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Current Notes

Tax and the EU Foreign Subsidies Regulation

It barely caused a stir in the tax world. But it should have done. The European Union's introduction of the Foreign Subsidies Regulation (the Regulation or the FSR),[1] as supplemented by the detailed guidance in the Foreign Subsidies Implementing Regulation (the Implementing Regulation),[2] entangles global tax systems in the philosophy and principles of the common market. That is, of course, not a novel experience for intra-EU tax systems. These have always been subject to the EU's state aid rules, which are designed to prevent distortions of the common market that may arise from state subsidy of undertakings. Until quite recently, the interaction between state aid and tax appeared quite sporadic and mainly theoretical.[3] But in the last decade or so the EU Commission has begun to use the state aid tool as a means to challenge what it has perceived to be unfair and selective tax treatment granted by EU Member States to (typically multinational) undertakings. In the course of doing so, it has argued for the existence of tax-analogous (but EU treaty originated) concepts such as the "EU arms-length principle".[4] This approach has not universally been applauded (either by the Court of Justice of the European Union (CJEU) or by commentators). And there is a legitimate concern that the Commission has recently sought to harmonise Member State tax regimes via the "backdoor".[5]

This is all relevant because the FSR can be viewed as an element of "state aid 2.0" (to use the parlance of the multinational tech groups seemingly being targeted by the Commission)—one that applies globally. In fact, any technical niggles (and there are many) that remain on the application of the existing state aid rules to tax measures, are amplified (and multiplied) by the scope and procedural operation of the FSR.

[1] Regulation 2022/2560 on foreign subsidies distorting the internal market [2022] OJ L330/1.

One of the authors has published a previous article on FSR (Sarah Bond, Rob Jones and Gabrielle Van der Haegen, "Supplementing state aid: the EU Foreign Subsidies Regulation" [2023] *Tax Journal*). This article draws upon that one, with kind permission of LexisNexis. It also draws upon a talk delivered by Jill Gatehouse at an International Fiscal Studies UK Branch meeting in April 2024.

[2] Commission Implementing Regulation 2023/1441 on detailed arrangements for the conduct of proceedings by the Commission pursuant to Regulation 2022/2560 on foreign subsidies distorting the internal market [2023] OJ L177/1.

[3] A *very* high-level summary being that there had been occasional and exceptional Commission Decisions on tax-flavoured state aids pre-2000, followed in the early 2000s by a flurry of Commission Decisions finding state aid in respect of the "coordination centres" special tax regimes introduced in a number of mainland EU Member States (the regimes being designed to lure US multinationals). The EU Commission's Notice on the notion of State aid as referred to in art.107(1) of the Treaty on the Functioning of the European Union [2016] C262/01 s.5.4 is recommended for a short history of the tax state aid cases.

[4] Apparently inherent in the Treaty on the Functioning of the European Union art.107(1).

[5] e.g. to supplement explicitly harmonised tax measures such as ATAD (Directive 2016/1164 laying down rules against tax avoidance practices that directly affect the functioning of the internal market [2016] OJ L193/1) and much bolder (albeit stalled) measures such as the proposal for a common consolidated corporate tax base, which in October 2023 was withdrawn and replaced by the EU's Pillar 2 implementing Directive (Directive 2022/2523 on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the Union [2022] OJ L328/1) and a proposal for a framework governing corporate income taxation in the EU (Proposed Council Directive on Business in Europe: Framework for Income Taxation (BEFIT) of 12 September 2023).

On top of the technical niggles, the dual factors of (i) the hugely expanded scope of relevant tax measures; and (ii) the need to self-assess, mean that the FSR is a significant development in the international tax framework. This note will explain what the FSR is, why and how it matters to tax and why it is worthy of even a tax purist's attention.

What is the FSR?

The FSR is intended to fill a gap perceived by the EU Commission in the regulatory framework that protects the single market from distortive state intervention. There is, of course, the EU state aid tool. This enables the EU Commission to investigate and remediate selective advantages granted by a Member State to undertakings out of state resources, to the extent the advantage could distort competition and affect trade in the EU. The paradigm example of tax state aid is a "sweetheart" tax ruling granted to a single taxpayer on a discretionary (and advantageous) basis.[6] Importantly, state aid only regulates subsidies made by EU Member States. For subsidies provided by states outside the EU, trade subsidies rules (one element of a blanket of EU trade policy tools) are relevant, but these are only relevant in relation to the import into the EU of subsidised goods. There was, until the FSR, no tool by which the EU could directly challenge economic activity within the internal market that was financially subsidised by a non-EU state. The EU Commission has designed the FSR to plug that gap.

