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State Aid: How Economic Development Trumps Tax Revenue

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1. Introduction

European state aid exists when a European Union (EU) member state gives any preferential treatment to a company that allows it to gain an advantage not available to other competitors. Generally, state aid is considered illegal unless proven to be necessary for economic development, which will be discussed later. Member states often provide this preferential treatment through tax rulings that result in massive company-specific tax breaks (DeNovio, Righini, and Gibbs 2016), but state aid can also take the form of government provided subsidies. Many U.S. multinational companies in different EU member states have been in the press recently because of these state aid investigations, which has created a spotlight on the issue of state aid.

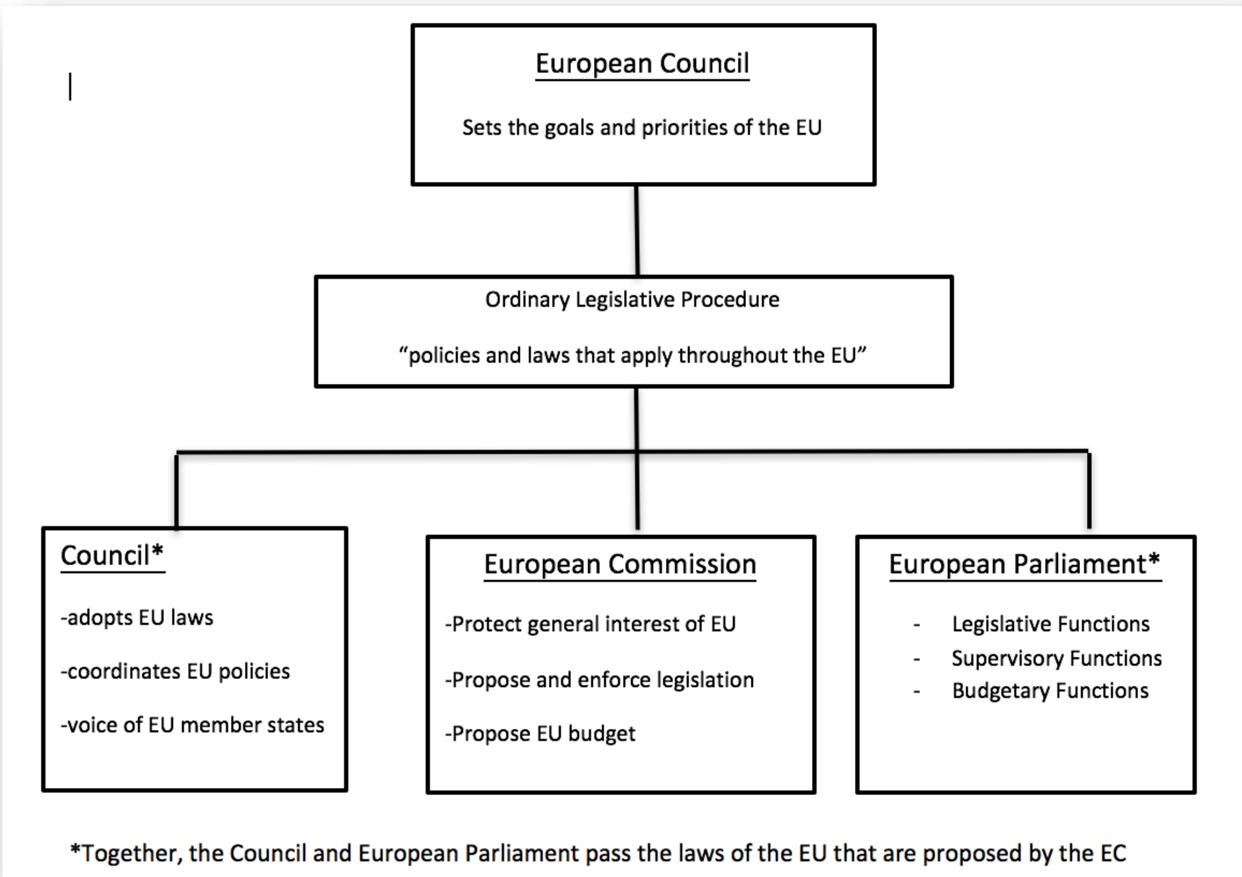
It is important to note that the EC's investigations target the EU member states, not the multinational companies. However, the investigations affect the companies that can be forced to repay state aid received in prior years, which the member states must estimate once the EC has determined that the tax ruling in question does not comply with the European objectives listed in the EU treaty and is therefore classified as illegal state aid (DeNovio, Righini, and Gibbs 2016).

