



Accounting for Income Taxes Considerations for Potential State Aid Investigations

Recent state aid investigations of tax rulings issued by European Union (“EU”) member states have created uncertainty for practitioners and tax executives in evaluating tax positions—some of which have been in place for many years. This article provides an overview of EU state aid rules (the “EU State Aid rules”), reviews the investigative and appeals process, and discusses financial accounting considerations for the changing landscape for state aid inquiries into income tax rulings.

Overview

By initiating formal investigations into tax rulings granted to several high profile multinationals over a year or so ago, the European Commission (the “Commission”) has added another layer of uncertainty over whether seemingly compliant tax planning will survive challenge, or result in substantial exposure to repayment of tax benefits realized over the preceding ten years.¹ These state aid investigations into certain tax structures of high profile multinationals with legal entities in Ireland, Luxembourg, and the Netherlands, as well as a package of tax transparency measures the Commission has announced on March 18, 2015,² have practitioners and tax executives alike considering whether tax planning implemented over the past decade may end up tainted—either directly or by analogy to final findings by the Commission. In addition, the

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¹ The descriptive and summary statements in this article are not intended to be a substitute for an entity’s legal analysis of the Commission’s process, for the potential requirements of the EU State Aid rules or any other potential or applicable requirements of the accounting literature or Securities and Exchange Commission (“SEC”) regulations. Companies applying U.S. generally accepted accounting principles (GAAP) or filing with the SEC should apply the texts of the relevant laws, regulations, and accounting requirements, consider their particular circumstances, and consult their accounting and legal advisors.

² European Commission – Press Release: Combatting corporate tax avoidance: Commission presents Tax Transparency Package, Brussels, 18 March 2015

Commission has indicated an intention to widen its inquiry to all other advanced tax rulings issued by EU member governments since 2010, potentially leading to additional investigations that may impact a wider population of multinationals.

Although the Commission first issued guidelines on the application of the EU State Aid rules to direct corporate taxation measures in 1998, the current investigations signal an important expansion of the application of these rules to rulings granted by member states to specific taxpayers. As a result, practitioners and tax executives are anxiously anticipating the publication of final decisions of the Commission that may come before the end of the third quarter with respect to two of the named taxpayers.

Though many are generally aware of the current investigations, there may be a number of unanswered questions on how the process works, what avenues of appeal exist, and the related financial accounting implications for potential exposures that may arise either directly or indirectly from the outcome of these investigations. The purpose of this article is to provide an overview of EU State Aid rules, the investigative and appeals process, and considerations when applying ASC 740, *Income Taxes*, to uncertainties related to the current state aid investigations.

What Are the European Union State Aid Rules?³

The EU State Aid rules are part of EU competition rules.⁴ The Commission, as the guardian of the EU Treaty, is responsible for enforcing the EU State Aid rules and monitoring compliance of the EU member states with the rules. A state measure is considered to be incompatible

³ The basic EU State Aid rules are set out in Articles 107-109 of the Treaty for the Functioning of the European Union (TFEU) [see <http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:12008E107>]. In addition there is a significant body of procedural rules (EU Council and Commission Regulations) and a significant amount of "soft law" (Guidelines, Notices, Communications, etc.) the Commission has published consolidating and codifying the case law of the EU Courts and its own decisional practices..

⁴ Thus, the state aid regime is inapplicable to tax rulings granted by jurisdictions that are not members of the EU, for example, by Switzerland. There is a free trade agreement with Switzerland which contains some provisions with language similar to the state aid provisions contained in the EU Treaty.

with the EU State Aid rules when the following four conditions are present⁵:

- The measure confers an economic advantage to the company or group of companies to which it is directed;
- The measure is imputable to the state (i.e. enacted by the state itself or an agency) and financed through state (public) resources;
- The advantage is selective, that is, only available to that specific company or group of companies to which it is directed; and
- The measure distorts or threatens to distort competition and has a negative effect on trade between EU member states.

Under the EU State Aid rules, member states need, if in doubt on the compatibility of their proposed measure with the EU State aid rules, to notify and obtain the Commission's approval before implementing any aid measure. If the aid is implemented without the notification or before the state obtains the Commission's approval, the Commission may open an investigation, as was the case in 2014 when the Commission opened its inquiries into the rulings in Ireland, Luxembourg, and the Netherlands.

Tax rulings can amount to incompatible state aid under the EU State Aid rules, if they grant a *selective* advantage to a company. The main question is whether a particular tax ruling confers a *selective* advantage to a company in so far as it results in a lowering of its tax liability in the member state. If the existence of a *selective* advantage can be shown, the presence of the other conditions for a finding of state aid may be relatively straightforward. However, whether a measure provides a "selective advantage" to a company, is assessed by the Commission on a case by case basis and that assessment is subject to the judicial review of the EU Courts and can take some time to conclude. This adds an element of uncertainty when taxpayers attempt to assess an exposure to loss of tax benefits as a result of a potential state aid challenge.

