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Legal limits to promoting equity capital investments using fiscal measures - State aid perspective

by

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Abbreviation list

ACE	Allowance for Corporate Equity
CBIT	Comprehensive Business Income Tax
CFI	Court of First Instance
ECR	European Court Reports
EU	European Union
GBER	General Block Exemption Regulation
MNEs	Multinational Enterprises
NID	Notional Interest Deduction
OECD	Organisation for Economic Co-operation and Development
PE	Permanent Establishment
RCG	Risk Capital Guidelines
SICAV	(fr.) *Société d'investissement à capital variable,* Investment Company with Variable Capital
SME	Small and Medium-sized Enterprises

1. Introduction

1.1. Background

Cost of capital is an important consideration impacting on the expansion prospects of European companies. Enterprises can raise funds either by taking out loans or inviting participation of investors and offering company equity to them. Both methods of financing attract different tax treatment. The situation is further complicated when the transactions are entered into by affiliated companies or with the the presence of cross-border element. Empirical evidence shows that the attractiveness of debt finance may lead to over-reliance on this form of capital injection into business ventures. This can in turn lead to over-indebtedness that is economically undesirable. As a consequence, governments attempt to bring the tax treatment of the two methods closer together so that the incentive for debt is minimised.

There are two principal avenues that the State can take to restore the balance. The first one involves limiting the deduction of interest income, for example by way of enacting thin capitalisation legislation. The second aims at making equity finance more attractive and available. Here, it is possible to allow for the return on equity to be treated as a deductible expense by the company, provide for beneficial tax treatment of investment funds acquiring stakes in enterprises or grant tax credits to individual taxpayers.

In the European Union context however, such legislative solutions may often conflict with the provisions of Community law, in particular with the rules prohibiting unlawful State aid to undertakings. This friction can in part be attributed to the principle of fiscal sovereignty enjoyed by Member States in the field of direct taxation as well as to the notoriously difficult application of State aid rules to fiscal provisions resulting in the lack of understanding of the scope of rules by the national lawmakers.

1.2. Aim

The purpose of this contribution is to undertake the analysis of the area of tax law relating to the treatment of debt and equity finance and provide recommendations for States aiming to promote investment activity using fiscal tools which are State aid-compliant.

Attainment of this objective will be possible following the presentation of the underlying issues pertaining to the choice between debt and equity as well as the notion of State aid as applicable in the field of fiscal measures. This will equip the author with the necessary toolbox for undertaking thorough analysis of the existing case practice. It is intended that the analysis will lead to a legislative solution that can be adopted by Member States of the European Union.

1.3. Method and materials

The principal focus of this contribution is the analysis of compatibility of national legislation with the EU law, in particular State aid provisions. This exercise will be performed by consulting the relevant case law of the Community courts as well as the Commission case practice which, although a source of soft law, is nevertheless highly influential in this area as the Commission enjoys exclusive competence to investigate State aid infringements. In providing answers to legal questions raised by this contribution, the traditional legal method will be employed.

Although it is acknowledged that there is a wealth of materials available, a necessary degree of discretion has been exercised is selecting primary sources of law which best illustrate the main principles and problems arising in this field. The selection was made with the assistance of secondary sources, most importantly academic journals which confirmed relevance of particular cases and decisions to the field of study. Furthermore, they've been employed as the source of further context.

In order to provide more structure to this work, the author adopted an analytical framework which helped classify the existing legislative instruments by types of investment which they support.

1.4. Delimitation

Having discerned the wide variety of types of investments which can be supported by State measures as well as forms of capital which may be injected into enterprises, this work restricts itself to the discussion of financial as opposed to physical capital.

It is recognised that the subject-matter of this contribution encompasses European and international law as well as economic theory. The concepts of debt and equity financing have been extensively discussed in the economic literature. Occasionally then, recourses to fields of study other than tax law will be made to illustrate similarities. By and large however, Community tax law is analysed and applied. The work is limited to the European law. For this reason, conclusions reached by the author pertain to the Member States of the European Union.

The focal point of this contribution is compatibility with State aid rules. For purposes of clarity, provisions regarding fundamental freedoms are left outside the scope of this paper. Similarly, the area relating to advance pricing agreements and transfer pricing more generally is omitted because emphasis is put on measures applying without discretion of national tax authorities. Although it is acknowledged that there are numerous research areas which can be explored in these fields, the author chooses to mitigate

the risk of too broad analysis by placing State aid rules in the centre of attention.

1.5. Outline

This work has been divided into seven chapters also referred to as sections. Coming after the introductory remarks, chapter 2 introduces the concepts of debt and equity as the two primary method of financing as well as highlights some of the implications of dissimilar treatment arising in cross-border situations. Chapter 3 explores the relationship between debt and equity financing and the provisions on State aid. There, the EU State aid framework is presented and the criteria for determining fiscal measures infringing on the rules are reviewed. In chapters 4 and 5, substantive analysis of State measures promoting respectively internal and external financing is offered. Chapter 6 highlights how the State may ensure compliance with EU law using soft law instruments. Finally, chapter 7 presents final conclusions and provides recommendations for problems undertaken in this contribution.

2. Tax treatment of debt and equity financing

2.1. Forms of capital

Before turning to the substantive issue of designing measures which on the one hand are effective in terms of promoting investments and on the other hand comply with the European Union law, in particular with the provisions on State aid, an introduction to the tax treatment of various methods of injecting capital into companies is presented.

Companies require capital in order to grow and expand their activities. Capital itself is not an uniform factor of production and there are a number of ways by which it can be contributed. First of all, a distinction can be drawn between physical and financial capital. The former consists of, for example, equipment and machinery as well as buildings and land. The latter, being monetary assets in the majority of situations is more mobile and responsive to distortions in the economy caused *inter alia* by changes in taxation. Consequently, it is financial capital that is most commonly used in the global markets.

2.2. Introduction to the tax treatment of debt and equity

There are two principal methods which can be distinguished with regard to this factor of production. Both are discussed in this piece as the primary forms of financial capital. The first one, referred to as equity financing involves transferring company's ownership for money or other assets. In return for the payment, the investor acquires stake (most usually in the form of shares) in an enterprise and thus becomes the holder of company's equity. Consideration paid can in turn be used by the company for development and further investments. The second method, known as debt financing involves borrowing funds. Here, no transfer of ownership takes place. Unlike holders of equity, creditors do not participate in entity's risk and business decisions.

Selecting either form of financing may not at the first sight warrant dissimilar tax treatment. In reality however, the opposite is true. The source of this difference can be traced back to company law which traditionally regarded interest paid by companies to lenders as the cost of doing business and thus a deductible expense. From an economic standpoint however, allowing such a deduction exclusively for interest payments can hardly be justified as both holders of equity and debt are equally entitled to payments on capital.[1] As postulated by corporate finance theory, the situation can further be complicated by developments in the financial markets with derivate instruments often not fitting neatly into strict legal definitions.

[1] see Peter H. Blessing, 'The Debt-Equity Conundrum - A Prequel' in Otto Marres and Dennis Weber (ed), *Tax Treatment of Interest for Corporations* (IBFD 2012) 47

Despite the validity of these arguments, in practice tax rules of the majority of countries allow the deduction of interest on debt from the tax base of the borrower company, profit distributions (equity payments) are non-deductible. The approach followed is thus that of corporate law which ascribes different rights and obligations to owners and non-owners of company equity.[2] This difference may however lead to the under provision of risk capital investments.