The problem for these companies is that they completed their tax planning based on these tax rulings, which created what they thought to be legal tax savings, but now the EC is retroactively requesting that the money saved from these tax rulings be paid back to the member state (Grinberg 2016). The EC sees recovering the amount the companies saved by the illegal tax rulings as a means of "restor[ing] equal treatment with other companies" (European Commission 2015b). In this paper, I will discuss a few specific types of state aid that have been investigated in recent years. Transfer pricing arrangements and excess profit rulings are two specific measures that the EC has especially targeted in state aid cases for large multinational companies.

The EC is one of four bodies of the EU that has decision-making power with the other three being the European Parliament, the European Council, and the Council of the EU. The citizens of the EU are represented by the European Parliament, whose members are elected by EU citizens. Then, the European Council consists of an overarching president of the council and the twenty-nine Heads of State or Government, who are elected by the citizens of the member states. The Council of the EU holds the interests of the governments of each member state and is divided into 10 different configurations based on subject area, such as Foreign Affairs and Environment. Although the Council is a single entity, membership varies by configuration and consists of representatives at the ministerial level from each of the EU member states. The overarching President of the Council is the government of one of the EU member states. Trios are set for an 18-month term, which consist of 3 governments of EU member states, and they rotate the official title of Presidency every 6 months before the Presidency moves on to the next trio. For example, the current trio is Estonia, Bulgaria, and Austria, but the current President is Bulgaria. Lastly, the EC is an overarching body that represents wholly the EU. The EC is made up of 28 members, one from each member state, serving 5-year terms. Every 5 years, the European Council submits a presidential candidate for the EC, and then that president-elect picks a Vice-President and 26 other Commissioners from the rest of the member states, who suggest potential candidates for the position of Commissioner. Once this list of candidates is approved by the European Council, European Parliament must vote as a whole to approve the entire list of candidates, which if approved, they become the Commissioners of the EC.

Figure 1 depicts an organizational chart that explains how the bodies of the EU interact with one another. The EC's main goal as explained in the chart is to implement new laws as a 'guardian of the treaties' amongst all member states. This role of enforcing legislation gives the EC the ability to prosecute member states for illegal state aid.

Figure 1: Organizational Chart of the EU's Institutions



To understand an analysis of different, specific state aid cases, a basic understanding of state aid and the underlying importance of its consequences must first be explored. The EC allows state aid for economic development. It prohibits any state aid that results in "a company which receives government support [gaining] an advantage over its competitors" (European Commission (c)). In more specific terms, according to Article 107(1) in the Treaty on the Functioning EU, state aid is as classified as "any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favoring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market."

Although this paper analyzes cases that involve illegal state aid arising from tax rulings, state aid can be considered legal as long as it meets one of the following criteria: “support that helps or promotes disadvantaged regions, small and medium-sized businesses, research and development, environmental protection, training, employment or culture” (European Commission (a)). These criteria support the clause that state aid is only justified “by reasons of general economic development,” which produces the question of when do member states cross the line of state aid being used as a means of general economic development and into illegal state aid?

One example of legal state aid occurred in 2009 when the EC approved the UK granting state aid to Lloyds Banking Group. After the financial crisis in 2008, HBOS plc was nearing bankruptcy, and the UK government wanted to step in to assist Lloyds in acquiring HBOS and implementing a restructuring plan to alleviate post-financial crisis issues. To help restore the struggling banks, the EU saw this case as one of economic development and permitted the UK to grant state aid to Lloyds. This case is an example of legal state aid because 1) the aid was necessary for the economic development of the member state and 2) the aid did not provide a selective advantage that would distort competition.

Essentially, the EC wants to preserve competition in its member states in the fairest possible manner. For an advantage to be considered impermissible state aid, it must have four features: member state intervention, exclusive advantage provided to the recipient, distortion of competition, and possibility of affecting trade between member states (European Commission (c)). Once the EC has reason to believe that the advantage being provided is not necessary for economic development and it meets all four of these conditions, then the EC begins an investigation by notifying the member state and requesting the information necessary to complete the investigation.

When the case under investigation involves tax as an aid instrument, the Court of Justice uses a three-step analysis in determining if the case qualifies as illegal state aid. The first step is to determine the "reference system" for the member state being investigated, which refers to the normal tax system the member state uses. Then, the tax measure that is being investigated is compared to the reference system to see if the member state deviated from the reference system in allowing this tax measure to be used. Lastly, if it is proven that the member state did indeed deviate from the reference system, then it must be determined if the tax measure in question "is justified by the nature or the general scheme of the reference system [… which it] may be justified if the member state concerned can show that that measure results directly from the basic or guiding principles of the tax system" (European Commission 2016c, 63). If it cannot be justified, then the tax measure is determined to be illegal state aid.

