

Edited by Otto Marres and Dennis Weber

Tax Treatment of Interest for Corporations

IBFD

Tax Treatment of Interest for Corporations

Why this book?

The tax treatment of interest for corporations continues to engage both tax academics and tax practitioners. In *Tax Treatment of Interest for Corporations* various aspects of this matter (interest deduction limitations, discriminatory treatment of equity versus debt, preferential tax regimes on group interest income and withholding tax on interest) are dealt with from different perspectives, including economics, tax policy, comparative law, and EU and international law.

Prominent practitioners and academics give their views on the tax treatment of interest.

Subjects discussed are:

- The debt/equity distinction in corporate taxation from a legal and economic perspective
- CBIT (comprehensive business income tax) versus ACE (allowance for corporate equity)
- The concept of interest in tax treaties
- The notional interest deduction (Belgium)
- Thin capitalization in Brazil
- Earnings stripping (Germany)
- Interest deduction in Denmark
- Withholding tax on interest within the EU: gross or net?
- Thin cap rules from an EU perspective
- EU State aid and the EU Code of Conduct combating harmful tax competition
- ACTL conference report on tax treatment of interest for corporations

Tax Treatment of Interest for Corporations is a unique combination of academic and practical discussions of economic and policy issues, domestic legislation, EU law and tax treaty law.

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**Corporate Tax Treatment of Interest:
EU State aid and the EU Code of Conduct
Combating Harmful Tax Competition**

Vinod Kalloe*

**11.1. EU harmful tax competition and the corporate tax
treatment of interest**

11.1.1. EU Code of Conduct for business taxation

In the mid-nineties of the previous century most Member States felt the need for coordinated action at the European level to reduce and avoid tax distortions in the EU internal market. Following a Commission-initiated discussion in the Taxation Policy Group, the Member States started discussions in the Council to tackle harmful tax competition in the European Union.¹ These distortions were identified as excessive losses of tax revenue in the field of business taxation, the taxation of savings income and the existence of withholding taxes on cross-border interest and royalty payments between companies. Since unanimity on any one of the given subjects separately would be almost impossible to achieve, the European Commission suggested forming a “tax package” for the three subjects where for all Member States there would be sticks and carrots to accept. These negotiations led to the ground-breaking result on 1 December 1997 at the ECOFIN Council where the Member States adopted the Code of Conduct for business taxation by resolution and the Commission was invited to submit proposals for directives for savings income and interest and royalty payments.² In 1998, the ECOFIN Council set up a special Council Working Group (the Code of Conduct Group) to assess tax measures that fall within the scope of the Code of Conduct. The aim of the Code of Conduct Group was and is to eliminate harmful tax competition in the EU

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1. The Taxation Policy Group is an ad-hoc Commission High Level Group chaired by the European Commissioner for Taxation for political discussions with Member States.

2. Conclusions of the ECOFIN Council meeting on 1 December 1997 containing the EU Code of Conduct, OJ 98C 2/01.

(and dependent and overseas territories) by identifying, describing, discussing, evaluating and monitoring potential harmful tax measures. The political link of the Code of Conduct for business taxation with a directive on savings and a directive for interest and royalty payments between associated companies has played an important role in reaching results of the Code of Conduct Group as agreed on adoption of the tax package on 3 June 2003.^{3 4} The results included the identification and commitments to rollback of 66 tax measures which were considered harmful by the Code of Conduct Group.⁵ This was the first result for a full exercise from investigating, discussing, and evaluating and accepting rollback commitments for harmful tax regimes where all EU-15 Member States committed to the work and results of the Code of Conduct Group. After this result in 2003, the Member States continued the work to monitor harmful measures and develop new strategies to further enhance the effectiveness of the Code of Conduct, notably by exporting the Code of Conduct principles towards third countries. Due to the sensitive nature of discussing Member States' tax measures in the Council, the Member States agreed that the work of the Group should be confidential, which means that for the public most of the work done and results achieved in the Code of Conduct Group has been clouded by a veil of secrecy.⁶