Corporate income tax is thus structured in a way that the return on equity is taxable in the hands of the lender (shareholder receiving dividend) as well as the corporation (CIT), whereas interest income is taxed at the level of the owner of debt only. Disallowing deduction of equity payments by the company may give rise to the problem of double taxation. It is however alleviated by the grant of a credit or tax exemption at the shareholders' level. As discussed above, interest on debt owned is usually deductible by the company and taxed in the hands of the lender. From the holder perspective, interest is taxable as an ordinary item of income, whereas dividends often enjoy more favourable treatment. Change of ownership also entails dissimilarities with capital gains tax being due on the sale of shares without a corresponding charge on the transfer of debt.

2.3. Instrument classification difficulties

Whereas dissimilar tax treatment of the two methods of financing might be justifiable by reference to historical corporate law concepts, their practical application has become increasingly challenging with the development of financial markets where a growth in demand for hybrid instruments with varying exposure to risk, participation rights as well as position of creditors can now be observed. As a consequence, even the classification of an instrument as either debt or equity measure is marked by complicatedness. Corporations may choose from an array of specialised investment vehicles commonly referred to derivatives which, while fulfilling their business role, may often not fit neatly with the legal definitions. Moreover, companies can choose to rent property or plant and draw profits similar in nature to interest payments. With the rising diversity of financial products offered, it has become increasingly important that legal criteria for distinguishing the two forms of financing for tax purposes are introduced or updated.

Classification of an instrument as either debt or equity for tax purposes usually follows that employed in the field of commercial law, however reclassification is sometimes used.[3] The distinction may become blurry with regard to hybrid instruments. Academic commentators argue that the classification can differ significantly between the countries as it is a matter of national law. Legal assessment ordinarily involves looking at the wide

[2] see Blessing (n 1) 44

[3] see ibid 34

range of factors, which further contributes to the complexity and uncertainty in this field of law.[4] Discrepancies in classification adopted by various states can often be taken advantage of by taxpayers in cross-border situations.

Such phenomenon is typically referred to as hybrid mismatch and can be described as follows: suppose that Company A in State X invests in its subsidiary, Company B in State Y. If State X considers the transfer to be a capital injection but State Y classifies it as loan then payment made by Company B will be treated as tax deductible interest payment in State Y (no tax) and treated as dividend payment in State X (usually no tax). Mismatches are the result of conducting business across borders. With the development of global markets further tax considerations are brought about. They are discussed in the next subsection.

2.4. Cross-border considerations for the taxation of debt and equity

Dissimilar tax treatment of debt and equity impacts on the investment decisions of enterprises operating in domestic settings to some degree. However, in present times with markets continuously opening up, the differences are further amplified in cross-border situations. Debt and equity financing is gradually becoming more internationalised.[5] Considering the lack of harmonisation in direct tax rates, the development of international trade as well as the emergence of multinational enterprises having the ability to take advantage of tax planning opportunities, the issue of dissimilar treatment of debt and equity becomes more relevant than ever for the authorities and legislators. The law as it stands today provides that dividends are taxed in the source state and interest in the state of residence of the entity that arranges the financing. Most countries exempt interest payments to foreign persons from domestic tax but levy withholding tax on dividends. As far as tax treaties are concerned, OECD Model prescribes a 10% and 15% withholding tax on interest and dividends respectively.[6]

From the perspective of a State that aims to attract investment activity within its borders there are three dimensions which should be taken note of. First of all, it's the debt and equity financing conundrum, the choice between which is often determined by tax motives. Those considerations are further augmented in cross-border as opposed to purely domestic situations with the lack of harmonisation between tax systems further influencing

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[4] see Henk Vording, 'The Debt/Equity Distinction in Corporate Taxation: Does It Work, Does It Matter?' in Otto Marres and Dennis Weber (ed), *Tax Treatment of Interest for Corporations* (IBFD 2012) 11

[5] Doron Herman, *Taxing Portfolio Income in Global Financial Markets* (IBFD 2002) 47

[6] OECD, Model Convention with respect to taxes on income and on capital (2014), Articles 10-11 Note that withholding tax on dividends may be reduced to 5% if 25% shareholding is held.

choices made by entities. The third dimension which is introduced for purposes of this contribution recognises that borrowing can be arranged internally (within the corporate group) or externally (via bank loan or with participation of third-party investors). It is especially in the latter situation, i.e. in the case of providing intra-group loans where "a clear and strong incentive to finance corporate investments out of debt rather than equity"[7] can be observed. Equally, such loans allow for tax planning by multinational enterprises to shift profit from high-tax jurisdictions.

It is submitted that there may exist sound business reasons pointing towards companies preferring debt finance.[8] The explanation put forward by Blessing rests on the fact that certain economic indicators used by company managers, such as weighted average cost of capital (WACC) take into consideration interest deductions when determining the profitability of the venture. Consequently, taking into consideration the after-tax cost of capital may give preference to debt financing when undertaking investment projects.[9]

Despite economic justifications offered, the structure of corporate taxation generally contributes to the preference for debt finance as the income of debt providers in the form of interest payments generally enjoys lower overall tax burden as compared to the income of holders of enterprise's equity received in the form of dividends.[10] The view of the overall preference for debt as more available and enjoying favourable tax treatment is supported by commentators who point to to the fact that unequal treatment of return of equity, being subject to corporation tax as compared to return on debt which is exempt may influence the choice of the form of financing.[11] In the end, a distortion in favour of debt financing is introduced as a result of the structure of the corporate income tax systems of most countries.[12] This distortion is further amplified in cross-border setting as a result of tax planning opportunities.

2.5. Tax planning opportunities

Tax treatment of the two forms of financing has an impact on the investment choices. Taxation determines financial indicators such as the cost of capital,

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[7] see Vording (n 4) 5

[8] see Blessing (n 1) 30

[9] see ibid

[10] see Vording (n 4) 6

[11] see ibid 7

[12] see ibid 8

the rate of return, and the net profit.[13] Apart from distorting real economic choices, unequal tax treatment of debt and equity may encourage tax planning and lead to tax base erosion particularly in countries maintaining high corporate income tax rates. Depending on the jurisdiction analysed, terms such as equity, debt, dividend and interest can be understood to have different scope.[14] Planning opportunities are a consequence of insufficient harmonisation in the field of direct taxation and pertain to vagueness of terminology used in this field of law.

Empirical studies show that despite there being opportunities for tax planning in cross-border situations, their use in general is "fairly modest in size".[15] Within the three dimensional framework identified above, one particular area can be determined as most notoriously exploited by taxpayers. It is therefore submitted that planning activities pertains primary to the internal as opposed to external debt financing across borders. Such internal borrowing can effectively be employed in cross-border situations where the difference in tax rates are utilised. Such avenues are open primarily to multinational enterprises. As a result of classification inconsistencies multinationals have been able to effectively reduce their tax burden. Vording submits that whereas deductibility of interest does not appear to have a major impact on companies' external borrowing, it may provide incentives for cross-border planning by MNEs using internal loans.[16] As a consequence, there is a danger of effective tax burden becoming detached from profits and increasingly dependent on companies' ability to offset profits using cross-border structures.[17]

2.6. Solutions for the unequal treatment of debt and equity

As has been shown above, dissimilar treatment which tax law prescribes to debt and equity financing creates a distortion in favour of the former. Therefore, corporate taxation generally contributes to the emergence of thinly capitalised companies. This over-reliance on debt may be problematic from the point of view of creditors which bear the risks associated with the solvency of enterprises, as well as tax authorities who may encounter negative consequences for the tax collection if companies are able to exempt the return on capital from taxation in the host country in cross-border

[13] see Theo Keijzer, 'Interest Costs Allocation: A Business View' in Otto Marres and Dennis Weber (ed), *Tax Treatment of Interest for Corporations* (IBFD 2012) 65

[14] see Vording (n 4) 10

[15] ibid 13

[16] see ibid 17

[17] see ibid

situations.[18] It is for this reason, that several attempts have been made in order to equalise debt and equity from the tax perspective. In the global economy, any attempt to unilaterally make up for the disadvantage equity finance suffers from will be limited in its effectiveness. Nevertheless, countries continue to employ a range of solutions to prevent over-indebtedness of their resident companies.