The FSR is at heart a tool to give the EU Commission the ability to be informed about, assess and (potentially) sanction foreign subsidies granted outside the EU to undertakings that either enter procurement processes or undertake M&A activity within the EU.[7] We say "to be informed about", because in either scenario, the FSR requires proactive notification (subject to de minimis thresholds) by the relevant undertakings. In this way, the FSR operates very similarly to EU merger control processes. The anodyne title of the Regulation disguises a heavy stick—failure to comply with the FSR can attract a fine of 10% of global turnover (as with EU merger control). And the EU Commission has the power to prevent a transaction from closing pending its FSR investigation and may ultimately block the transaction or allow it conditional upon remedies such as repayment of the subsidy (also as with EU merger control). In the tax world, it is rare to see consequences and penalties on this scale.

In addition to the notified FSR assessment, the EU Commission has ex officio powers to investigate potentially foreign subsidies (as with state aid). It has already flexed those powers. Within weeks of the FSR being in operative effect,[8] EU Commission President Ursula von der Leyen announced an investigation into Chinese subsidy of electric vehicle manufacturers.

Whether notified or investigated, an FSR assessment is concerned with "foreign subsidies" and, in particular, those that are distortive to the internal market. A "foreign subsidy" is present where a third country provides, directly or indirectly, a financial contribution (a "foreign financial contribution" (FFC), which we shall come back to) which confers a benefit on an undertaking

[6] In reality, the EU Commission has found that modern tax measures are rarely so unnuanced as that, with the result that some of its more ambitious recent state aid decisions have successfully been challenged in the CJEU.

[7] The Regulation uses the very European "concentration" to describe mergers, acquisitions and joint venture activity. We use the anglicised term "M&A" to refer to the same topic.

[8] The FSR was enacted in January 2023 and from October 2023, the notification obligation arose in respect of transactions signed after July 2023. At the time of writing, the FSR can be considered fully in force and in operation.

engaging in an economic activity in the EU, and that benefit is limited in law or in fact to one or more undertakings or industries. The test is therefore assumed to be intended to be similar in substance to that of EU state aid (for obvious reasons), although it is somewhat curious that different language has been used. So far as tax goes, it will almost always be clear that the benefit derives from a third country state actor.[9]

However, it is in relation to the notification requirements that the FSR diverges (significantly) from EU state aid rules in respect of its practical implications. As noted above, the FSR is designed to catch foreign "subsidies" (and the "subsidies" assessment is the substantive legal test). But the notification obligation for undertakings arises in respect of FFCs. In practical terms, then, it is the existence of tax measures that amount to FFCs under the definition in the FSR explained below that will drive the application of the FSR (as a regime to be complied with by business). Further, the concept of a FFC is, potentially, very wide indeed, in particular not explicitly requiring any element of selective advantage, as will be discussed below.

The FSR, thankfully, at least includes some thresholds for notification. For M&A transactions, the target[10] entity must be established in the EU and have an aggregate annual turnover in the EU of at least €500 million; and the parties to the transaction (taken together) must have been granted combined aggregate foreign financial contributions of at least €50 million over the previous three years. In public procurement procedures, the estimated contract value must be at least €250 million and the bid must involve combined aggregated foreign financial contributions of at least €4 million per third country over the previous three years. While these thresholds will filter out many smaller enterprises, large corporate groups undertaking cross-border M&A transactions may find these thresholds do not provide much of a filter at all.

Once the overall threshold for notification is met, the Implementing Regulation provides detailed information requirements for notifying FFCs. The requirements differ as between public procurement and M&A-triggered notifications, but in each case the minimum threshold for an FFC to be reportable is €1 million. And in each case, so-called "Article 5" FFCs require separate, more detailed reporting on an individual basis. The "Article 5" FFCs are those which are deemed by the FSR to be "most likely distortive" by virtue of the circumstances in which they are given.

The Article 5 circumstances include restructuring situations, direct support of M&A, state guarantees, subsidising tender pricing and non-OECD export financing. The first two items have obvious links to tax measures. Various tools are deployed by tax authorities to provide support in restructuring situations (loss preservation rules, favourable treatment of debt restructuring etc.). In a similar vein, tools such as participation exemptions, goodwill amortisation and holding company regimes can all (to varying degrees) be viewed as facilitating M&A activity. All of these—quite *ordinary*—examples will likely constitute FFCs and would all potentially be treated as the most serious "Article 5" FFCs, requiring detailed disclosure in the FSR notification.

For FFCs that are not Article 5 FFCs, the notification requires only a calculation of the aggregate FFCs obtained in the previous three years, grouped by country and type, together with

[9] Including, of course, the UK. Having thrown off the shackles of EU state aid, the UK Government introduced its own subsidy control regime (the Subsidy Control Act 2022 with effect in relation to subsidies granted on or after 4 January 2023). The nature of the new regime (the default position being to permit unless prohibited) sits in contrast to the EU state aid approach.