The EU Code of Conduct contains provisions which, in very general terms, identify harmful tax measures and also highlight related areas such as anti-abuse, State aid and geographical extension. The tools in the Code of Conduct provide nothing more than a general indication and certainly do not provide clear-cut answers on the complex issues that the Group has faced in the past and will face in the future. The Code of Conduct includes a variety of criteria which should be used to determine whether or not a tax measure can be considered harmful. The first condition is whether a tax measure in the area of business taxation affects, or may affect, in a significant way the location of businesses. Furthermore, the measure must provide for a significantly lower effective level of taxation than those levels which generally apply in the state concerned. Such a lower level of taxation may be the

3. Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments.

4. Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States.

5. "Rollback" in this context means the effective removal of harmful features of identified tax measures.

6. Council Conclusions 9 March 1998, concerning the establishment of the Code of Conduct Group for business taxation, Council document 98/C 99/01.

result of the nominal tax rate, the tax base or any other relevant factor. If a measure is caught by these two conditions it is “potentially harmful” and covered by the Code of Conduct. The next step in the evaluation process of the Code of Conduct Group is the assessment of a tax measure according to paragraph B of the Code of Conduct listing further conditions to assist in the assessment whether a measure is actually harmful or not. This non-exhaustive list has, in the vast majority of cases, been used to determine whether or not a measure is harmful. It should also be noted that the Group discussed and agreed on the practical applications of these conditions.⁷

The conditions listed in paragraph B are:

- *Criterion 1: Whether advantages are accorded only to non-residents or in respect of transactions carried out with non-residents (ring-fencing I)*

According to the practice of the Code of Conduct Group, this criterion contains two elements: the first is whether the measure is only open for (de jure) or in a majority of cases used by (de facto) non-residents. Non-residents in practice mainly meant permanent establishments of non-resident head offices or resident companies owned by non-resident corporate shareholders. This means that this criterion considers the legal interpretation of the rules in question and the actual use of the measure.

- *Criterion 2: Whether advantages are ring-fenced from the domestic market, so they do not affect the national tax base (ring-fencing II)*

In the Code of Conduct practice this criterion focused on the question whether the measure is clearly limited in its effect on the national tax base. The Code of Conduct Group also applied the de jure and de facto distinction as mentioned for ring-fencing I. Furthermore, the application of criterion 2 has led to the interpretation that, in case all or a majority of beneficiaries is non-residents, the domestic tax base is deemed to be (completely or partially) ring-fenced from the effects of the regime. Therefore, in principle, the evaluation against criterion 2 follows closely the evaluation of criterion 1.

7. ECOFIN Council of 26/27 November 2000, Progress report including guidance on rollback and standstill, Council document 13563/00.

- *Criterion 3: Whether advantages are granted even without any real economic activity and substantial economic presence within the Member State offering such tax advantages.*

In the Code of Conduct practice, this criterion takes account of the nature and the scope of the activities in relation to the capital invested in, and the income derived from, these activities. In practice, this criterion was only marginally tested.

- *Criterion 4: Whether the rules for profit determination in respect of activities within a multinational group of companies depart from internationally accepted principles, notably the rules agreed upon within the OECD.*

In the Code of Conduct practice, this criterion was used especially to target rulings and advance pricing agreements on intercompany transactions where, contrary to the principles agreed in the OECD Transfer Pricing Guidelines, certain elements were not included in the transfer price in order to reduce the effective tax rate on a certain type of activity.

- *Criterion 5: Whether the tax measures lack transparency, including where legal provisions are relaxed at administrative level in a non-transparent way.*

In the Code of Conduct practice three tests have been applied relating to this criterion. If a tax measure is (1) fully set out in the legislation, or (2) is fully explained in the form of regulations or guidelines, and (3) is not subject to any administrative discretion by individual tax inspectors, it should be treated as transparent and therefore as not harmful.