There are a number of methods which are aimed at making both debt and equity financing neutral from the tax law perspective but at the most general level they can be divided into two types of measures. Conceptually, bringing the two forms of financing closer can done either by way of disallowing the deductibility of interest (comprehensive business income tax (CBIT)) or by allowing such deductions for equity (allowance for corporate equity (ACE)).

In practice, elements of CBIT are already being introduced in many parts of the world. Most often employed are interest deduction limitations which take the form of thin capitalisation (thin-cap) rules or provisions on earnings stripping. The growing popularity of the former can be evidenced by the fact that in the mid-1990s less than a third of European countries had such regulation in place, ten years later this proportion grew to two-thirds.[19] Thin-cap rules are provisions which determine the amount of interest paid on debt owned by companies that can be deducted effectively preventing taxpayers from using excessive amounts of interest to reduce their taxable bases. They are targeted at companies with high debt-to-equity ratio with debt finance typically provided by another company within the group situated in the low-tax jurisdiction where the return on investment is taxed. These rules prevent interest deduction if the debt-to-equity ratio of the company exceeds the ceiling stipulated by the domestic law or if the company cannot prove that the loan is granted on the market (arm's length) terms. Earnings stripping rules are thin capitalisation derivative. They provide for a statutorily determined amount of interest expense that can be deducted by the company.

The second category of measures includes schemes which allow equity to enjoy more favourable tax treatment. In practice, such allowance was implemented in Belgium as notional interest deduction although, as will be shown below, several areas of conflict with the provisions of EU law were found. Promoting more favourable tax treatment of equity may furthermore be achieved by means of measures indirectly benefitting companies operating in the State. Consequently, fiscal instruments such as preferential tax regimes for investment funds or tax credits granted to individual taxpayers are often introduced with the aim of closing the equity gap which

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[18] see Thiess Buettner, Michael Overesch, Ulrich Schreiber, Georg Wamser, 'The impact of thin-capitalization rules on the capital structure of multinational firms' (2012) Journal of Public Economics 96 931

[19] see Buettner et al. (n 18) 930

affects the markets. It should be noted that adverse effects of CBIT include increasing the cost of capital, however this could be mitigated if tax rates are lowered as a result of broadening the tax base.[20] On the contrary, if ACE system is adopted, CIT rates should correspondingly be increased. Commentators submit that introducing any of the proposed approaches would result in more tax neutrality.[21]

Lastly, it should be submitted that the practice of MNEs using internal debts as a tool in tax planning could be curbed by reclassifying such payments as equity. However, this would potentially add to the existing complexity of distinguishing between debt and equity instruments by introducing another internal/external condition. Also present is the risk of double taxation. Moreover, disregarding business purpose behind such intra-group loans appears to be a controversial proposition.[22] With regard to the the question of where the line between debt and equity should be drawn there are a number of proposals involving looking at the economic function of instruments (Weisbach), criteria such as voting power, the duration of contract (Benshalom) and the rate of interest (Ceryak).[23]

In conclusion, the lack of neutrality in the tax treatment of debt and equity financing was identified. This difference may lead to distortions in the markets with choices of companies being motivated by fiscal rather than business considerations. Furthermore, the result of the dissimilarity may be over-indebtedness and tax planning. There are some conceptual solutions to the challenges identified. In practice, there is an observable trend towards limiting the benefits brought about by interest deduction as well as making equity finance more available. However, legislative solutions adopted by Member States may often infringe on Community law provisions. Of particular interest to this contribution are the rules on State aid. Before exploring the potential contentious areas, the overall State aid framework is introduced.

[20] see Vording (n 4) 21

[21] see Keijzer (n 13) 66

[22] see Vording (n 4) 18

[23] see ibid 19-20

3. Interaction between debt-equity finance and the provisions on State aid

3.1. Introduction

As has been demonstrated above, tax considerations may make debt financing more attractive from the point of view of companies. However, both over-indebtedness and more importantly in the years following the financial crisis the limited supply of traditional forms of lending contribute to the creation of an equity gap. Consequently, within the EU certain Member States seek to redesign their tax codes in order to promote more equity investments. This chapter includes the introduction of the notion of State aid as a demarcation line between the fiscal autonomy in the field of direct taxation and compatibility with Community law concepts.

3.2. EU State aid criteria

National prerogatives enjoyed by the Member States of the European Union in the field of direct taxation should be exercised in compliance with the EU law. Like any other area, taxation falls under State aid rules. The Commission which enjoys exclusive rights to enforce Treaty provisions in this area[24], has over the years recognised that fiscal measures can be a powerful tool with an appreciable effect on the position of undertakings benefitting from favourable treatment. Likewise, Community courts to which review Commission's decisions recognise the importance of fiscal measures being in compliance with the Treaty law. Tax rules are subject to the four criteria stipulated in Article 107(1) TFEU that provides the Treaty basis for State aid prohibition:

> Save as otherwise provided in the Treaties, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring 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.[25]

Provisions on State aid form part of the Community competition rules which apply exclusively to undertakings. This notion can most generally be described to include any entity engaged in the economic activity regardless of its legal status and the way in which it is financed.[26] Therefore, competition rules are focused on the substance of entities and transactions putting function before form.

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[24] Case C-74/76 *Ianelli &Volpi SpA v Meroni* [1977] ECR 557; Case C-78/76 *Steineke und Weinlig v Germany* [1977] ECR 595

[25] Treaty on the Functioning of the European Union (TFEU), Article 107(1)

[26] Case C-41/90 *Höfner and Elser v Macrotron GmbH* [1991] ECR I-0197 para 21

If the measure is held to apply to undertakings, four substantive criteria are then analysed. When examining the existence of aid, it should be established if the measure is granted from State resources, whether it has appreciable effect on trade between Member States, whether it confers an advantage on the recipient and lastly, whether that advantage applies selectively.[27] Commentators add that there exists one final condition which concludes the State aid test, i.e. the possibility of justifying a prima facie selective measure by reference to the nature and overall structure of the tax[28], a concept originally developed as far back as in *Italy v Commission*[29] and subsequently applied in *Adria Wien*[30] and *Paint Graphos*[31]. As far as fiscal measures are concerned, it is usually the selectivity criterion that will be decisive for establishing the existence of State aid. Consequently, it continues to present most practical difficulties.