[10] Or merging entity or joint venture partner.

a summary description of their purpose and the granting entity. This summary information is also required only for those countries where the estimated aggregate FFCs in the previous three years is €45 million (for an M&A-triggered notification, and across all parties) or €4 million (for a procurement-triggered notification, for the notifying party or parties).

What is an FFC?

The application of the state aid test to EU tax systems has proved challenging and (on both sides of the table) controversial. The challenge has typically arisen from trying to evaluate a specific tax rule or treatment by reference to the "advantage" and "selectivity" limbs of the state aid test. That is because sophisticated tax systems are evolving and reactive by nature. Resultingly there are aspects that do not internally cohere. The state aid assessment requires identifying comparable taxpayers and identifying whether one is treated better than another. Making that assessment in the context of an imperfect tax system(s) is inherently difficult. The appeals of state aid Commission Decisions that have and are working their way through the CJEU are testament to that.

An FSR notification regime[11] that side-steps that difficulty by not requiring the notifying parties to judge selectivity and advantage, might appear attractive. In a sense it is. But what tax measures are properly treated as FFCs is arguably no easier to pin down.

Article 3 of the FSR defines "foreign financial contribution". A FFC (we are told by Article 3(2)):

> "shall include, inter alia:[12]
> (a) the transfer of funds or liabilities, such as capital injections, grants, loans, loan guarantees, fiscal incentives, the setting off of operating losses, compensation for financial burdens imposed by public authorities, debt forgiveness, debt to equity swaps or rescheduling;
> (b) the foregoing of revenue that is otherwise due, such as tax exemptions or the granting of special or exclusive rights without adequate remuneration; or
> (c) the provision of goods or services or the purchase of goods or services."

Limb (b) explicitly refers to "tax exemptions". Limb (a) includes transfers of funds and fiscal incentives. Putting those together, a tax rule will be a FFC if it involves a transfer of funds, a fiscal incentive, a tax exemption, or another type of tax measure that constitutes a foregoing of revenue. Further, the definition in Article 3 does not include any requirement that a benefit or advantage is conferred on the taxpayer. Nor does it require that the measure only impacts an individual or select group of taxpayers. On the basis of Article 3, it appears that any tax rule excluding income from the tax base (directly, or by way of relief) is in scope and reportable.

The Implementing Regulation provides some relief from the requirement to notify tax measures. The items on the list quoted below do not need to be included in the information provided in a notification, unless they are Article 5 "most likely distortive" FFCs. However, these "exempt"

[11] Which as noted above is engaged by FFCs, not foreign "subsidies" (the latter being approximate to the state aid legal test).
[12] Meaning, the following list is not exhaustive.

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FFCs still count towards the FFC aggregation calculation for the purposes of determining whether a notification is required in the first place. The relevant list includes quite disparate tax measures:

> "Deferrals of payment of taxes or of social security contributions, tax amnesties and tax holidays as well as normal depreciation and loss-carry forward rules that are of general application. If these measures are limited, for example, to certain sectors, regions or (types of) undertakings, they have to be included.
>
> Application of tax reliefs for avoidance of double taxation in line with the provisions of bilateral or multilateral agreements for avoidance of double taxation, as well as unilateral tax reliefs for avoidance of double taxation applied under national tax legislation to the extent they follow the same logic and conditions as the provisions of bilateral or multilateral agreements."

While this list may appear helpful, it invites a conceptual concern. Why have these items (and only these) been chosen to constitute the safe(ish) harbour? Is not a tax holiday or amnesty exactly the type of foregoing of revenue measure that the FSR is or should be targeting?

That aside, this exempt (from normal notification) FFC list highlights two significant issues. First, the actual descriptors are not detailed: what (for example) is "normal" depreciation or "normal" carry-forward losses rules? Is depreciation "normal" only if in line with accounting depreciation, or is "normal" to be tested by reference to the tax system of the relevant jurisdiction (in which case full expensing might be "normal")? Is the ability to carry forward losses following a change in control "normal"? Is it "normal" if carried forward losses are capable of use without limitation? The more significant issue, though, is that by inference all these items (including treaty-based double taxation relief) are as a basic matter, FFCs.[13] That is alarming, because if basic (and near-universal) rules are (without more) FFCs, it becomes very difficult indeed to identify tax rules that are not FFCs.