One pressing question that should be asked is why these countries are willing to forgo tax revenue by enacting these tax provisions that are later found to be illegal state aid? Prior to the 2017 Tax Cuts and Jobs Act (signed December 22, 2017), the U.S. had a worldwide tax system but did not tax the earnings of a foreign subsidiary until the money was repatriated to the U.S. parent. In addition, the high U.S. corporate tax rates encouraged U.S. multinational firms to store their money in foreign jurisdictions (often tax havens) to take advantage of the tax deferral. These EU member states that are being prosecuted in these state aid cases purposefully enacted tax rulings resulting in lower tax revenue as a means of attracting companies to their country. For these countries, a tradeoff exists where on one hand they have missed tax revenues but on the other hand they have benefits from increased foreign investment and economic development.

Countries deciding to forgo tax revenues by enacting these tax rulings in favor of the companies must conclude that the benefits of increased foreign investment and overall economic development are greater than the lost tax revenues.

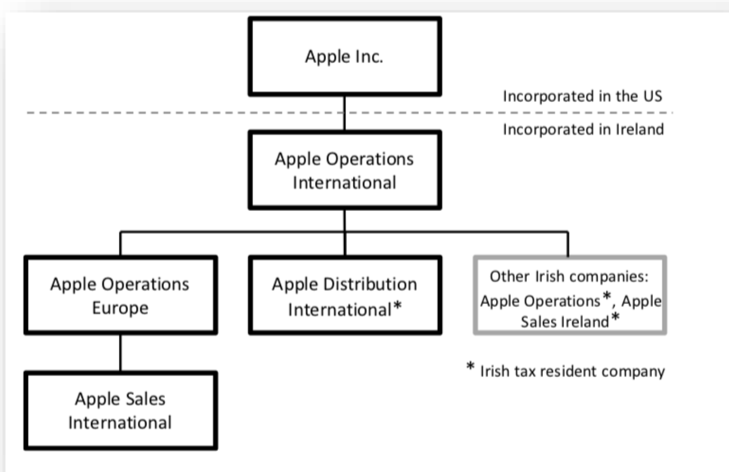
This article aims to analyze three differing state aid cases to understand why countries enact these tax rulings that cause a loss of tax revenues and how the magnitude of these state aid cases will affect international tax planning. In analyzing these cases, it became clear that countries are willing to forgo tax revenue when they realize the economic benefit that arises from attracting multinational investment to their country. In illegal state aid cases, the EC prosecutes the country that enacted the tax law, but the companies are hurt greatly in the clawback of the past taxes avoided. As a result, firms may will start looking more closely at their international tax planning to ensure that they are in line with state aid rules.

2. Cases of State Aid

Case 1: Apple and Ireland

The EC's state aid case against Ireland for tax rulings that favor Apple bring into question tax rulings that were passed in 1991 and 2007 and the structure of Apple's companies in Ireland. Apple has 6 incorporated companies in Ireland, but only 3 of these companies are considered tax residents according to the Irish Revenue, and these companies are Apple Distribution International, Apple Operations and Apple Sales Ireland. However, the other three companies, Apple Sales International (ASI), Apple Operations Europe (AOE), and Apple Operations International, are not considered to be tax residents by Irish Revenue, and the EC's state aid case focuses on two tax rulings that directly affect AOE and ASI. Figure 2 below was provided by the EC in the Commission Decision on this state aid case and shows the corporate structure of Apple in Ireland.

Figure 2 – Apple's corporate structure in Ireland



Source: European Commission State Aid Case SA.38373

ASI and AOE both "hold the rights to use Apple's intellectual property to sell and manufacture Apple products outside North and South America under a so-called 'cost-sharing agreement' with Apple Inc." (European Commission 2016b), with the payments for this agreement funding Apple's research and development in the US and being treated as expenses by ASI and AOE. Although ASI and AOE both have branches in Ireland, their head offices are not in Ireland, which is why the Irish Revenue considered them to be non-resident companies for tax purposes. This non-resident status led to the ruling of 1991 that determined a tax allocation method for taxing ASI and AOE in Ireland.

Under the 1991 ruling by the Irish Revenue, ASI would allocate net profit to its Irish branch as 12.5% of branch operating costs. AOE would allocate net profit of AOE as 65% of branch operating expenses with a ceiling of $60 or $70 million and 20% of its operating expenses in excess of $60 or 70 million. The condition to determine whether to use $60 or $70 million stated that if overall profit of AOE's Irish branch was less than the allocated net profit allocated to the branch, then the $60 million figure would be used as the threshold.