3.3. Application of selectivity criterion to fiscal measures

Very little guidance for the application of selectivity criterion to fiscal measures is given in primary law sources. It is an area marked by judicial activism where the decisions of Community courts put flesh on the bones of Treaty provisions. As far back as 1974, the Court laid down the principle that Article 107 TFEU is concerned with the effects, rather than objectives pursued by measures introduced by Member States.[32] The understanding of the notion of selectivity was further developed in the case of *Maribel*[33], where the Court for the first time used the "analytical formula that has led to the current standard test for selectivity"[34]. There, an interpretation of the term "all undertakings" as limited to "those [entities] which are in an objectively similar position"[35] was accepted, therefore emphasising the need for comparability of situations. The test was further refined in *Adria-Wien*[36] which reinforced the requirement that undertakings treated favourably are in

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[27] see e.g. Case C-280/00 *Altmark Trans and Regierungspräsidium Magdeburg* [2003] ECR I-07747 para 75

[28] Eduardo Travesa, 'Tax Incentives and Territoriality within the European Union: Balancing the Internal Market with the Tax Sovereignty of Member States' World Tax Journal (2014) 332

[29] Case C-173/73 *Italy v Commission* [1974] ECR 709

[30] Case C-143/99 *Adria-Wien Pipeline and Wietersdorfer & Peggauer Zementwerke* [2001] ECR I-8365

[31] Joined Cases C−78/08 to C−80/08 *Paint Graphos and Others* [2011] ECR I-7611

[32] *Italy v Commission* (n 29) para 13

[33] Case C-75/97 *Belgium v Commission* [1999] ECR I-3671

[34] Juan Jorge Piernas López, *The Concept of State Aid Under EU Law* (1st edn, OUP 2015) 120

[35] *Belgium v Commission* (n 33) para 17

[36] *Adria-Wien* (n 30)

a comparable legal and factual situation in the light of the objective pursued by the measure[37], before *prima facie* selectivity is to be found. If such selectivity is present, it can nevertheless be justified by the nature or general scheme of the system it formed part of.[38]

Understanding of the reference framework was developed in the *Azores*[39] judgment where the Court left open the possibility of defining the comparability framework more narrowly in situations where regional authorities retain sufficient degree of political and economic sovereignty from the central government, thereby including only undertakings operating in the smaller geographical area. Further narrowing-down of the criteria, this time with regard to justification grounds came in the *British Aggregates*[40] case where the Court did not accept environmental goals pursued by the United Kingdom as capable of saving selective fiscal measures.[41] Such secondary objectives are incapable of warranting difference in tax burden.[42] Finally, in *Paint Graphos*[43] the Court refined its formula to the effect that comparability is undertaken in light of the objective pursued by the tax more generally.[44] After the judgment in *Gibraltar*[45], it is accepted that the legislative technique used by the Member State cannot exclude the applicability of State aid provisions. There the introduction of a new corporate taxation in Gibraltar was held bring about similar effect to derogations from the normal tax system.[46]

In summary, selectivity is defined as affording advantageous treatment to "certain undertakings or the production of certain goods"[47]. Determining the existence of selective treatment involves conducting a comparison test between the undertakings receiving favourable treatment and "other undertakings which are in a legal and factual situation that is comparable in the light of the objective pursued by the measure in question"[48].

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[37] see ibid para 41

[38] see ibid para 42

[39] Case C-88/03 *Portugal v Commission* [2006] ECR I-7115

[40] Case C-487/06 P *British Aggregates v Commission* [2008] ECR I-10515

[41] see *British Aggregates* (n 40) para 92

[42] see Pierpaolo Rossi, 'The *Paint Graphos* Case: A Comparability Approach to Fiscal Aid' in Dennis Weber (ed) *EU Income Tax Law: Issues for the Years Ahead* (IBFD 2013) 132

[43] *Paint Graphos* (n 31)

[44] see *Paint Graphos* (n 31) para 54

[45] Joined Cases C−106/09 P and C−107/09 P *Gibraltar v Commission* [2011] ECR I-11113

[46] see *Gibraltar v Commission* (n 45) para 93

[47] TFEU, Article 107(1)

[48] *Portugal v Commission* (n 39) para 54

Conceptually then, selectivity analysis comprises of two tests: comparability and derogation. Over the years, they have been merged and now appear to both form part of a comprehensive analysis performed by the Court when examining fiscal measures in State aid proceedings.[49] Travesa submits that "the selectivity of a measure can be of a different nature: sectorial, material or territorial."[50] It is to be borne in mind that if no selectivity can be established by the Commission, the contested instrument is to be regarded as a general measure that is within the margin of appreciation of Member States and will thus escape State aid prohibition.

Having explored both challenges created by the unequal treatment of debt and equity as well as theoretical underpinnings of the State aid rules, the substantive issue of designing measures which promote investment activity, in particular in the form of equity transfers will now be discussed. The approach that has been adopted analyses tax measures that have been the subject of assessment by the Commission and Community courts in order to determine the potential lack of compatibility with the State aid provisions. Then, recommendations for to drafting effective, EU-compliant rules are presented.

[49] see e.g. Claire Micheau, 'Tax Selectivity in State Aid Review: A Debatable Case Practice' 12 EC Tax Review 6, Pierpaolo Rossi-Maccanico, 'The Point on Selectivity in State Aid Review of Business Tax Measures' in Pasquale Pistone (ed) *Legal Remedies in European Tax Law* (IBFD 2009)

[50] Travesa (n 28) 333

4. Fiscal measures promoting internal financing

4.1. Introduction

Although in the context the European Union the ability of governments to enact tax legislation is qualified by the requirement of compliance with Community rules, there appears to exist a wide variety of tax measures which may be used by Member States to promote investment activities of their resident companies.

In order to better understand the underlying principles of the Community legal order and in particular the provisions on State aid, it is useful to resort to the theoretical framework introduced in subsection 2.4. In accordance with that approach, three dimensions which provide guidance on compatibility of investment-inducing measures with EU rules can be distinguished. Firstly, state intervention may have the effect of promoting debt or equity finance. Both debt and equity can in turn be arranged internally (within the corporate group) or externally (using bank borrowing or third-party investors). Lastly, the impact of the legislation may be that cross-border as opposed to domestic finance is used.

In the EU setting, the possibility of providing preferential treatment for domestic investors is restricted by the fundamental freedoms on which the internal market is built. For this reason, the analysis of such measures is outside the scope of this contribution. Instead, emphasis is put on the compatibility of measures promoting internal and external debt and equity investments. As will be demonstrated, the objective of the legislation put forward by the State will be disregarded if the true intention behind the instrument can be identified. Where appropriate, an explanation taking account of the tax competition Member States are engaged in is offered.

4.2. Coordination centres regimes

As it was stipulated above, Members of the European Union often find themselves in competition for investments. Multinational enterprises may seek to minimise their tax burden by way of locating corporate coordination centres in countries that offer attractive taxation for holding companies. European Union institutions are aware of the existing competition and consequently tend not to take justifications presented by Member States at face value. Governments can employ differentiation in tax treatment of group interest income. Such tax advantage may involve exemption from taxable base of foreign-source income with the result that tax burden is significantly reduced.

Applying the classification of measures presented above, they can be termed as instruments promoting internal cross-border debt financing. Existing case

practice[51] shows that favourable treatment of group interest *vis-á-vis* other items of income is problematic from the State aid point of view. Preferential regimes reserved only for companies performing holding, managerial, financial or coordination functions has over the years been held to be selective as evidenced in the case of Irish International Financial Service Centre of Dublin.[52] Also, in the case of French treasury companies, derogating from the general rule by allowing full deductibility of interest in favour of companies performing treasury functions within the group was held to be selective.[53] With regard to regimes for conduit companies in Luxembourg[54] that had their taxable base calculated as a spread between money borrowed and re-lent to other entities within the group, setting of fixed margins was considered not at arm's length and therefore harmful taxation.[55] With regard to State aid analysis of the Luxembourgish regime it was held the administrative practice allowing finance companies being part of multinational groups to benefit from the favourable calculation of the taxable base was contrary to State aid rules.[56] In similar vein to sectorial restrictions, it is doubtful that territorial limitations are permitted as evidenced by the exemption from Italian CIT provided for the financial sector for activities performed in Eastern Europe that was held to be State aid.[57]

