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Supplementing state aid: tax and the EU Foreign Subsidies Regulation

The EU Foreign Subsidies Regulation imposes a mandatory notification obligation for proposed M&A and joint venture transactions involving EU entities if certain thresholds are met, to enable the European Commission to investigate whether any "foreign subsidy" has been granted. Groups will need to consider whether "financial contributions" have been provided by non-EU states to ascertain whether a notification is required and the information that must be disclosed. Little guidance is given on what that means in the tax context, but the concept is likely to capture a wide range of situations where reduced rates are applied or tax relief is given.

The European Commission's powers under the EU state aid regime have been actively deployed in the tax sphere in the last decade to challenge measures perceived to amount to distortive aid. That is, circumstances in which there is (i) a beneficiary undertaking, which is (ii) granted an advantage, (iii) in a selective way, (iv) provided out of state resources that (v) distorts or may distort competition and affect trade within Member States.

But those powers are constrained by the requirement that the aid be provided by an EU Member State. Enter stage left the EU Regulation on foreign subsidies distorting the internal market (or the EU Foreign Subsidies Regulation (***FSR***)). The FSR, supported by an Implementing Regulation, in effect extends the Commission's powers so that it can investigate subsidies granted by non-EU states to undertakings operating in the EU, with a view to levelling the playing field.

The regime in outline

The FSR gives the Commission three tools to investigate foreign subsidies:

1. a mandatory notification system for certain "concentrations", to facilitate investigation;
2. a mandatory notification system for certain public procurement contracts (ditto); and
3. a "catch-all" general *ex officio* power to investigate foreign subsidies on its own initiative.

It's the first of these that is likely to have the most impact and is the focus of the remainder of this article. That is because it means that, in the M&A context or where a joint venture (***JV***) is to be created (which is where, in the terminology of the FSR, a "concentration" is deemed to arise), it will be necessary before implementing the transaction to consider if the thresholds are met to trigger the mandatory obligation to notify the Commission.

If notification of a concentration is made, the Commission has an initial 25 working day period in which to undertake a preliminary review. Then, if an in-depth investigation is initiated within that preliminary period, the Commission has a further 90 working days in which to reach a decision in relation to the transaction. A standstill applies during these periods, with significant financial penalties for failure to notify or jumping the gun and implementing the transaction prior to the outcome of the Commission's investigation.

That outcome can take one of three forms:

- in the absence of a finding that an undertaking benefits from a distortive foreign subsidy, a "no objection decision";
- a "decision with commitments" imposed on the relevant economic operator to remedy the distortion (e.g. to repay a foreign subsidy); or
- if no commitments are offered or commitments could not fully and effectively remedy the distortion, a "decision prohibiting the award of the contract".

Notification obligation for "concentrations"

The notification obligation applies from 12 October 2023, to qualifying transactions signed on or after 12 July 2023 that have not already completed. The relevant thresholds for a notification to be required are that:

- the target / one of the merging entities / the JV is established in the EU and has an aggregate turnover in the EU of at least EUR 500m; and
- in the three years prior to the relevant transaction, aggregate "financial contributions" of more than EUR 50m have been granted from third (i.e. non-EU) countries to the purchaser and target / the merging entities / the JV partners and the JV itself.

These are very broadly framed triggers. For large multinationals, the turnover threshold is not terribly high and is therefore unlikely to provide much of a filter. The financial contribution test is accordingly going to be critical for determining whether a notification is required to be made, and if it is (which seems likely, as discussed further below), what information must be included.

There are detailed information requirements for financial contributions equal to or exceeding EUR 1m which may qualify as most likely distortive subsidies (as listed in Article 5(1) FSR). For all other financial contributions (with certain specified exceptions), it is sufficient to complete an overview table (Table 1 of the FSR Implementing Regulation) which requires an estimate of the aggregate financial contributions obtained in the three years prior to the notified transaction by third country and type, with a high-level description of their purpose and the granting entity. This summary information is also only required for those countries where the estimated aggregate amount of all relevant financial contributions in the previous three years is EUR 45m or more.

"Third countries" will, of course, include the UK and there is potentially some interaction here with the UK's post-Brexit subsidy control regime (the equivalent to the EU state aid regime), which was introduced by the Subsidy Control Act 2022 with effect in relation to subsidies granted on or after 4 January 2023. That regime is set up in such a way that subsidies are prima facie lawful so long as they comply with certain principles and enforcement is via the ability for complainants (likely competitors of the recipient) to seek redress through the courts if a subsidy is alleged not to comply with those principles. To facilitate this, public authorities are required to upload details of subsidies granted onto a public transparency register. Since a challenge may only be brought within a short period of time after those details are made publicly available, public authorities have (predictably) been taking a conservative approach to what counts as a subsidy for these purposes – with potential implications for what may be viewed as a financial contribution relevant to the FSR notification thresholds in relation to the UK.