In practice, once a tax measure has been notified or identified as potentially harmful, the Commission provides a formal description of the measure for further discussion in the Council Group. The Group will discuss the full detail of the measure where the Member State concerned is obliged to cooperate as transparently as possible. If the Group decides that, after the explanation of the Member State concerned, the measure could have harmful effects, the Group will ask the Commission to provide a draft evaluation (the grid) of a measure where a cross (X) indicates that the measure is not contrary to that principle of paragraph B of the Code and a tick (✓) indi-

cates that the measure is contrary to that principle.⁸ A question mark (?) in the grid indicates that there is no or not sufficient evidence to substantiate a tick or a cross. The Group will subsequently discuss the draft grid and will provide an overall assessment. The criteria 1 to 5 only provide indications of harmfulness and there is no real formula or mix of ticks that leads to an overall assessment of harmfulness. All factors are being used as mere indicators. The results of the Code of Conduct Group are then being forwarded to the ECOFIN Council of Ministers that will have to adopt the final results of the Code of Conduct Group.

11.1.2. EU State aid provisions

When drafting the EU Code of Conduct the Member States and the European Commission recognized that most of the tax measures covered by the Code of Conduct may also constitute EU State aid according to the EU Treaty.⁹ The Code of Conduct itself states that the Commission “intends to examine or re-examine existing tax arrangements and proposed new legislation by Member States case by case, thus ensuring that the rules and objectives of the Treaty are applied consistently and equally to all.”¹⁰

Up to establishment of the EU Code of Conduct Group, the European Commission did not consider the application of EU State aid provisions towards tax measures being a priority. However, when EU Commissioner Monti, one of the founding fathers of the harmful tax competition initiative, changed his position from Internal Market Commissioner to Competition Commissioner in 1999, his services (DG Competition) became an active member in the tax competition arena. After the publication of the 1999 Code of Conduct listing 66 harmful tax measures, many Member States in the Code of Conduct Group remained reluctant in accepting the results and in taking steps towards offering rollback commitments and even actually implementing an effective rollback. Due to this lack of cooperation from 1999 onwards, Commissioner Monti started opening State aid proceedings on tax measures that were included in the list of 66 harmful measures. In 2001, the European Commission opened 15 direct tax cases against tax measures in 12 Member States and 13 of these measures were also found

8. Example grid:

Code of Conduct criterion	1a	1b	2a	2b	3	4	5
Tax measure A	X	?	X	?	√	X	X

9. Art. 107 et seq. TFEU.

10. Para. J EU Code of Conduct

harmful by the Code of Conduct Group in the 1999 report. The EU State aid provisions provided the European Commission with actual legal powers in a time when the EU Code of Conduct Group, being a consensus Council Group, did not deliver results. This State aid prioritization from the European Commission certainly helped the progress in the EU Code of Conduct Group and was instrumental to the final adoption of the tax package in 2003, where for all 66 harmful tax measures, Member States had offered a rollback commitment that was considered adequate by all. The European Commission also provided more guidance on the application of the State aid rules to direct business taxation in a Commission Notice.¹¹ The Commission's aim was to use the State aid provisions to support the harmful tax agenda of the European Commission and the EU Member States.¹²

The EU State aid provisions state that “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 common market.”¹³

The Commission Notice provided guidance on the application of this generally formulated article specifically for tax measures. Furthermore, in 2004, the European Commission published the Report on the implementation of the Commission notice on the application of the state aid rules to measures relating to direct business taxation.¹⁴ The guidance explains that a set of cumulative criteria should be met:

- Firstly, the measure must confer on recipients “an advantage” provided through a reduction in the firm’s tax burden in various ways, including a reduction in the tax base (such as special deductions, special or accelerated depreciation arrangements or the entering of reserves on the balance sheet), a total or partial reduction in the amount of tax (such as exemption or a tax credit), or a deferment, cancellation or even special rescheduling of tax debt. An advantage in this sense can be identified in case, for example, a Member State allows using a cost-plus method for profit determination and excludes certain costs from the taxable base, using a fixed markup irrespective of the actual facts of the transactions or economic reality.