Reserving benefits to entities being part of multinational groups is typically not permitted.[58] It is submitted that the reduction of the tax base for group interest income in favour of offshore entities is contrary to EU State aid provisions.[59] Kalloe thus concludes that "offering a lower effective tax rate for foreign-source interest income […] can be considered contrary to […] EU State aid."[60] Likewise, in the case of Hungarian interest from affiliated

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[51]Commission, Swiss holding companies, State aid decision OJ 2007 C411final, Coordination centres in Belgium, State Aid decision OJ 2003 L282/25, Luxembourg 1929 Holding companies, State aid decision OJ 2006 L366, Basque coordination centres, State aid decision OJ 2001 C48 see Vinod Kalloe, 'Corporate Tax Treatment of Interest: EU State aid and EU Code of Conduct Combating Harmful Tax Competition' in Otto Marres and Dennis Weber (ed), *Tax Treatment of Interest for Corporations* (IBFD 2012) 183-187

[52] Commission, E/1/98 Ireland State aid decision OJ 1998 C395/14

[53] See Commission, Central corporate treasury companies, State aid decision OJ 2003 L330/23, Kalloe (n 51) 193

[54] Commission, Luxembourg Finance companies, State aid decision OJ 2003 L153/40

[55] See Kalloe (n 51) 194

[56] See ibid 195

[57] Commission, Trieste Financial services and Insurance centre, State aid decision OJ 2003 L91/47

[58] See with regard to Luxembourg 1929 Holding companies Kalloe (n 51) 186

[59] See Kalloe (n 51) 187

[60] Kalloe (n 51) 189

companies scheme[61], the Commission found sectoral differentiation and the opt-out mechanism to constitute prohibited aid which could not be justified by the nature and general scheme of the system.[62] It has been held that indefinite tax deferral in favour of certain entities performing financing activities constitutes State aid.[63]

4.3. Dutch group interest box

Whereas coordination regimes are hardly justifiable in the light of State aid provisions, Member States may often invoke aims such as "reducing the difference in fiscal treatment between two instruments of intra-group financing, i.e. debt and equity"[64] in order to justify the introduction of new measures. Group interest box was exactly such pieces of legislation developed in the Netherlands. It should be noted from the outset that, although following public consultation the measure was not introduced as it was claimed that such deduction would discourage foreign investment,[65] it is nevertheless worth examining in more detail.

The box prescribed a tax rate of 5% for the balance of interest on intra-group loans.[66] In essence, the measure allowed Company A (the lender) to be taxed at 5%. At the same time, the borrower Company B was able to deduct at a corresponding rate of 5%. As such, no benefit was to be gained in a domestic situation. However, in cross-border setting, provided that interest was deductible by the borrower at the rate higher than 5%, the overall burden for the group was reduced. Thus, an incentive for lenders resident in the Netherlands was created as they could apply a favourable tax rate to interest income received from their subsidiaries.[67] This in turn promoted locating group-financing activities of multinationals in the Netherlands as the foreign subsidiaries of Dutch parents were not harmed by the rules restricting the deductibility in their respective states of residence.

The amount of interest that could benefit from the reduced tax rate was capped at the percentage of the equity capital owned by the company.[68]

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[61] Commission, Tax deductions for intra group interest, State aid decision C10/2007

[62] See Kalloe (n 51) 190

[63] See Commission, Dutch International Financing Activities regime, State aid decision OJ 2003 L180/52 See Kalloe, 191

[64] Commission, Groepsrentebox Scheme, State aid decision C4/2007 (ex N 465/2006) L288/2009

[65] See Kalloe (n 51) 192

[66] see Groepsrentebox Scheme (n 64) para 21

[67] see ibid para 24

[68] see Rita Szudoczky and Jan L. van de Streek, 'Revisiting the Dutch Interest Box under the EU State Aid' Intertax Vol 38/5 2010 262

Therefore, an upper limit on interest deduction was introduced, which was aimed at reducing excessive debt financing and encouraging equity investments.[69] It is observed by Szudoczky that the rationale behind the cap was to limit the advantage to activities funded with equity capital,[70] thereby promoting such kind of investments, however it should be noted that the funds borrowed from the third party (e.g. bank) could be reinvested within the group and thus artificially increase equity capital thereby allowing for more interest income to be taxed favourably, albeit this situation had been foreseen and would arguably be caught by anti-abuse provisions.[71]

4.4. Commission's decision and academic response

The Commission did not find the measure to infringe EU State aid rules. In its investigation procedure it arrived at the conclusion that the affiliated loan provider benefitting from the measure could not be regarded as being in comparable situation to a third-party lender subject to the ordinary rate of corporate tax.[72]

This decision has been criticised by some academic commentators.[73] They argue that the Commission was wrong to conclude that the measure was open to all undertakings as it in fact pertained only to entities providing finance within groups and thus did not grant an advantage.[74] Also, with regard to selectivity criterion academics comment that the justification by the nature and general scheme of the system was not available as the Commission had been wrong to conclude that beneficiaries of the measure could not have been regarded as being in comparable situation to third-party loan-providers.[75] Similarly, the discord between the declared objective of the legislation and the practical advantage gained multinationals and consequently the lack of proportionality was pointed out.[76]

It appears that there is a lot of merit to arguments presented in academia. Applying the three-dimensional framework, it becomes evident that the measure was aimed at cross-border internal borrowing. One can certainly disagree with the view that the introduction of a cap on the amount that could be deducted that was in turn linked to equity capital owned by the entity did in fact promote this type of financing. As will be shown below a

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[69] see Groepsrentebox Scheme (n 64) para 18

[70] see Szudoczky et al. (n 68) 262

[71] see Groepsrentebox Scheme (n 64) para 23

[72] see ibid para 103

[73] see e.g. Szudoczky et al. (n 68)

[74] see ibid 266

[75] see ibid 271

[76] see ibid 273

similar scheme in launched Belgium was held to infringe EU law despite "Europe-proof" characteristics alleged by national legislators.

4.5. Notional interest deduction

Belgian experience with introducing the "deduction for risk capital", more commonly referred to as the "notional interest deduction" (NID) highlights practical difficulties with drafting legislation promoting risk finance that's compatible with the EU law. The rules were implemented into the Belgian tax code in 2005 as a replacement of the coordination centres regime which the Commission found to constitute unlawful State aid. The law took effect from tax year 2007. The rationale behind NID was improving the competitiveness of enterprises, in particular those representing the SME sector by increasing their equity as well as continuing to attract coordination centres of multinational groups.[77] Commentators submit that it was in particular the consideration for catching the eye of the big business that motivated the Belgian government which feared the trend of lowering corporate income tax rates by many European countries at the time.[78] There appears to be empirical evidence pointing to the fact that the Belgian government was successful in achieving its goal of enhancing and increasing the equity of companies in Belgium. Study conducted by the National Bank of Belgium shows the decrease in reliance on debt as a source of capital and a corresponding increase in equity finance.[79] Similarly, according to commentators, the objective of retaining existing coordination centres and attracting new investments of similar character was attained.[80]

The operating principle of the notional interest deduction was that a company subject to corporate taxation in Belgium was availed the possibility of deducting certain percentage of its equity capital. Following the transfer of resources e.g. in the form of IP rights into such companies (an informal capital injection), profits of the Belgian entity relating to that informal capital was treated as a return on investment and hence not part of the taxable base.[81] Company equity consisting of share capital and retained earnings at the end of the applicable financial year was thus benefiting from the same treatment as interest payment which could be classified as a deductible expense when debt finance was used. Unlike debt instruments, notional interest for equity was fictitious, calculated on the basis of the

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[77] see Bernard Peeters and Thomas Hermie, 'Notional Interest Deduction' in Otto Marres and Dennis Weber (ed), *Tax Treatment of Interest for Corporations* (IBFD 2012), 69-70