Key concepts

Financial contribution

The "financial contribution" concept effectively acts as a gateway to the foreign subsidies regime, given that it is relevant to whether the notification threshold is met and the contents of the notification. As such, understanding its scope is particularly important for those groups which may need to make a notification – and the FSR casts its net widely.

"Financial contribution" includes:

- any transfers of funds or liabilities (such as debt or equity funding, loans, guarantees, and debt forgiveness);
- foregoing revenue that is otherwise due (such as tax exemptions);
- granting special or exclusive rights without remuneration; and
- providing or purchasing goods or services.

It is important to note that the definition of "financial contribution" does not stipulate that any benefit must be conferred on an EU entity or industry. *Any* transfer of funds, foregoing of revenue etc. can therefore qualify as a financial contribution. This is a key point of distinction from the (narrower) definition of a "foreign subsidy" which does require such a benefit.

As in the case of state aid, fiscal incentives in the form of tax measures are clearly capable of being in scope – that much is explicit in the FSR. However, the key (and difficult) question that is not answered by the FSR will be: when is a tax measure a financial contribution for these purposes? We set out below some suggestions on how to answer that question.

Another relevant point in the tax context is the time at which a financial contribution is considered to be granted, being the moment the beneficiary obtains an entitlement to receive it. In the case of tax measures that qualify as financial contributions, the Commission is expected to consider the relevant moment in time to be the due date for payment of the (reduced) tax liability.

Foreign subsidy

The question of whether there is a foreign subsidy is one that falls to be considered by the Commission once a notification has been made.

A "**foreign subsidy**" is deemed to exist where:

- a third country provides, directly or indirectly, a financial contribution (a "foreign financial contribution"),
- which confers a benefit on an undertaking 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.

This requires some unpacking.

First, it is clear from the FSR that "a third country" includes any non-EU public authorities or state-owned entities and therefore, in the tax context, clearly encompasses tax authorities. It is less clear what "indirect" provision of a financial contribution means, although one might infer that it is targeting financial contributions provided by a private entity on the instructions of a public entity.

Secondly, a "benefit" is treated as arising if it could not (either as a matter of law or fact) have been obtained under normal market conditions, taking into account comparative benchmarking data, such as financing rates available in the market, examples of comparable tax treatment (which in state aid terms is called "selectivity") or (in relation to goods and services) transfer pricing studies. Further, it must relate to the recipient's economic (as distinct from non-economic) activities.

Most likely distortive

As noted above, the information that must be provided in a notification differs as between those foreign financial contributions that are within the "most likely distortive" categories listed in Article 5(1) of the FSR (i.e. the categories of foreign subsidies which are most likely to distort the internal market) and those that are not.

The Article 5(1) categories into which tax measures are most likely to fall are:

a) directly facilitating a merger or acquisition; and

b) providing support in a restructuring or insolvency context.

The first category may catch tax financial contributions that are generally relevant in the M&A/JV transactions context, such as investment vehicle regimes, goodwill amortisation reliefs, participation exemptions and special reliefs for holding companies. By contrast, the second category will likely catch tax financial contributions that apply only in restructuring or insolvency circumstances (perhaps in the form of more generous reliefs, tax exemptions for releases of debts, or the disapplication of ordinary change in control rules).

Tax aspects

As noted, the FSR regime can be viewed as an ex-EU equivalent to the intra-EU state aid regime. But there are (at least) two fundamental differences which are relevant to how it may apply in relation to tax.

The first is that state aid decisions in the tax sphere have tended to be the product of *ex officio* investigations by the Commission. That is particularly true of more recent tax state aid cases, in which (some commentators might say) the Commission has taken an expansive approach in characterising tax rules as state aid. While the Commission has a similar *ex officio* power in the FSR context, the FSR notification requirement means that undertakings will effectively have to self-assess whether any tax rules that apply to them in any non-EU jurisdiction fall within the Commission's understanding of the relevant test.

That leads to the second fundamental difference between the FSR and state aid. As one would expect, there are significant similarities between the state aid test and the "foreign subsidy" concept. The former requires both an advantage and selectivity (with regard to comparable undertakings) and these two limbs of the test tend to be the focus of most tax state aid disputes (given that the 'state resources' limb will probably always be met and the 'distortive effect' limb is usually taken as read, at least by the Commission). As discussed above the foreign subsidy concept similarly requires both a 'benefit' and that the benefit is limited to certain undertakings. Unsurprisingly, therefore, the Commission has said that it will draw on principles from the fiscal state aid arena to determine when a tax treatment might amount to a "foreign subsidy". This makes sense, given the wider purpose of the FSR: it should not characterise as a foreign subsidy something that would not fall foul of the state aid rules if it was done by an EU member state and, conversely, a tax treatment that might constitute state aid in an EU context should also be within scope of the FSR. However, because the FSR notification requirement tees off the much wider concept of "financial contribution", groups are having (effectively) to self-assess the application of the FSR by reference to a different and much broader concept than the one by reference to which the regime actually applies.