The 2007 ruling replaced the 1991 ruling following a similar set of standards for its tax allocations for ASI and AOE. For ASI, [10-15%] of branch operating costs would be allocated to ASI's Irish branch as net profit. AOE would determine its tax base on three components: 1) tax base of AOE Irish branch equal to 10-15% of branch's operating costs 2) addition of intellectual property return of 1-5% of branch turnover in respect of accumulated manufacturing process technology of the branch 3) deduction for capital allowances for plant and buildings.

These two rulings allowed Apple to allocate a minimal amount of profit to its ASI and AOE Irish branches, while allocating the majority to its respective head offices for ASI and AOE. Because neither company had property or employees, they paid no taxes on the profits allocated to the head offices. The EC determined that "the two tax rulings issued by Ireland endorsed an artificial profit split for Irish tax purposes" (PwC International Tax Services and

Transfer Pricing 2016, 1) and that "the methods endorsed by those rulings allow ASI and AOE to determine their annual taxable profit in Ireland in a manner that departs from a reliable approximation of a market-based outcome in line with the arm's length principle" (European Commission 2016c, 73).

These tax rulings gave Apple an unfair advantage by minimizing their tax liability through a ruling that was not available to competitors. The EC utilized the three-step analysis in concluding that Ireland did give a selective advantage to Apple through these tax rulings. In step one, the EC determined that the appropriate reference system to use is the ordinary rules of taxation of corporate profit in Ireland. In step two of the analysis, the EC determined that Ireland did deviate from the reference system by using the tax measures as explained earlier. According to the reference system, an allocation method based on the arm's length principle must be determined for non-resident companies that taxes the company on all chargeable profits. Ireland agreed to abandon its arm length principle in favor of formula approaches that minimized Apple's taxes in Ireland. The ruling did not comply with arm's length policy because it gave Apple an unfair advantage over other companies in the EU. In step 3, Ireland did not offer a justification of the tax rulings as a result of the general scheme of the tax system, and therefore, the EC determined that the tax rulings were in fact illegal state aid.

In Apple's 2016 annual report, it warned investors of the EC's decision to recover an estimated €13 billion, plus interest, stating that they intend to paying this "out of foreign cash into escrow". However, Apple and Ireland have both submitted appeals of the EC's decision, so the payment will depend on the outcome of the appeal.

Case 2: Starbucks and Netherlands

In October 2015, the EC declared that the tax advantages the Netherlands provided to Starbucks were illegal state aid, and Starbucks would have to pay between €20 and €30 million in taxes to the Netherlands. These tax savings were a result of a transfer pricing tax ruling that the Netherlands granted a Starbucks subsidiary in a 2008 advance pricing agreement (APA) that the EC now declared as an inaccurate reflection of economic reality.

The Dutch tax administration granted this APA on April 28th, 2008 to the Starbucks Manufacturing EMEA BV (SMBV), which is a Starbucks subsidiary incorporated in the Netherlands. The main issues that the EC focused on in the APA were 1) the royalty paid to Alki Limited Partnership (UK) and 2) the pricing of the unroasted coffee beans. Within the APA, an arm's length remuneration was accepted by the Dutch tax administration that SMBV could mark-up operating expenses for SMBV in the range of [9-12%] based on the use of the transactional net margin method (TNMM).

Alki LP received royalty payments from SMBV in exchange for intangible assets that include information regarding the Starbucks brand and store layouts, such as trademarks, technologies, and "know-how." Under the APA, SMBV's royalty payment to Alki LP was "the difference between the realized operating profit before royalty expenses and a [9-12%] mark-up on operating expenses" (European Commission 2015c, 7). Then, SBMV could deduct the royalty payment for corporate income tax purposes and thereby avoid Dutch withholding taxes. The EC determined that the SMBV did not fairly estimate this royalty payment in the APA in that it does not reflect what the royalty would have been if two independent companies participated in the transaction, rather than intra-group companies. Further, the EC determines that "no royalty should be due for the roasting IP licensed by Alki LP to SMBV" (European Commission 2015c, 65).

The second question that the EC presses in the investigation is the price that SMBV paid for coffee beans. SMBV purchases coffee beans from a Starbucks subsidiary located in Switzerland called Starbucks Coffee Trading SARL. The APA failed to evaluate the transfer pricing of these coffee beans as compliant with arm's length policies. Upon investigation, the EC determined that the prices SMBV paid for coffee beans were not comparable to market prices, rather they were inflated resulting in a reduced profit and lower tax liability (PwC International Tax Services and Transfer Pricing 2015).