This is the root of the problem for those trying to apply the FSR to tax rules. The consequence of adopting the position implied in the Regulation and Implementing Regulation is that it is very difficult to identify tax treatments that are not FFCs—perhaps *only* tax measures that provide for taxable income following accounting income and allowable deductions following accounting expense are certain to be exempt (unless one of the specified items)? Some of the Commission's language here is reminiscent of its approach in the state aid sphere, where words like "normal" and "ordinary" are often used by it in the setting of the reference system against which the alleged measure is tested. This raises the obvious question "what is normal?", and it is fair to say that, in the state aid context, the Commission's answer has often left commentators scratching their heads.[14]

A related technical point arises from the temporal parameters used to aggregate FFCs (i.e. those provided over a three year period): when should a tax measure be treated as granted by a state?[15] The Commission has provided a public statement: "in the case of foreign financial

[13] If they were not, the exemptions list would be otiose.

[14] With some justification, as a number of these cases have successfully been challenged at the CJEU wholly or in part because the CJEU has disagreed with the Commission's perspective on "normal".

[15] The state aid regime does not face an equivalent issue, but as there is a 10 year lookback for the purposes of the state aid recovery mechanism, similar points arise in determining when a tax state aid is said to be given.

contributions in the form of tax reductions, the relevant moment in time would in principle be the date when the final tax liability is determined, so that the beneficiary is entitled to pay a lower amount of tax than what would otherwise be due."[16] Unfortunately this introduces more uncertainty, as "final tax liability" could mean (as it does in other contexts) once all appeal rights have been exhausted. But we understand that the Commission would generally view it as the point in time at which a return is filed and corresponding tax is paid (or refunded, if appropriate), which strikes us as the most sensible (and practically workable) approach.

It should be noted that the FSR and supporting materials make clear that all tax and tax rules are potentially in scope. The EU Commission has published materials alongside the Implementing Regulation including a "Q&A" note[17] which notes that "Exemptions granted by third countries from ordinary tax regimes (e.g. profit-based taxes, property taxes, stamp duties etc.) constitute 'foreign financial contributions'", emphasising that taxes other than profit-based ones are intended to be in scope.

Many had hoped that the Commission would clarify that a tax-derived FFC would not be notifiable if it were of general application. Unfortunately, the EU Commission has confirmed, both in Answer 26 of the Q&A, and in its recent brief on the first six months of FSR notifications,[18] that tax measures of general application are to be reported unless they fall within the explicit exemptions discussed above—and that those exemptions are exhaustive. We understand that, informally, Commission officials have expressed the view that fewer tax measures had been reported within notifications than they might have expected (presumably as notifying taxpayers had proceeded on the basis of a narrower reading of FSR). Given that the wording of the Regulation (and Implementing Regulation) provides for a very widely-cast net of tax rules, and given that this reading has been confirmed by the EU Commission, it feels very difficult to support a narrower or a benefit-filtered approach to applying the FSR.

Seemingly, the position is that any (corporation) tax rule in any non-EU country which operates otherwise than to tax in-year the difference between accounting income and expense, will require at least consideration of whether that amounts to an FFC. As a consequence, any multinational group[19] buying a business in the EU (or tendering within the EU) will be required to undertake a thorough analysis of their (and other parties') tax position in each non-EU state and identify, aggregate and (potentially) report many of the tax rules relevant to them in that jurisdiction. Of course, the EU Commission can be expected to ask further questions in respect of specific disclosures. This must all take place before (for example) an M&A transaction may close. This is why the FSR matters to the tax community.

Even beyond the question of "what is a tax FFC", the practical exercise of complying with the notification requirements of the FSR can raise difficult legal questions, such as the timing of different types of tax contributions and the qualitative link between a tax rule and its impact on taxpayer behaviour (for the purposes of Article 5). However, the fundamental question remains the extent to which the body of tax (and non-tax) state aid law can and should apply to the FSR.

[16] EU Commission, *FSR Questions and Answers*, *https://competition-policy.ec.europa.eu/foreign-subsidies-regulation/questions-and-answers_en* [Accessed 13 May 2024].
[17] EU Commission, *FSR Questions and Answers*.
[18] EU Commission, *Competition FSR Brief* (1 February 2024).
[19] That is not so fortunate as to fall below the de minimis.

On the relevance of state aid, the link to the “foreign subsidy” test is obvious. The more interesting question, perhaps, is whether the CJEU-refined state aid test may (or should) also influence (directly or indirectly) how the “foreign financial contribution” concept evolves over time, given that even absent an explicit benefit or advantage requirement, the FSR does require some benchmark against which to test a possible FFC. We may find that absent a more suitable guide, the CJEU turns to the (state aid) reference system jurisprudence in order to make sense of the “ordinary” regime, in determining whether a tax rule or “exemption” is an FFC. It might be hoped that the influence of that line of CJEU guidance may sensibly temper a concept that currently seems to cast a net so wide it hits land.

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