⁵ [Basic rule 107\(1\) TFEU \(ex-Article 87 TEC\)](#)

How the State Aid Investigation Process Works⁶

Provisional Findings

After the initial investigation with the member state concerned, the Commission will need to decide whether the tax ruling raises doubts as to its compatibility with the EU State aid rules. The Commission will issue a letter with its preliminary view (a "Provisional Finding") as to whether a tax ruling constitutes state aid to the member state concerned. The letter takes the form of a preliminary decision and it is published in the Official Journal of the EU (the "OJEU") and the web-site of the Commission. The member state, the beneficiary/taxpayer and the competitors of the beneficiary/taxpayer will then have a 30-day window of opportunity from the publication of the letter in the OJEU to submit comments and provide other information before the Commission draws its final conclusions.

Commission's Final Decision

If the Commission concludes that the measure under investigation provided state aid that is not compatible with the internal market, it will issue an adverse decision (a "Final Decision").⁷ In that scenario, absent a successful appeal to the General Court of the EU, the pertinent member state will be directed to recover the aid granted over the last 10 years,⁸ including the interest from the time the aid was at the disposal of the beneficiary until the date of its recovery. The Commission will normally calculate the amount of the aid to be recovered; however, in certain complex cases it may ask (by giving directions) the national tax authority (the "NTA") of the member state to determine the relevant amount of aid. Moreover, the Commission can force the member state to sue the taxpayer through the member state's national courts if payment is not voluntarily made.

⁶ European Commission, *Vademecum, Community Law on State Aid* (30 September 2008) available at

http://ec.europa.eu/competition/state_aid/studies_reports/studies_reports.cfm

⁷ Conversely, if the Commission concludes that the aid provided is compatible with the internal market, then it will issue a favorable decision which (with or without conditions on the member state and/or the beneficiary) would also be "Final Decision."

⁸ It is important to note that the 10 years limitation period begins when the Commission sends its first letter to the member state concerning its request for information about the member state's tax rulings. This occurred in June and July of 2013, and additional information was requested naming specific taxpayers a year later, in June of 2014.

EU Appeals Process

Following an adverse decision, generally, the taxpayer's recourse is an appeal to the EU General Court. The member state can also launch its separate application or intervene in favor of the beneficiary/taxpayer in its appeal. The decision of the EU General Court can be appealed, generally limited to points of law, to the Court of Justice of the EU by either party. The Court of Justice may give the final judgment in the case or refer the case back to the General Court, which is generally bound by the decision given by the Court of Justice. During the time of the appeals process, the effects of the Commission's final decision are generally not suspended. However, a taxpayer can generally request a national court to authorize a delay of the recovery of the state aid pending the EU Courts' decision. If the taxpayer pays in advance but is ultimately successful in court, any payments made are remitted back to the taxpayer (potentially with interest, depending on the member state's tax regime).

Fines for Recalcitrant Member States

If a member state refuses to enforce the Commission's order to recover the full amount of unlawful state aid from the beneficiary/taxpayer, then the Commission (or another member state) can ultimately go to the Court of Justice, which can impose a daily penalty on the recalcitrant member state. Among the ways the fine might be collected from a recalcitrant member state is through adjustment of any EU subsidies to that member state.

Key Observation

It may be noteworthy to point out that the first four investigations into individual tax rulings were opened last year, and, despite an expectation of a ruling in the second quarter of this year, the Commission recently announced a delay in its decision pending further information from the countries involved. Given the appeals rights outlined above, and other due process mechanisms available to taxpayers and member states in dealing with potential assessments made or to be made by tax authorities in the relevant jurisdictions, it may be some time before the picture comes into better focus concerning recapture of tax benefits associated with rulings previously provided by member states.

Accounting for Income Taxes Considerations

Although this is an unfamiliar and evolving tax area for many, to the extent that the original benefit was presented as a reduction of income taxes subject to ASC 740, the existing principles of accounting for uncertainty in income taxes will likewise apply to these tax uncertainties.

Review of Basic Principles

In accounting for uncertainty in income taxes under the basic framework of ASC 740:

- The financial statement effects of tax positions are recognized if they are more likely than not, based on the technical merits (including widely understood administrative practices), to be sustained in a dispute if the taxpayer takes the dispute to the court of last resort.
- It is presumed that the tax position will be examined by the relevant taxing authority with full knowledge of all relevant tax information.
- A tax position that meets the more likely than not recognition threshold will be measured as the largest amount of tax benefit that is greater than 50 percent likely of being realized upon settlement with a taxing authority that has full knowledge of all relevant information.
- Subsequent changes in judgment that lead to changes in recognition, derecognition, and measurement should result from the evaluation of new information.
- The difference between a tax position taken or expected to be taken in a tax return and the benefit recognized and measured under the above guidance results in the establishment of a liability or other adjustment referred to as an “unrecognized tax benefit.”
- All information that is available at the balance sheet date is considered in the recognition and measurement analyses.
- There are disclosure requirements for unrecognized tax benefits, including when it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date.