In the formal investigation, the EC uses the Dutch corporate tax system as an appropriate reference system in determining if the APA in question should be considered a selective advantage. Next, the EC compares the APA to the Dutch corporate tax system to determine if the APA was in fact a derogation. As detailed earlier, the EC determined that the APA allowed SBMV to have a reduced tax liability, as compared to the reference system, so the EC determined that the APA was indeed a derogation from the Dutch corporate tax system. In the EC's conclusion, the APA was determined to be lacking a "reliable approximation of a market-based outcome," which resulted in the EC determining that the APA was in fact a selective advantage, and therefore, illegal state aid.

In the 10-K for 2015, Starbucks included a brief note to inform shareholders of the state aid decision issued by the European Commission. In this note, Starbucks estimated the taxes to be recovered spanning the period of 2008 to 2014, in which the APA was in effect, to be not material and less than $32 million. Starbucks also mentioned that this state aid decision is currently being evaluated and used to determine what impact it could potentially have on their 2016 tax liability. However, there is no mention of the state aid case or the effect it had on their income tax liability upon analysis of the 2016 financial statements.

Case 3: Belgium's Excess Profit Ruling

In February of 2015, the EC opened a state aid investigation against Belgium for its "excess profit" tax scheme that would affect 35 multinational companies that had utilized this ruling since it became legal in Belgium in 2005. Under this ruling "the actual recorded profit of a multinational enterprise is compared with the hypothetical average profit [of] a stand-alone company in a comparable situation" (European Commission 2015a). This hypothetical profit, which is an estimated number, is subtracted from the amount of profit the company actually recorded resulting in what this tax ruling calls "excess profit." The company then pays taxes on the hypothetical profit and does not have to pay taxes on the "excess profit" resulting in substantial tax breaks for the multinational companies. Belgium argues that this "excess profit" ruling allows multinationals to be on the same playing field as stand-alone companies, regarding tax law, when an inherent different exists because stand-alone companies operate solely within Belgium, whereas multinationals have operations both within and outside of Belgium.

The EC ruled the "excess profit" scheme to be illegal and rejected Belgium's defense of using the OECD's arm's length policy because "transfer pricing is to be used in the absence of reliable prices […but] in the present case the fact that observable prices and profits are available is ignored" (European Commission 2015a). This argument led to the EC declaring the "excess profit" scheme to be illegal, but it ultimately resulted in being a state aid case because "it only benefitted certain multinational groups who were granted a tax ruling on the basis of the scheme, whilst stand-alone companies only active in Belgium could not claim similar benefits" (European Commission 2015a), which directly violates the clause of state aid that states a company cannot receive government support that is not available to competitors. As per most state aid cases, these 35 companies that participated in what they thought to be a legal tax ruling in Belgium will have to retroactively pay back the taxes they avoided under the “excess profit” scheme, which Margrethe Vestager, the EU competition chief, estimated to total around 500 million Euros in total (Oliver and Robinson 2016).

Many of the companies affected by this state aid case are European, but a vehicle technology company, WABCO, is one US firm that took part in this “excess profit” scheme in Belgium. In an income tax footnote in WABCO’s June 30, 2016 financials, they referenced the state aid issue, specifically the taxes they must retroactively pay, by stating “during Q1 2016, we recorded a non-cash income tax provision of $86.4 million related to the clawback of the tax benefits.” However, they also mentioned that they were able to use net operating losses against the tax. WABCO further mentioned that they submitted an appeal to the General Court of the European Union, in which if successful, “the income tax provision of $86.4 million may be entirely or partly reversed.” In their annual report, the effect of the state aid case was discussed again to warn investors that their “annual cash tax rate will likely increase, perhaps significantly in future years, as a result of the European Commission’s decision on the Belgian excess profit ruling program which would negatively impact our results of operations.”

