Member State's own residents). One then finally needs to analyse whether the advantageous treatment of N's banks by B may be justified by the need to avoid (international juridical) double taxation. This is one of the (few) justifications which the Commission and the ECJ have accepted as a justification for a selective treatment of a specific group of taxpayers.[13] The exemption of withholding tax in B on interest arising in B allows banks resident of N to pay CIT on their net profit only in N. It therefore seems to be an appropriate means to achieve single taxation and thus an acceptable justification for a prima facie selective (discriminatory) treatment.

7 *See* most recently in matters of direct taxation, ECJ 21 Dec. 2016, C-20/15 P and 21/15 P *Commission v. World Duty Free Group*, § 54.

8 *See* in particular: ECJ 14 Feb. 1995, C-279/93, *Schumacker*, § 31–38, ECJ 14 Dec. 2006, C-170/05, *Denkavit et alia*, § 23–29. When non-residents are taxed less favourably by the State of source than residents, there is a prima facie violation of one of the fundamental freedoms.

9 ECJ 17 Nov. 2009, *Regione Sardegna*, § 62–64.

10 ECJ 22 Dec. 2008, C-282/07 *Truck Center*, § 38–50; ECJ 17 Sept. 2015, C-10/14 *Miljoen*, § 50–61.

11 In *Regione Sardegna*, residents were treated more favourably than non-residents. The Court found there to be an infringement of the freedom to provide services and of the rules preventing state aid. This demonstrates the similarity between the discrimination-tests under both provisions of the TFEU. AG Kokott in her Opinion to that case (C-169/08, § 134) as well as in her Opinion to the *Finanzamt Linz*-case (C-66/14, § 103) argued that where the aid may be selective because it favours domestic transactions over foreign ones, it is appropriate to apply the same principles under the fundamental freedoms and state aid.

12 However, as opposed to *Regione Sardegna*, in the examples examined here, there is less favourable treatment of a domestic taxpayer or a discrimination between groups of non-resident or groups of resident taxpayers. It is therefore uncertain whether one may apply the case law under the fundamental freedoms to the state aid area. Where there is discrimination of domestic taxpayers or transactions (reverse discrimination), strictly speaking one cannot apply that case law as the fundamental freedoms are not at stake. However, in *World Duty Free Group* (*see* fn. 6), where the domestic transaction was treated less favourably, the ECJ applied a discrimination-test (§ 54, 67, 71, 74 and 77) and concluded: '*All that matters in that regard is the fact that the measure, irrespective of its form or the legislative means used, should have the effect of placing the recipient undertakings in a position that is more favourable than that of other undertakings, although all those undertakings are in a comparable factual and legal situation in the light of the objective pursued by the tax system concerned*' (§79). In my view, factors which the ECJ has upheld to determine the comparability of taxpayers or transactions in the area of fundamental freedoms should be applied in the area of state aid, unless there are compelling reasons not to do so which are peculiar to the state aid analysis.

13 ECJ 8 Sept. 2011, C-78/08 to 80/08 *Paint Graphos,* § 69–75. The ECJ added that the Member State concerned should have in place and apply appropriate control measures to assure that the rule is not abused and that it does not go beyond what is necessary to achieve its aim. *See also* the Commission's Notice on Aid 2016 (2016/C 262/01) § 139 which adheres to that case law (Official Journal of 19 July 2016).

Let us now assume that Member State B has signed a tax treaty with Member State S that follows the OECD Model and allows B to levy 10% withholding tax on interest arising in B and beneficially owned by residents of S. It does not provide for a zero rate for interest paid to banks resident of S. B's treaty network arguably distorts competition between banks. Can banks resident of S claim that B confers state aid to banks resident of N? Or put it differently, can banks resident of S claim most favoured nation-treatment in B by relying on the rules prohibiting state aid? Obviously, a different reference framework than B's domestic CIT system is needed. Here, B's tax treaty network should be the reference system and then the question arises whether banks resident of N are, from a point of view of B's treaty network, comparable to banks resident of S. Under its case law concerning the fundamental freedoms, the ECJ has denied claims based on most favoured nation-treatment. Benefits granted by one Member State (*in casu* B) to a resident of another Member State (*in casu* N) under a tax treaty should not be extended by that same Member State to a resident of another Member State (*in casu* S) because a resident of State S is not comparable to a resident of State N. Such benefits form an integral part of the B/N treaty, which is based on reciprocity. They contribute to its overall balance and can therefore not be separated from it. If the TFEU rules would require Member State B to extend such benefits to residents of other Member States, the overall balance of its tax treaties would be upset.[14] If we may extrapolate this case law to the area of state aid, we should conclude that differences in the treaty network of a Member State do not lead to a grant of state aid to taxpayers benefiting from more advantageous bilateral treaties of that Member State. Arguably, the same reasoning should apply where a taxpayer resident of a non-treaty country would claim that taxpayers resident of a treaty country receive state aid on ground that the latter can claim benefits under their treaties with Member State B (e.g. reduced withholding taxes, exceptions to the rules on permanent establishments) which are not available to residents of non-treaty countries.