11. European Commission Notice OJ C38, 10/12/1998 P. 0003 – 0009.

12. European Commission COM(97) 495.

13. Art. 107(1) TFEU.

14. European Commission C(2004)434.

- Secondly, the advantage must be granted by the State or “through State resources”. A loss of tax revenue is considered equivalent to consumption of State resources in the form of fiscal expenditure.
- Thirdly, the measure must “affect competition and trade between Member States”. This criterion has usually only been marginally tested. The mere fact that the aid strengthens the firm’s position compared with that of other firms which are competitors in intra-Community trade is enough to allow the conclusion to be drawn that intra-Community trade is affected.
- Lastly, the measure must be “specific or selective”, favouring certain undertakings or the production of certain goods. The selective advantage may result from an exception to the tax provisions of a legislative, regulatory or administrative nature or from a discretionary practice of the tax authorities.

The above presupposes that tax measures which are open to all economic agents operating within a Member State are in principle general measures and therefore not State aid. These general measures must be effectively open to all firms on an equal access basis.¹⁵ Furthermore, the European Commission notes in the guidance that the qualification of a tax measure as harmful under the EU Code of Conduct does not affect its possible qualification as a State aid.

11.1.3. Interaction of EU Code of Conduct and EU State aid proceedings

The starting point is that, although the two procedures pursue, to a certain extent, the same goal of reducing distortions of competition within the internal market, they are not identical. The key element for the EU Code of Conduct evaluation is to (inter alia) prevent tax base erosion between EU Member States. Therefore, ring-fencing I and II are considered to be the most important criteria of the Code Group. However, the purpose of State aid is to prevent situations where competition and trade between companies in the EU internal market are affected. The two procedures consist of different criteria and it is therefore quite possible for a measure to be found

15. However, this condition does not restrict the power of Member States to decide on the economic policy which they consider most appropriate and, in particular, to spread the tax burden as they see fit across the different factors of production.

harmful under the EU Code of Conduct which does not constitute State aid and vice versa.

Paragraph J of the EU Code of Conduct states that some of the tax measures covered by the Code may fall within the scope of the provisions on State aid. However, the paragraph does not provide any procedure for the fact that both State aid proceedings and Code of Conduct discussions can take place in parallel. The practice of the Group has been that, in cases where a measure is part of an ongoing State aid procedure (after the formal opening of the State aid procedure), the Group will suspend the Code of Conduct discussion until the State aid procedure has taken its course (including any eventual Court proceeding). This procedure has been formalized by the ECOFIN Council agreement on the future work package 2008.¹⁶

11.2. Case law on corporate tax treatment of interest

Having explained the interaction of the EU Code of Conduct Council proceedings and the EU State aid procedure this section will highlight some of the more interesting cases that have been dealt with focusing (wholly or partly) on the corporate tax treatment of interest. The case law mentioned below provides for a mix of Code of Conduct and State aid assessments, all leading to further guidance on the EU boundaries for the corporate tax treatment of (group)interest.

16. Council document 16084/08, p.9:

“Situations where measures are affected by State aid proceedings
Paragraph J of the Code states that some of the tax measures covered by this code may fall within the scope of the provisions on State aid. However, the paragraph does not provide any procedure for the fact that both State aid proceedings and Code of Conduct discussions can take place in ‘parallel’.

- In cases where a measure is part of an ongoing State aid procedure (after the formal opening of the State aid procedure), the Group will suspend the Code of Conduct discussion until the Commission’s State aid procedure has taken its course. A preliminary description of the measure, drafted by the Commission in close consultation with the MS concerned, can already be provided to the Group. A final (possibly revised) version of a description should be provided immediately after the end of the State aid procedure, if need be.
- The Group should be reminded that a Code of Conduct evaluation is not necessarily the same as a Commission State aid decision (or vice versa). The two procedures are separate and follow their own set of rules and criteria. MSs should therefore explicitly recognize that a COM State aid decision does not affect the outcome of a Code of Conduct evaluation (and vice versa).”