Considerations for State Aid Rulings

At the time favorable rulings were issued by member states, some companies may have determined that their tax positions that were the subject of the ruling were so “highly certain” due to the agreement of the member state taxing authority that the positions were fully recognized. As noted, tax measures in general can be a focus of EU State Aid probes. However, individual company tax rulings were not a focus until the middle of 2013 when the Commission initiated its request for information about a member state’s tax rulings—first in a general sense, and then with respect to specific taxpayers. Thus, until recently, tax rulings issued to taxpayers by member states weren’t generally investigated by the Commission under the EU State Aid rules. And, until recently, many assumed that only a few rulings out of the thousands issued would be investigated under the EU State Aid rules. On this point it is worth noting that in June 2015, the Commission requested tax rulings information from another 15 EU Member States. That suggests that there could be a second wave of investigations once the Commission has evaluated this additional information.

The threshold question of considering when to reevaluate the need for an unrecognized tax benefit is when new information has emerged that may impact recognition and measurement—even if such new information may not necessarily lead to a different conclusion.

Therefore, practitioners and tax executives who are evaluating a company’s specific facts may consider whether Provisional Findings by the Commission represents new information relevant to a particular tax position. This assessment will be dependent on each company’s specific facts and circumstances.

Provisional Findings issued by the Commission thus far have asserted certain facts and circumstances which, if validated, may result in a Final Decision of unlawful and incompatible state aid.

For a company that may have rulings from the same member state on similar transactions, consideration should be given to whether the unfavorable factors alleged in the Provisional Findings are new information with respect to that company’s tax positions (e.g., perhaps because those factors are present in that company’s ruling or because they are clearly not present). If there is a reevaluation due to new information, that information

may or may not impact the recognition or measurement of the tax position.

We understand that some of the negative factors about the original tax rulings provided to the taxpayers outlined in the Provisional Findings issued to date that may influence a judgment whether and to what extent a taxpayer should recognize the benefit of a state aid related tax position are:

- There was not sufficient evidence or information submitted with the ruling to form a basis for the ruling,
- The ruling was issued so quickly that there couldn't have been sufficient time for a proper review of all pertinent facts,
- The ruling was based on a negotiation with the tax authority instead of the application of transfer pricing principles,
- An economic analysis in the ruling didn't comply with Organisation for Economic Co-operation and Development ("OECD") standards, or
- A preferred transfer pricing method of the OECD was available but another, albeit acceptable, method was used (this factor being more controversial).

The existence of one or more of these factors in a taxpayer's specific ruling may be an indication of an exposure to an eventual finding of state aid, and thus impact the judgment of the amount of benefit to recognize and measure for the tax position.

Final Decisions by the Commission would appear to be similar to final findings of a taxing authority at the end of a tax examination. It is likely that such an adverse Final Decision with the corresponding order to the member state to recover the incompatible state aid would lead to additional considerations in the reevaluation of recognition or measurement, as taxpayers can then enter the process and file appeals; potential settlement negotiations⁹ also could come into play and affect measurement.

⁹ There is no formal settlement process with the Commission. However, we understand that there are informal settlements taking place with the Commission during a lengthy EU Courts appeals process.

For other taxpayers who may have rulings on similar transactions from the same member state, these more definitive decisions should be considered and compared to the facts and circumstances of their rulings in any reevaluation. If any settlement negotiations are known publically, these may also affect the measurement of other taxpayers with rulings from the same member state on similar transactions.

Judgments by EU courts would appear to be similar to judgments of national courts in terms of new information that would affect the assessment of recognition and measurement. Like all such judicial decisions, they would normally carry more weight than the Commission's Final Decision in any reevaluation analysis—with the judgment of the Court of Justice of the EU correspondingly carrying more weight than the judgment of the General Court.

Financial Statement Disclosure

Companies should consider whether the "reasonably possible" standard has been met in terms of disclosing unrecognized tax benefits that may significantly increase or decrease within 12 months of the reporting date as findings of the Commission and courts move along the spectrum summarized above.

U.S.-parented companies that have been named in state aid investigations have generally disclosed that the matter is being investigated by the Commission and that there is risk that the Commission may find that the company should repay the illegal state aid.

In Conclusion

Recent state aid investigations by the Commission and the prospect of further inquiries to remaining EU member states are yet another matter creating uncertainty for practitioners and tax executives in evaluating tax positions—some of which have been in place for many years. As with the OECD's Base Erosion and Profit Shifting initiative, these individuals need to remain cognizant of new developments and new information with respect to the EU State Aid investigations that should be taken into account for judgments concerning tax uncertainties under ASC 740. Without the certainty of prior precedents found with many other tax positions, or limitations in the knowledge of differences between a company's specific fact pattern and those of others that may be relevant

to an evaluation of exposure, a specific facts and circumstances analysis will be especially important for state aid tax uncertainties.

Because of due process, it may take an extended period of time before there is ultimate clarity over whether and in what amount, if any, an obligation exists to repay tax benefits that are under investigation by the Commission. Nevertheless, practitioners and tax executives alike should review the rulings received by their clients and their companies from EU member states to consider how they compare against the negative factors identified in the Provisional Findings, assess whether they have robust documentation of their judgment around the amount of tax benefit to recognize and measure, and put a process in place to monitor developments in ongoing state aid investigations.



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