There is limited guidance (either in the legislation or other Commission material) on how to apply the "foreign financial contribution" concept to tax measures. As noted above, the FSR specifically references "tax exemptions" as an example of the state foregoing revenue (thereby giving a "financial contribution") and the Commission's Questions and Answers on the FSR elaborate on this slightly, stating that exemptions granted by third countries from ordinary tax regimes constitute "foreign financial contributions". That would seem to suggest that, although not specifically required by the definition, a tax-flavoured financial contribution necessarily confers some benefit or favourable treatment on those that are "exempt" compared to those that are not.

Given that tax regimes do not typically involve easily identifiable transfers of funds from state to undertaking, the question of what constitutes a tax financial contribution in the many situations that could not straightforwardly be viewed as a "tax exemption" remains largely unanswered by the legislation. Even if 'benefit' or 'advantage' cannot be used to identify a financial contribution, there has to be some yardstick or comparator

to make sense of "financial contribution" as it applies to tax rules.

The FSR Implementing Regulation contains some interesting further clues. It specifies certain types of tax measures that are exempt from being notified as foreign financial contributions, unless they have been given in a "most likely distortive" context (in which case a detailed notification is required).

The exempt categories of tax measures are:

- deferrals of payment of taxes, tax amnesties and tax holidays as well as normal depreciation and loss-carry forward rules that are of general application (although if these are limited to certain sectors, regions or types of undertakings, the exemption does not apply); and
- 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.

Given the implication that these tax measures are as a basic matter financial contributions (otherwise there would be no need to exempt them), tax practitioners may find the logic behind this list hard to follow. Certain items seem squarely to fit within the box of potential foreign subsidy that the Commission *would* want to know about. However, the inclusion of tax amnesties and tax holidays raises further questions, given that they are rarely generally available and any measures that are limited in application are likely to fall outside the exemption in any case. Other items, such as accounts-based depreciation would not logically seem capable of being a "financial contribution" any more than a deduction for trading expenses is. But given the dearth of other guidance, the exemptions must influence how the FSR is intended to be read.

Pending any further (or more detailed) guidance from the Commission, a reasonable starting position for identifying "financial contributions" might be to pause over any situation where an item of income or gain is not subject to full taxation at the ordinary rate, or where tax relief is given on a more generous basis than just by reference to accounting expense. That is clearly a discouragingly low threshold for assessing tax measures as "financial contributions" and it is to be hoped that in time the Commission sees fit to either to raise it, or to make it more targeted. The application of the state aid test to tax measures is already the subject of significant and ongoing controversy and dispute; and it seems likely that the application of the FSR to tax measures will be just as challenging.

Practical implications for transactions

What does all this mean for groups currently contemplating "concentration" transactions involving entities operating in the EU? Certainly they would well be advised to give thought now to the types of funding, fiscal incentives and tax measures that have been received from third countries in the last three years, as it is quite likely that a notification will be required. The time taken for due diligence and analysis as well as preparing any FSR notifications will need to be factored into deal timetables.

A particular issue here is the extensive information that notifying parties are required to provide in relation to most likely distortive financial contributions, which includes (for example) an explanation of whether a benefit is conferred, whether that benefit is limited to specific entities or industries and supporting documentation.

Notifying parties also have the opportunity to list and substantiate any possible positive effects of the subsidies on the relevant economic activity (particularly having regard to the EU market), which might potentially outweigh any benefits conferred. Again, this will require considered input. A working knowledge of EU strategy / policy might conceivably hold a notifying party in good stead here, although there is currently no guidance on how such a balance should be struck in practice.

There are potentially some tools available for notifying parties to reduce the volume of information that needs to be given as follows:

- notifying parties are encouraged to approach the Commission for a pre-notification discussion, by reference to a draft notification. While this is voluntary, engaging early with the Commission seems likely to be valuable, particularly where there is uncertainty as to whether a measure constitutes a "financial contribution" that should be included in the notification or whether a financial contribution falls into one of the most likely distortive categories. This may be especially useful in the tax context where the financial contribution concept appears to be so broad in scope; and
- notifying parties may also request waivers from the requirement to provide certain information on the basis that it is not reasonably available or not necessary for examination of the case, although it will be for the Commission to determine whether adequate reasons are given for those waivers to be granted.

Overall, however, the mandatory notification obligation seems likely to impose a significant, onerous and unavoidable compliance burden on groups engaging in M&A activity involving an EU operator.

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