11.2.1. Generic corporate tax measures

The EU Code of Conduct Group and the European Commission reviewed several cases where the design of the tax measure had a general character but where, due to its design, interest income was effectively taxed at a level that was considered lower than the general applicable corporate tax rate.

Table 11.1.: Generic corporate tax measures

No.	Country and case	EU Code of Conduct	EC State aid
1	Malta Advance corporate income tax with refund	Not harmful Council 15472/06	No State aid EC IP/06/363 appropriate measures NN 35/2005 E 11/2005
2	Isle of Man, Jersey, Guernsey 0-10% tax regimes	Harmful effects, pending Council 9633/08 Council 6054/11	Not applicable
3	Gibraltar Payroll taxes	Not harmful Council 14812/02	State aid decision 2005/261/EC OJ 2005 L 85 challenged before the Court CFI T211/04 and T215/04
4	Belgium notional interest deduction ¹⁷	Not potentially harmful	Not notified

After EU accession in 2004, Malta aimed at rolling back several corporate tax measures that were considered harmful tax competition by the Code of Conduct Group and State aid by the European Commission.¹⁸ In this process, Malta proposed a new general income tax system where all companies resident in Malta are subject to income tax at a rate of 35%. Under this general system, an Advance Company Income Tax (ACIT) was proposed. ACIT will be payable upon distributions, by all companies, of all

17. Not including the possible EU infringement of the freedom of establishment and the free movement of capital (for the exclusion of assets allocated to foreign permanent establishments and real estate in EEA countries).

18. Council document 15472/06, EU Code of Conduct ML4 (International Trading Companies) and ML5 (Dividends from (other) Maltese Companies with Foreign Income)).

profits which are not derived from immovable property situated in Malta. The ACIT paid may be set off by the distributing company against its company income tax. Once ACIT has been paid by the distributing company, all shareholders, whether resident in Malta or not, may claim tax refunds at 6/7ths of the ACIT and for dividends arising from passive income consisting of interest and royalties (whether locally sourced or foreign sourced) 5/7ths. For certain participating holdings, the ACIT paid by the distributing company is wholly refunded to the shareholder, in principle, resulting in an effective 0% tax rate and thus in practice leads to a similar result as a participation exemption (holding regime).

Table 11.2. shows the way the EU Code of Conduct Group assesses the final effective tax rates depending on the type of income and on the type of shareholder in order to determine any harmful effects in the sense of the EU Code of Conduct.

Table 11.2.: Malta – Code of Conduct¹⁹

Tax treatment at company level						
	Maltese company					
Total company profits	1,000					
Income tax payable (rate 35%) normal tax or ACIT	(350)					
Profits available for distribution	650					
Tax treatment at shareholder level						
Source	Dividends from participating holdings			Other Income		
Shareholder of Maltese company	Resident individual	Resident company	Non-resident person	Resident individual	Resident company	Non-resident person
Net dividend received	650	650	650	650	650	650
ACIT Refund (100% or 6/7; or 5/7 for passive income) of the ACIT paid by the company on the profits	350	350	350	300	300	300
	250**	250**	250**	250*	250*	250*

19. Council document 15472/06.

Tax treatment at company level						
Taxable income in Malta for shareholder (at rate of maximum 35%)	1000	0	0	950	0	0
	900**			900*		
Imputation credit to shareholder						
Tax payable by shareholder	350	0	0	332.5	0	0
	315**			315*		
Total tax on profits payable in Malta (on company and shareholder level)	350	0	0	382.5	50	50
	415**	100**	100**	415*	*100	100*
Effective combined level of taxation of corporate profits in Malta	35%	0%	0%	38.25%	5%	5%
	41.5%**	10%**	10%**	41.5%*	10%*	10%*

* In the case of passive income (interest and royalties) the refund becomes 5/7, instead of 6/7.