Even within the treaty between B and N, a different tax treatment may be provided for items of income that are of a similar nature (i.e. passive investment income). If the treaty follows the OECD Model, B may levy 5% or 15% withholding tax on dividends arising in B and beneficially owned by residents of N and 10% on interest arising in B and beneficially owned by residents of N. But it may not levy withholding tax on royalties arising in B and beneficially owned by residents of N. Can residents of N receiving dividends and interest arising in B claim that B confers state aid to residents of N who receive royalties arising in B? No doubt that the reference system is the B/N tax treaty. The question is whether residents of N receiving B sourced dividends and interest are comparable to residents of N receiving B sourced royalties. According to the ECJ's case law in *Gilly*, in the absence of harmonizing Union law in the area, Member States are free to determine the rules allocating the taxing rights amongst themselves in their tax treaties and it is appropriate for them to rely on the OECD Model for that purpose.[15] Hence, B may tax different items of income earned by non-residents differently. It is an open question whether this case law applies in the state aid area. In its decision in *Gibraltar II*, the Commission seems to suggest, however, that taxpayers receiving different types of income are comparable: *'Given that companies are exempted from taxation on the basis of the type of income, i.e. active (i.e. profits) vs. passive (interest, dividends or royalty), the exemption differentiates between certain kinds of income and must […] be considered prima facie selective'*.[16] On the other hand, it may be questioned whether this decision – which concerns a differentiated tax system in the State of residence – may be extrapolated to a case like the one discussed here which concerns unequal taxation of non-residents by the State of source. If the conclusion is that this differentiated tax treatment of items of income by B amounts to the grant of state aid, the question arises whether such prima facie selective treatment of residents of N can be justified on the basis of the inner logic of the tax treaty. The exemption of withholding tax on royalties aims to avoid double taxation and that goal is achieved where residents of N are taxable on those royalties in N. Double taxation on dividends and interest that have been subject to withholding tax in B is only prevented if the resident of N can claim a tax credit in N for that withholding tax. Such is by no means guaranteed. However, the tax treatment in the State of residence of the taxpayer is not relevant to determine whether the State of source has conferred state aid as the selectivity-test is to be assessed only at the level of one Member State and emerges only from an analysis of the discriminatory treatment between undertakings by that Member State.[17] According to the Commentary on the OECD Model, no agreement could be reached amongst member countries to achieve single taxation on dividends and interest and the levying of a withholding was a compromise, while for royalties such an agreement has been reached. [18] Such a policy reason is not very convincing and presumably not an acceptable justification for a different taxation of various items of passive income.

14 ECJ 5 July 2005, C-37603 *D*, § 58–63; ECJ 12 Dec. 2006, C-374/4 *ACT GLO*, § 83–92.

15 ECJ 12 May 1998, C-336/96 *Gilly*, § 30–31.

16 Opening Decision of Commission of 16 Oct. 2013, State aid SA.34914 (2013/C) UK Gibraltar Corporate Tax Regime, § 34.

17 *See* e.g. General Court 7 Nov. 2014, T-399/11 *Banco Santander*, § 75; General Court 1 July 2004, T-308/00 *Salzgitter*, § 81.

18 Commentary OECD Model, Art. 10 § 4–10; Art. 11 § 2–3; Art. 12 §3.

Another question is whether residents of N (non-banks) that suffer 10% withholding tax on interest arising in B could claim that B confers state on banks resident of N where the latter are exempt from withholding tax in B on such interest. Here the reference system is Article 11 of the N/B treaty. The ECJ held in *3M Italia* and in *World Duty Free Group* that the fact that a tax advantage is subject to conditions does not as such imply that the grant thereof is selective. What matters is that the conditions for that advantage are set in a non-discriminatory manner in light of the goal of the measure.[19] It is difficult to deny that non-banking enterprises resident of State N that derive interest arising in B are in the same legal and factual circumstances as to place of residence and type of income as banks resident of N deriving such interest. Hence, the different tax treatment in B seems to be prima facie selective and is thus subject to justification. According to the Commentary on the OECD Model the exemption from withholding tax in the State of source for non-residents banks is explained by the fact that banks are highly leveraged and thus taxed in their State of residence only on their net interest margin. The levy of a withholding tax on gross interest by the State of source would be excessive as the bank might pay higher effective tax in the State of source than in its State of residence.[20] It follows that undertakings resident of N that are not banks but which are also highly debt funded may have a legitimate claim that the zero withholding tax rate for banks amounts to a grant of state aid to the latter.

The second example concerns a tax treaty between Member State B and third country U. Under U's domestic tax rules, branches of non-resident companies do not pay CIT if they comply with certain conditions. The treaty follows Article 23A OECD Model and provides that B will exempt profits of a permanent establishment (PE) in U of a resident of B that '*may be taxed*' in U. The relief article also provides, unlike the OECD Model, that a company resident of B may claim a tax sparing credit on interest and royalties which it derives from U, notwithstanding the fact that such interest and royalties are exempt from withholding tax in U under Article 11 and 12 of the treaty. Under Member State B's domestic law (unilateral relief provision), income of a foreign PE is only exempt if it has been effectively taxed abroad and credit for withholding tax can only be claimed if interest and royalties have been effectively subject to withholding tax in the State of source.