[78] See ibid 70

[79] K. Burggraeve et. al., Macro-ekonomische en budgettaire impact van de belastingaftrek voor risicokapitaal, available at: https://www.nbb.be/doc/ts/publications/economicreview/2008/ecotijdiii2008n_h1.pdf accessed 31st May 2016, 15

[80] see Peeters et al. (n 77) 75

[81] see Kalloe (n 51) 199

percentage determined by the government (linked to the interest on 10-year linear bonds issued by the State) and was multiplied by eligible items of company equity.[82]

4.6. Compatibility of the notional interest deduction with European Union law

Notional interest deduction scheme was not notified to the European Commission. It is evidenced by the memorandum to the new legislation that the Belgian government considered the deduction to be "Europe-proof", i.e. in line with the Community rules.[83] Following the inquiry of the Code of Conduct Group who found the scheme which allowed up to 90% of profits of the entity to be deemed as relating to informal capital received to be a measure of harmful taxation, Belgium decided to rollback this scheme. Furthermore, another area of conflict was found in the case of *Argenta Spaarbanken*,[84] where the then European Court of Justice ruled that the Belgian rules also infringed the EU fundamental freedoms. The Court noted that "assets attributed to permanent establishments which are situated in a Member State other than the Kingdom of Belgium and the income from which is not taxable in Belgium are not taken into account when calculating the risk capital serving as a basis for calculation of the deduction"[85]. Such limitation was held to discourage Belgian companies from carrying on business through a PE established in a MS other than Belgium.[86] That restriction was found not to be capable of justifying by reference to the the need to preserve the balanced allocation between the Member States of the power to tax.[87]

4.7. Concluding remarks on the compatibility of measures promoting internal financing

Kalloe concludes that existing decision practice of the Code of Conduct Group suggests that "in principle a Member State could have different tax rates for different types of income, provided that the benefits are not ring-fenced from the domestic tax base"[88]. However, as far as interest is concerned, it appears that the reduced nominal rate for group financing which results in lower effective tax burden may be considered harmful

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[82] see Peeters et al. (n 77) 76

[83] see ibid 78

[84] Case C-350/11 *Argenta Spaarbank* [2013] C:2013:447

[85] ibid para 23

[86] see ibid para 34

[87] see ibid para 58

[88] Kalloe (n 51) 202

taxation.[89] Following the 1998 Commission Notice, State aid rules provide that taxing one factor of production to a lesser extent will not automatically lead to the finding of aid[90], however the Notice has not been updated in nearly twenty years which warrants caution.

Summing up, the investigation of measures which promote internal cross-border borrowing shows that this type of legislation is very likely to be considered as conflicting with the provisions of Community law, in particular the rules on State aid. Having said that, the question remains whether adopting measures which stimulate external financing activity can be effectively employed by States aiming at eliminating problems associated with over-reliance on debt. This issue is dealt with in the next section.

[89] See Kalloe (n 51) 202

[90] Commission, Notice on the application of the State aid rules to measures relating to direct business taxation, OJ 1998 C384/03 para 13

5. Fiscal measures promoting external financing

5.1. Investment funds as vehicles for external financing

External dimension of financing depends on the method of injecting capital. In the case of debt, perhaps the most widespread are bank loans. On the other hand, equity investments often attract smaller investors. For efficiency reasons, their investments are in many instances managed by specialised funds. The question that emerges with regard to such vehicles is whether or not they are subject to State aid rules and further if favourable tax treatment of those entities is permissible.

Risk capital guidelines provide the main rule that investment funds are not ordinarily regarded as State aid beneficiaries. There, the following provision is laid down: "[i]n general, the Commission considers that a financial intermediary is a vehicle for the transfer of aid to investors and/or enterprises in which the investment is made, rather than a beneficiary of aid in its own right, irrespective of whether the financial intermediary has legal personality or is merely a bundle of assets managed by an independent management company."[91] However, the Commission introduces an important precondition to the main principle and states: "[…] measures involving direct transfers to, or co-investment by, a financial intermediary may constitute aid unless such transfers or co-investments are made on terms which would be acceptable to a normal economic operator in a market economy."[92]

In its decision regarding investment funds operating in Italy[93], the Commission considered that applying a reduced rate of 5% tax to funds investing two-thirds of their assets into SME constituted unlawful State aid. Perhaps interestingly, the fact of exempting investment funds from income tax and instead subjecting them to 12.5% substitute tax on operating revenue was not considered an infringement of EU law.[94] Commission thus asserted that the benchmark against which reduced rate should be measured is "the 'normal' substitute tax regime for investment vehicles and not the general corporate income tax to which other legal entities are normally subject"[95].

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[91] Commission, Guidelines on State aid to promote risk finance investments ('Risk capital guidelines') OJ 2014 C19/04 para 37

[92] ibid para 38

[93] Commission, Italian scheme for collective investment, State aid decision OJ 2006 L268/1

[94] Raymond H.C. Luja, 'Investment Funds, Tax Planning and State Aid' European Taxation 2006, 565

[95] Luja (n 94) 567

5.2. Status of an undertaking of investment vehicles

In response to Commission's claims, Italian government argued that investment funds cannot be considered undertakings for the purposes of Community competition rules.[96] This is because they are not themselves engaged in economic activity. Rather, they should be considered intermediaries between the investors and companies receiving financing. Luja points to VAT jurisprudence which contains some valuable contributions regarding situations in which investment funds may be considered to engage in economic activity and thus fall within the scope of State aid rules.[97] In accordance with the *BBL* case[98], the acquisition of a holding in a company is similar to exploiting property with the view of drawing income therefrom. Any return on such investment is "the result of ownership of the property and is not the product of any economic activity."[99] In the same way, purchase and sale of other negotiable securities does not usually amount to exploitation of an asset.[100] As a consequence, these types of transactions are not considered economic activities within the meaning of the Sixth Directive.[101] However, when funds go beyond mere holding of securities i.e. by assembling and managing for remuneration investment portfolios, then such activities calculated at producing income on continuing basis and not just on the sale of assets will be considered economic in nature.[102] Luja observes[103] that activities of investment funds involving the provision of loans may also be considered economic activities as evidenced in the *EDM* case[104]. There, the Court held that receiving interest for loans granted to companies in which the lender holds shareholding cannot be excluded from the scope of VAT. In such scenario "interest does not arise from the simple ownership of the asset, but is the consideration for making capital available for the benefit of a third party"[105]. Despite the above, academics suggest that the Commission considers

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[96] Case T-424/05 *Italy v Commission* ECR [2009] II-00023

[97] Luja (n 94) 565

[98] Case C-8/03 *Banque Bruxelles Lambert SA (BBL) v Belgian State* ECR [2004] I-10157

[99] ibid, para 38

[100] see ibid para 39

[101] Council, Directive 2006/112/EC - the EU's common system of value added tax (VAT) OJ 2006 L 347

[102] *BBL* (n 98) paras 41-43

[103] Luja (n 94) 566

[104] Case C-77/01 *Empresa de Desenvolvimento Mineiro SGPS SA (EDM) v Fazenda Pública* ECR [2004] I-4295

[105] ibid para 65

investment funds not to be engaged in economic activities and thus escape State aid rules in the majority of situations.[106]