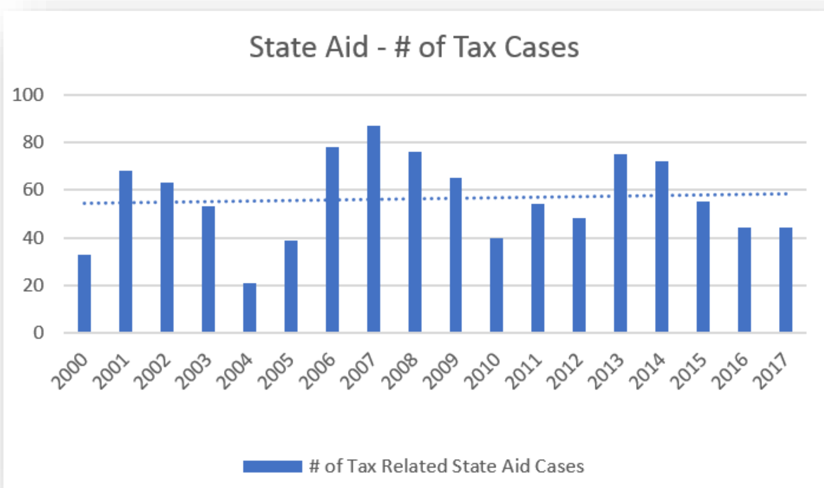
In the Management’s Discussion and Analysis of Financial Condition and Results of Operations section of WABCO’s 2017 financials, the appeal of the state aid decision is discussed. Both WABCO and Belgium decided to appeal the decision and are awaiting the results of the appeal. However, WABCO also mentions that they have obtained an alternative means of tax relief to offset the clawback of the excess profit scheme savings through a program called Belgium’s Patent Income Tax Deduction, which they are awaiting authorization by the EC. Lastly, they discuss the Belgium corporate tax rate because Belgium passed legislation to lower their corporate tax rate from 33.99% to 29.58% starting in 2018.

3. Implications of State Aid

The three cases analyzed above all included a tax measure being utilized as the means of achieving the illegal state aid that the EC prosecuted. The figures below include data regarding state aid cases involved with tax measures to indicate that these three cases are not isolated, rather state aid cases related to tax is a pressing issue of the European Commission.

Figure 3 data consists of any state aid case that relates to the aid instrument in the case being related to tax. These instruments include tax advantages or exemptions, tax allowances, tax base reductions, tax deferments, tax rate reductions and any other forms of tax advantages. While there is not an apparent trend in how many tax cases are prosecuted each year, there is a general decline in cases during the Great Recession.

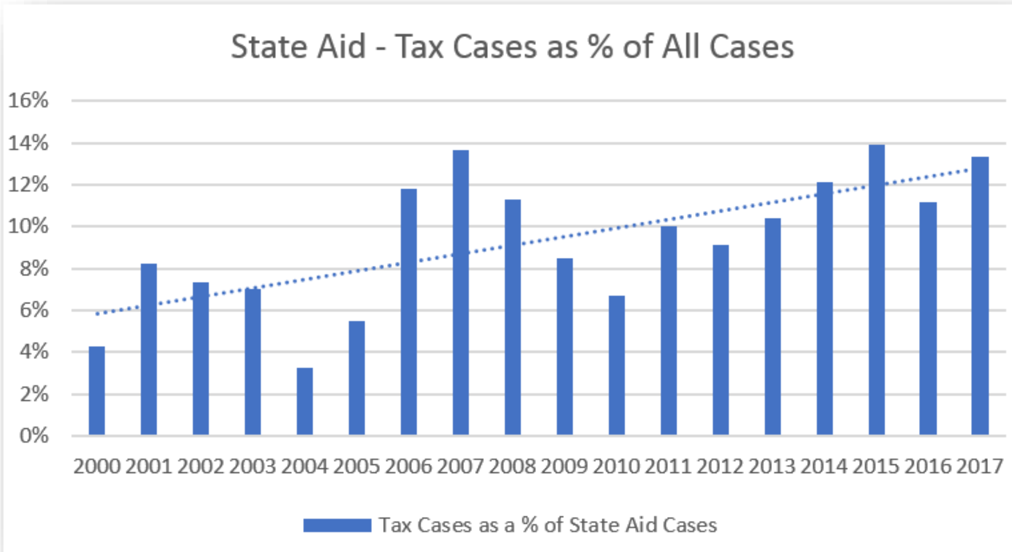
Figure 3 – Number of State Aid Cases by Year



Source: European Commission State Aid Register

However, Figure 4 shows the number of tax cases as a percentage of all cases has been growing over the past 17 years. This means that the focus of state aid cases has become increasingly more focused on cases that involve tax as the choice of aid instrument.