Here again the choice of the reference framework is crucial. If that framework is the domestic unilateral relief provision, the derogation from that rule provided by the B/U treaty amounts to a prima facie selective advantage (in the nature of an export subsidy) in favour of B's resident companies that invest in U.[21] This assumes that companies resident of B investing in treaty country U and those investing in non-treaty countries are comparable. That assumption is open to question. Paraphrasing the ECJ's case law denying most favoured nation treatment, one may argue that the B/U treaty is a delicate balance of reciprocal concessions by the two Contracting States and that residents of B that invest in a non-treaty country are therefore not legally comparable to residents of B that invest in treaty country U.[22] However, if they are comparable, the relief provision of the B/U treaty confers a selective advantage which needs to be justified. Arguably, the purpose of the rule is to avoid international double taxation, a justification which has been accepted by the ECJ and the Commission. However, as the ECJ emphasized in *Paint Graphos*, the measure should still be proportionate and not go beyond what is necessary to achieve its aim, i.e. avoiding double taxation where there is a risk of such double taxation. [23] It is questionable whether relief provisions that result in double non-taxation comply with this principle of proportionality, unless they are in the nature of permissible developing aid.[24]

The Commission's opening decision in *Mc Donalds* further complicates the analysis. According to the Commission the reference framework is not only composed of (Luxembourg's) domestic tax law, but also of the tax treaties to which Luxembourg is a party.[25] Let us assume that Member State B has signed several treaties which include a '*subject to tax*'-clause in Article 23 pursuant to which B exempts foreign PE-income only if it has been taxed abroad and provides for a tax credit only if the income has been taxed abroad. In the area of fundamental freedoms, the ECJ has decided that a resident of a Member State deriving income from a treaty country is not comparable to a resident of that same Member State deriving income from another treaty country which provides more advantageous relief for double taxation and that accordingly the former cannot claim the benefits provided by the latter treaty – which is another denial of most favoured nation-treatment but this time to the detriment of a resident of a Member State.[26] If this case law may be extrapolated to the State aid area, residents of B investing in U do not receive a selective advantage, although they enjoy double non-taxation,

19 ECJ 29 Mar. 2012, C- 417/10 *3M Italia*, § 42; ECJ 21 Dec. 2016, C-20/15 P and 21/15 P *Commission v. World Duty Free Group*, § 59. *See also*: ECJ 14 Jan. 2015, C-518/13 *Eventech*, § 53; Opinion of AG Kokott in *Finanzamt Linz*, C-66/14, § 82 and of AG Wathelet in *World Duty Free Group* (§93).

20 Commentary OECD Model, Art. 10 § 4–10; Art. 11 § 7.7.

21 The Commission has decided that a derogation from a general applicable system for relief of double taxation in Ireland may be selective. (Decision of 17 Feb. 2003, no. 2003/601/EC, Official Journal L 204 of 13 Aug. 2003, § 33).

22 *See* in particular: ECJ 20 May 2008, C-194/06 *Orange European Smallcap Fund*, § 51 and 61 et seq.

23 *See* fn. 11.

24 The Commission has exceptionally accepted that a tax exemption in relation to transactions with developing countries is permissible aid under Art. 107 (3) c) TFEU (Decision of 5 Mar. 2003, no. 2003/590/EC, Official Journal L 199 of 7 Aug. 2003, § 28 et seq.).

25 *See* fn. 4, § 72.

26 ECJ 20 May 2008, C-194/06 *Orange European Smallcap Fund*, § 50–51; ECJ 30 June 2016, C-176/15 *Riskin*, § 31.

as they are not comparable to residents of B that invest in countries with which B has treaties with less favourable relief provisions. Another complicating factor in the *Mc Donalds'* decision is the fact that the Commission does not seem to have a fundamental problem with double non-taxation, at least not where the State of residence applies the treaty correctly and the State of source correctly applies its domestic law when it does not tax the income for which it has received taxing rights under the treaty: '*The Commission does not consider that the requirement "may be taxed" in Article [25 (2) of the Luxembourg – US DTT should be read as a requirement to be effectively taxed*'.[27] This does not sit easily with the above conclusion that a relief provision that follows Article 23 A OECD Model may be disproportionate where it leads to double non-taxation.

I have tried to highlight that it is difficult to determine whether tax treaties confer state aid and that there are many questions to which there are no clear answers yet. In fact no state aid case involving a tax treaty has ever reached the European Courts. The case law of the European Courts on state aid in matters of direct taxation stands where the ECJ's case law in the area of the fundamental freedoms stood twenty years ago. It will be interesting to see how it will develop in the next twenty years.

[27] *See* fn. 4, § 88.