The question regarding carrying out of economic activity by investment funds was taken up again by CFI in the appeal from the Commission decision. There, the Court held that qualification as an undertaking usually depends on the nature of tasks performed by the fund. Whereas CFI did not deny the Commission the reference to the VAT case law, it did advise against broad interpretation of those judgments. In its analysis, the Court of First Instance submitted that on the facts, proving that funds could be regarded as undertakings appeared questionable and ambiguous.[107] The Court recommended exercising caution and taking into consideration the context in which previous decision had been taken. As noted by commentators, it is perhaps disappointing that the Court did not expand on how the analysis performed by the Commission could be improved.[108]

5.3. Investment funds as State aid recipients

In its judgment, the CFI decided that there is a possibility of finding selectivity even if the measure concerns an entire economic sector.[109] On the facts, the Court concluded that the scheme for vehicles investing in SME could not be regarded as a general measure as it did not apply without discrimination to all undertakings. Rather, it was held to apply selectively within the financial sector to some entities which derived indirect benefits from favourable tax treatment.[110] It is sometimes argued that the the presumption of no aid to investment funds appears to have been reversed. Luja contends noting on the Italian funds case that "[i]f the Commission's considerations are examined in more detail, the general position that the fund itself is not normally a beneficiary appears to have become the exception to the rule, especially with regard to (open-ended) funds that invest money from a large number of investors."[111] In its decision regarding funds operating in Italy[112], European Commission considered that vehicles may obtain indirect economic benefits as "the tax reduction on investments in specialised vehicles prompts investors to buy shares in such vehicles, thereby providing additional liquidity and extra income in terms of entry

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[106] see Luja (n 94) 566

[107] see Case T-445/05 *Associazione italiana del risparmio gestito and Fineco Asset Management v Commission* ECR [2009] II-00289, para 96

[108] see Raymond H.C. Luja, Fiscal Autonomy, Investment Funds and State Aid: A Follow-Up, European Taxation Vol. 49 2009 7

[109] see *Fineco* (n 107) para 155

[110] see ibid para 156

[111] Luja (n 94) 567

[112] Commission, State aid decision (n 93)

and management fees."[113] Furthermore, where a fund takes corporate form, it may be regarded as benefitting individually from State aid. Where vehicles themselves do not have legal personality, undertakings which manage them may nevertheless be considered beneficiaries of tax advantages.[114] There are two levels at which the aid might be present. Firstly, lesser tax burden will benefit target companies as the demand for their shares will grow.[115] Secondly, benefits may accrue to investment vehicles or, if they lack legal personality, fund managers personally as the funds are allowed to charge higher management and entry fees for services they provide.[116] Luja further submits that whenever legal personality is found, the Court will have to determine if the fund engaged in economic activity and can thus be considered an undertaking.[117] Summing up, the Commission contended that "a tax advantage provided to investors investing in specialised investment vehicles favours the vehicles themselves as undertakings when they have corporate form or the undertakings managing such vehicles when they have contractual form."[118]

5.4. Compatibility of maintaining a separate rate of tax for investment funds

One conclusion that could be drawn from the Italian investment funds investigation is that Member States should be allowed to "maintain a 'normal' tax regime for investment vehicles and their investors."[119] Academics point out that introducing specialised regimes for particular types of funds may lead selectivity and consequently to a conflict with State aid rules.[120] It is worth mentioning however that a scheme may at any point be notified by the MS to ensure compatibility with Community legal order. It should be recalled that the State aid prohibition as provided for in the Treaty refers to "favouring certain undertakings". Therefore, if investment funds can be considered a group of undertakings defined with sufficient certainty then the practice of offering a more favourable taxation regime exclusively for a selected class of entities may be problematic from State aid perspective unless a justification by the nature or general scheme of the tax system is put forward.[121] It is unhelpful that in the case at hand, the

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[113] Commission, State aid decision (n 93) para 36

[114] ibid para 37

[115] see Luja (n 108) 6

[116] see *Fineco* (n 107) para 141

[117] see Luja (n 108) 6

[118] Commission, State aid decision (n 93) para 39

[119] Luja (n 94) 567

[120] ibid

[121] See Luja (n 94) 567

Commission did not present any justification for using the rate generally applicable to investment funds as a point of reference. Commentators submit that the "Commission appeared to be willing to exclude a Member State's general fund regime from the State aid prohibition, although this appears to be at odds with the verbatim text of Art. 87(1) of the EC Treaty."[122] In *Fineco*, "CFI carefully avoided the issue of addressing the State aid compatibility of investment fund regimes in general"[123]. Luja concludes that the existence of a specialised regime for investment funds will ordinarily fall within the State aid prohibition as provided for in Article 107(1) TFEU.[124] He further submits that, it is for this reason that the most decisive factor for such vehicles becomes the question of whether or not scope of services they provide can amount to economic activity and thus being classified as undertakings.[125]

In summary, there is a rebuttable presumption that activities performed by investment funds are not economic in nature, and for this reason they fall out of State aid rules which holds relevance for undertakings. However, academic commentators contend that this situation may be reversed if funds take more active managerial role. Furthermore, the finding of aid may be effected both at the level of investment vehicles as well as target enterprises. Another contentious area which should be recognised by Member States aiming at promoting equity investment activities concerns maintaining a separate tax rate for investment funds as it may be held selective.

5.5. Risk capital tax credit for individual investors

Member States may choose to use other tools to compensate for the disadvantageous tax treatment of equity capital and the resulting equity gap which may inhibit growth of small and medium-sized companies. For example, in Sweden it was proposed to allow individual taxpayers the benefit of "a tax credit of 20% of the acquisition cost of shares in [newly formed] unquoted companies resident in an EEA State and with a permanent establishment in Sweden."[126] The maximum amount of credit was set at EUR 10.000 per annum for up to five years. The government viewed that there was no likelihood of conflict with the EU State aid prohibition as the measure did not benefit undertakings or was reserved to shares of domestic entities.[127]

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[122] Luja (n 94) 569

[123] Luja (n 108) 7

[124] ibid

[125] ibid

[126] Cécile Brokelind, 'Risk Capital Incentives, a Risky Business?', European Taxation January 2012 11

[127] see Brokelind (n 126) 12

One equivocal matter is that individual taxpayers are normally not regarded as engaged in economic activity. Consequently, a measure providing tax incentive to such parties should not be considered as falling within the scope of State aid rules. This reasoning, however is not correct. There is an important distinction to be drawn between a direct recipient of aid and a beneficiary who indirectly enjoys favourable tax treatment. The example given in literature is that of tax allowances for private individuals on mortgage interest payments which indirectly benefit construction and banking entities.[128] Academic commentators also point to the fact that the distinction has been recognised by the Court of Justice[129] that held a tax concession in favour of taxpayers who purchased shares in East German SME was affording an advantage to companies established in that region which were regarded as indirect beneficiaries.[130] Similarly, the Court found indirect benefits accruing on the part of undertakings, even though at the first sight the fiscal break was granted to individuals in *France v Commission*.[131]

In such situation, undertakings that constitute the target group of individual investors are benefitting indirectly from the measure as they are likely to see an increase in investment activity and the demand for shares they issue. As it is submitted by commentators, with regard to tax measures, the conditions for the existence of aid will ordinarily be met.[132] In conclusion, the fact of granting a tax advantage to natural or legal persons who themselves are not engaged in economic activities and therefore cannot be regarded as undertakings does not exclude the existence of aid. Rather, the notion of an undertaking should be understood to encompass not only the direct recipients of aid but also its indirect beneficiaries.[133]

5.6. Selectivity criterion in tax credit measures

In the area of direct taxation, measures applying without discrimination to all undertakings are neutral from the State aid perspective. This is because general measures do not satisfy the selectivity condition for the existence of aid. However, pursuing objectives such as promoting research and development or improving access to risk capital by small and medium-sized companies may prove more problematic. By their nature, such schemes will benefit certain actors to a larger extent. Therefore they are regarded as lying

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[128] see ibid 14

[129] see ibid

[130] Case C-156/98 *Germany v Commission* ECR [2000] I-06857

[131] Case C-102/87 *France v Commission* ECR [1988] I-04067

[132] see Brokelind (n 126) 13

[133] see ibid 14

"in the grey zone."[134] In particular, commentators submit that SMEs cannot be regarded as "a general category of taxpayers" therefore measures targeted at such entities only will unlikely be general in nature.[135]

To conclude, it has been demonstrated that by electing the legislation which can be described as aimed at attracting domestic as well as cross-border external equity finance, Member State will come into far less conflicts with the rules on State aid. However, existing case practice shows that such measures may still infringe upon the selectivity criterion or afford beneficial treatment on to parties which not originally foresaw by the lawmakers. The next section contains a presentation of safe harbours for fiscal measures promoting equity investments.