Figure 4 – % of All State Aid Cases Relating to Tax Measures



Source: European Commission State Aid Register

One of the state aid cases analyzed above included Apple and Ireland, so why would Ireland forgo billions of dollars in tax revenue from 1991 to 2013? During the 1990s and early 2000s, Ireland's economy experienced rapid growth, and Ireland earned the nickname, *The Celtic Tiger*. This rapid economic growth was mainly attributed to Foreign Direct Investment coming from U.S. multinationals (Killian 2006). Ireland issued the first favorable tax ruling of this state aid case to Apple in 1991, which coincides with the beginning of *The Celtic Tiger*. In addition to Ireland wanting to continue this period of economic growth, Apple is an attractive company that countries desire to have incorporated in their country. As of 2016, Apple had 116,000 full-time employees worldwide, and of their total cash and cash equivalents ($237 billion), roughly 80% of this cash was held by foreign subsidiaries ($216 billion). Apple keeps this money overseas to avoid paying the U.S. taxes, apply the corporate rate of 35%. As stated in their 2016 10K, Apple has $35.9 billion in deferred tax liabilities, that arise solely from the amount owed to the U.S. if they decided to repatriate their money to the U.S. Apple's attractive size and desire to invest in foreign subsidiaries met with Ireland's desire to experience economic growth created the perfect incentive for Ireland to forgo tax revenue by issuing tax provisions that allowed Apple to pay a tax rate lower than Ireland's statutory corporate tax of 12.5%. For Ireland, the tradeoff of tax revenues for economic development weighed heavily in favor of economic development.

The second case analyzed involves Starbucks and the Netherlands. Starbucks is similar to Apple in the previous scenario in that its massive size is attractive to countries who want multinational investment to help economic growth. As of September 27, 2015, Starbucks had 238,000 employees with 81,000 of these employees being located outside the U.S. In the Netherlands specifically, Starbucks has a 97,000 ft^2 facility used for roasting and distributing coffee beans. Starbucks also holds money overseas in an effort to avoid U.S. corporate tax rates with $56.5 million in deferred tax liability relating to U.S. taxes. These factors are all contributors to why the Netherlands would want to incentivize investment by Starbucks through attractive tax policies. When these tax policies were granted to Starbucks in 2008, Netherlands had a fairly high statutory corporate income tax rate of 25.5%, which placed them as the 15th highest tax rate out of the 35 OECD countries. So the APA grant to Starbucks caused the Netherlands to miss out on tax revenue they otherwise would have collected but incentivized Starbucks to continue multinational investment into the Netherlands.

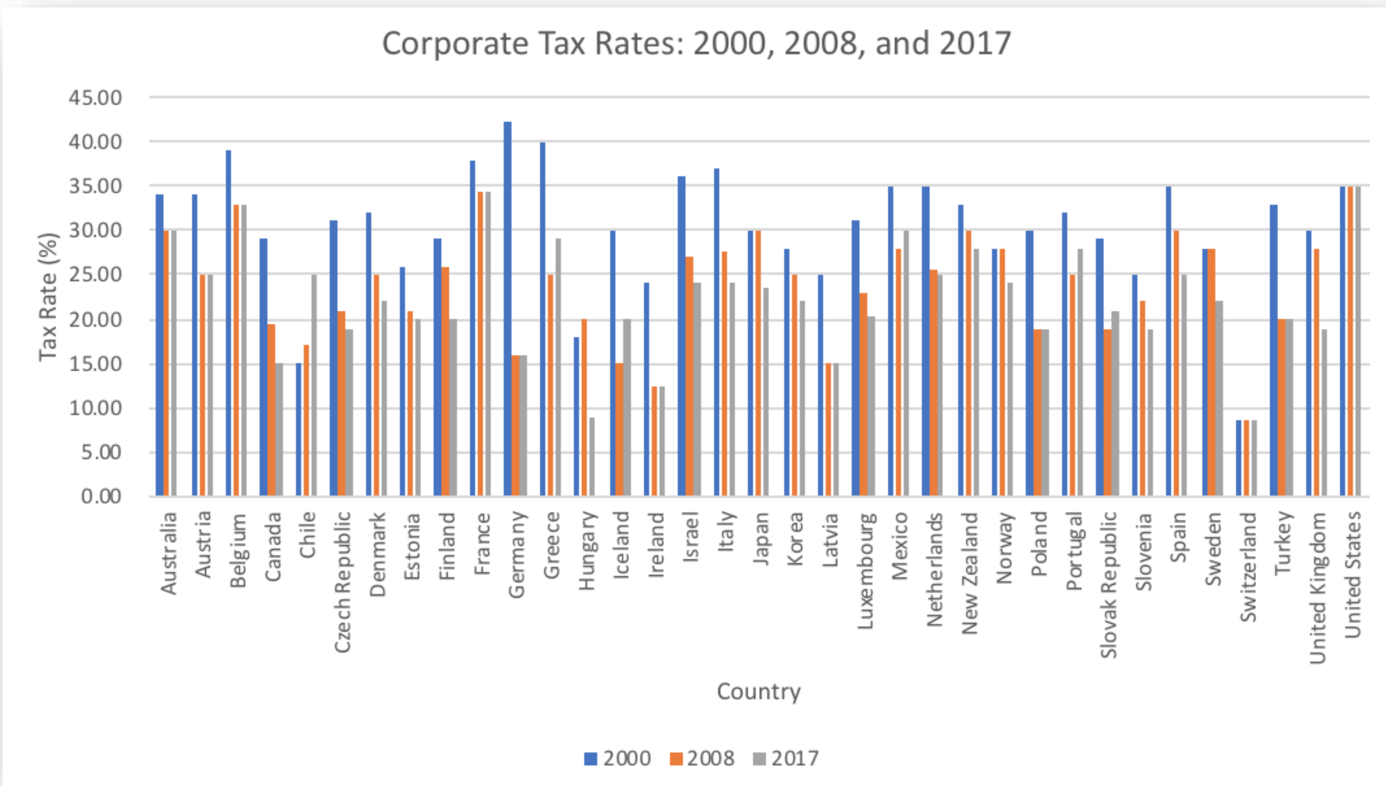
The last case analyzed involved a multitude of companies and an excess profit scheme permitted by Belgium. This excess profit tax policy was advertised to multinationals as "only in Belgium" by the Belgium Tax Authority (European Commission 2016a), which indicates that Belgium specifically enacted this tax policy into in order to attract multinational investment into their country. The effect of multinational investment and economic development on a country's corporate tax regime cannot be too strong without solid profit of the impacts. However, when countries like Belgium specifically design tax policies that disregard state aid rules to attract companies, all while forgoing millions of dollars in tax revenues, it raises important questions around just how strong this effect is.

In the first two cases analyzed above, a primary reason that companies became involved in the state aid case was because of the relatively high U.S. corporate income tax rate. Figure 5 below compares the corporate tax rate for all OECD countries for the years 2000, 2008 and 2017. These years were chosen to show how tax rates have changed over the past two decades.

Figure 5 shows that the U.S. is one of two OECD countries, that did not change its corporate income tax rate from 2000 to 2017, remaining at 35% in all years. The only other country that had a constant tax rate is Switzerland with a tax rate of 8.5% in all years. It is interesting that the lowest and highest tax rates were the only ones to remain constant over time. Another important take-away from this graph is that every country that did enact a change in corporate tax rate had the highest tax rate in 2000 and lowered their tax rate in either 2008 and/or 2017. No OECD country raised its tax rate during this period.

An overall trend of decreasing corporate tax rates has occurred over the past two decades. Going into the future, the U.S. will join this trend with the recent passing of the Tax Cuts and Jobs Act (TCJA) legislation. The TCJA permanently reduces the corporate income tax rate from a maximum 35% to 21%, effective January 1, 2018. It also moves the U.S. taxation of multinational businesses from a worldwide system to a quasi-territorial regime, more consistent with the OECD countries. Previously untaxed earnings that have been held in cash or other assets are subject to a one-time deemed repatriation, subject to tax rates of 15% on cash and 8% on other assets. Going forward, dividends received from foreign subsidiaries of U.S. corporations will be 100% deductible. The TCJA imposes a host of new international tax provisions intended to make the US more competitive but also reduce tax planning in tax haven countries. With many countries having tax rates below 21%, it will be interesting to see if this lower tax rate changes how U.S. corporations choose to operate in foreign jurisdictions.

Figure 5 – Corporate Tax Rates in 2000, 2008, and 2017 for OECD Countries



Source: OECD http://stats.oecd.org/index.aspx?DataSetCode=TABLE_II1

4. Effect on International Tax Planning for U.S. Multinationals

Moving forward, it is hard to tell whether or not countries will make a proactive effort to stop using tax measures as an aid to help multinationals avoid taxes. Considering the positive effect of bringing the multinational to their country on economic development and the lack of consequences for the country in the state aid case, it would not be surprising for countries to continue to try and bring multinationals to their country with attractive tax policies. However, companies bear most of the consequences of these state aid decisions because the decision results in the country being required to pay back the taxes they avoided. This has resulted in multinationals looking more closely at their tax planning to make sure it is in line with state aid rules (Yonah and Mazzoni 2016).

The issue of state aid provides a challenge to companies in their international tax planning department because it is not enough to know that the tax policy is legal in a given country, rather within EU countries, companies must now look further to see if the tax policies are legal with regards to state aid rules of the EU. If countries are not going to make a proactive effort to make sure their tax policies comply with state aid rules, it is crucial that companies do this analysis, or they may end up being blindsided in later years in the clawback of previous taxes. The issue of state aid is not one to be ignored, as Apple and Starbucks realized upon being required to pay back millions in taxes. Multinational companies must consider state aid in their international tax planning because state aid cases are only becoming increasingly more focused on tax issues.

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