[134] Brokelind (n 126) 14

[135] ibid

6. Safe harbours

6.1. Risk capital investments in small and medium-sized enterprises

It is recognised that raising capital may prove difficult for companies especially at the early stages of their development. Small and medium-sized entities often lack valuable assets which can serve as a collateral for loan from financial institutions. Equally, obtaining information regarding their growth potential may be complicated. One of the factors impacting the availability of finance is information asymmetry. The European Commission considers that proving creditworthiness and soundness of business plans to investors is often problematic because the costs of testing entities' records may be high in proportion to the expected return on the investment.[136] Consequently, investments in small and medium-sized companies may be regarded too risky.

This arguably leads to a market failure as many beneficial business ventures cannot come to fruition. At the European Union level, it has long been recognised that more often than not it is those small players that are responsible for disruptive innovation. Productivity growth is often achieved by more efficient and technologically advanced undertakings at the cost of market incumbents. Stifling such growth by unavailability of finance may thus lead to negative growth externalities.[137] Consequently, while Member States may choose to provide incentives for investments in such enterprises, the response of the European institutions has been to devise rules for ensuring compatibility of such schemes with the EU law, in particular State aid provisions.

Investments in small and medium-sized enterprises is an area where *lex specialis* in the form of Community guidelines ensures compatibility and abet the "equity gap" as identified by the European Commission. Risk Capital Guidelines have over the years been continually revised and updated. Initially enacted in the form of 2001 Communication on the State aid and risk capital[138], they were replaced by the 2006 Community guidelines on state aid to promote risk capital investments in small and medium-sized enterprises[139] and then again by the 2014 Guidelines on State aid to promote risk finance investments.[140] In accordance with the Commission's position well-targeted State aid has been regarded as the tool

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[136] see Risk capital guidelines (n 91) para 3

[137] see ibid para 4

[138] OJ 2001 C 235

[139] OJ 2006 C 194

[140] Commission, Risk capital guidelines (n 91)

of choice in dealing with the market failure and providing impetus for private involvement in investment activities. Such interventions should respect the principle of proportionality, i.e. distort competition to a minimum degree and have an overall positive effect on trade within the EU. It is submitted that the guidelines are "an expression of the balancing test" involving weighing up pros and cons of State intervention and comparing them.[141] They are discussed in more detail below.

6.2. Risk Capital Guidelines and Block Exemption Regulation

When deciding to promote equity finance investments, Member States may choose to either design the measure in such a way that it does not entail State aid in accordance with Article 107(1) TFEU or one that benefits from the block exemption as provided for in the GBER and is therefore exempt from the notification obligation. If these conditions cannot be satisfied, aid measure may be drafted in in conformity with the RCG and then notified as provided for in Article 108(3) TFEU.[142] Furthermore, guidelines apply to risk finance schemes, *ad hoc* measures are thus excluded from their provisions.[143]

According to RCG, incentives have to be deployed through financial intermediaries or alternative trading platforms. The Commission does not consider that limited access to finance exists in relation to large undertakings, consequently the scope of RCG is limited to schemes aimed at small and medium-sized companies.[144] Similarly, guidelines do not apply to listed enterprises, undertakings in financial difficulty, recipients of unlawful aid, companies engaged in export activities.[145] Measures should comply with the market economy investor test which provides that transactions carried out in line with the market conditions are deemed not to give rise to any advantage at the level of the aid recipient.[146] Conditions of the test are normally fulfilled in instances including: effecting the investment pari passu between public and private investors (aid to investors), avoiding excessive remuneration to the financial intermediary or its managers (aid to financial intermediaries), fulfilling certain conditions relating to terms of loan or guarantee investments (aid to the undertakings). Measures that fall outside the scope of market economy investor test may nevertheless be considered

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[141] see Peter Vesterdorf, Mogens Uhd Nielsen, *State Aid Law of the European Union* (1st ed Sweet & Maxwell 2008) 167

[142] see Commission, Risk capital guidelines (n 91) para 15-16

[143] see ibid para 19

[144] see ibid para 21

[145] see ibid paras 22, 26, 27

[146] see ibid para 30

State aid compatible with Article 107(3). This will usually occur in one of the three situations: undertakings failing one of the conditions for the block exemption,[147] measures with different design parameters to those stipulated in the GBER at the same time targeting the same eligible entities[148] and schemes with large budgets.[149]

6.3. Compatibility analysis of risk finance aid

In its assessment of risk finance aid, the Commission performs a balancing test weighing up possible distortions of competition against the positive effects of the measure, i.e. their contribution to a well-defined objective of common interest, e.g. developing innovative products and solutions. Section 3 of the RCG contain the list of factors which are decisive in the Commission assessment of measures' compatibility with State aid provisions. Areas that are scrutinised involve: contribution to the well-defined objective of common interest, the need for State intervention, appropriateness of the aid measure, the incentive effect, proportionality of aid, avoidance of undue negative effects on competition and trade between Member States as well as the transparency of aid. Risk capital guidelines should be viewed as an extension of the Block Exemption Regulation. Its provisions allow for widening the scope of schemes which may be regarded as not infringing the State aid prohibition enshrined in the Treaty. This broadening constitutes a response to the criticism that previous risk capital guidelines were "too restrictive in terms of eligible SME, forms of financing, aid instruments and funding structures."[150] Despite the wider scope, their application is still limited. It is for this reason that Member States should respect the obligation to refer new fiscal measures for the review by the European Commission.

[147] see Commission, Risk capital guidelines (n 91) para 47

[148] see ibid para 48

[149] see ibid para 49

[150] ibid para 12

7. Conclusion and recommendations

This contribution was aimed at undertaking an analysis of the area of tax law relating to the treatment of debt and equity finance and devising recommendations for Member States of the European Union that seek to promote equity participation without the risk of infringing upon Community law provisions relating to State aid.

Following the presentation of the underlying issues pertaining to the choice between debt and equity as well as the notion of State aid as applicable in the field of fiscal measures, an analytical framework which helped classify the existing legislative instruments by reason of types of investment which they supported was adopted by the author.

The examination of numerous legislative tools which have over the years been scrutinised by the Commission and Community courts showed that promoting internal financing is exceptionally likely to be considered as conflicting with the rules on State aid.

After reaching this conclusion, the second category of measures, i.e. that encouraging external financing was then discussed in depth. Here, noticeably fewer contentious areas were pointed to, although it was highlighted that the area of State aid rules bring about consequences which are difficult to foresee at the time of drafting legislation. Bearing this in mind, safe harbours which exist with regard to a small area of support were presented.

Having identified the most notorious areas which cause measures to be classified as State aid, perhaps unsatisfactorily the final recommendation is to submit new fiscal measures for the clearance by the Commission.

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