** In the case the anti-abuse provision for participating shareholdings applies, a 5/7 tax refund will be applied upon the distribution of dividends

The Code of Conduct Group approved this regime which was already approved by the European Commission as being an appropriate measure in replacing the former tax regimes. The conclusion is that the Maltese system allows an effective rate of 10% for interest income (as opposed to the general effective rate of 5% for other income for non-residents). The 5/7ths refund resulted after extensive Code of Conduct discussions where the European Commission already seemed to have allowed a 6/7ths refund for passive income in its appropriate measure decision in 2006. One could argue that the Council herewith set a form of minimum taxation on passive income, notably interest income.

In the framework of rolling back several harmful tax measures, the United Kingdom territories, Jersey, Guernsey and Isle of Man introduced a tax system with a differentiated rate ranging from 0% to 10% (or 20%) for corporate income tax combined with an additional provision at shareholder level to avoid domestic tax deferral through incorporation. These tax measures are currently still under discussion in the Code of Conduct Group. Since the measures share a similar design, the Isle of Man regime serves as an example which covers all these regimes.

Rolling back the Isle of Man’s harmful tax measures, a new tax system was introduced in 2006. The standard rate of income tax for all Isle of Man resident companies and branches of non-resident companies is set at 0%. A higher rate of 10% is charged on income of licensed banks derived from banking business and on income from land and property situated in the Isle of Man. Combined with these general systems, a Distributable Profits Charge (DPC) was introduced to combat deferral of personal taxation by individuals transferring sources of income into companies taxed at 0%. The DPC is payable by companies, on behalf of their Isle of Man resident shareholders, which do not distribute some or all of their income.

The DPC is charged at 18% on 55% of the profits of a “trading corporate taxpayer” (defined as a company whose business consists wholly or mainly of the carrying on of an active trade or trades) distributable to Isle of Man resident shareholders, unless at least this proportion of profits is distributed, or 18% on all of the profits of a company that is not a “trading corporate taxpayer” (a passive investment company) distributable to Isle of Man resident shareholders, unless 100% of this income is distributed. Upon distributions, Isle of Man resident shareholders receive a tax credit equal to the full amount of any DPC paid on their behalf by the company. This credit is repayable to the extent that it exceeds the individual’s personal tax liability. The DPC of the Isle of Man was found harmful by the Group in 2007 under standstill.²⁰ An Isle of Man company would be taxed, e.g. on interest income, at an effective tax rate of 0% in the case the receiving company would have non-resident shareholders; however, in case the same company would have been a resident shareholder, the effective tax rate on interest would be 18%. Therefore, the Isle of Man decided to abolish the DPC and introduced a new system (Attribution Regime for Individuals) to safeguard the tax revenue at the level of the resident individual shareholder.²¹ The Attribution Regime for Individuals is a new charge on individuals who are shareholders in a company. They will be treated as if they had received a dividend irrespective of whether they have received a distribution from the company or not.

The EU Member States concluded that personal income taxation falls, as a general rule, outside the scope of the Code. However, the EU Member States also concluded that certain aspects of such taxation may fall under the scope in specific circumstances, such as the regime of the Isle of Man

20. Council document:15545/07.

21. Isle of Man government website: www.gov.im/lib/docs/treasury/incometax/pdfs/gn41.pdf.

and Jersey.²² The background is that shareholders are not taxed exclusively on actual distributions, but also on deemed distributions. This element ensures current taxation of business profits at shareholder level. One could argue that this protection of the domestic tax base forms a sort of tax base protection covered by the ring-fencing II criterion in the Code of Conduct. Furthermore, the EU Member States concluded that these regimes give rise to harmful effects. A final Code of Conduct assessment has to be awaited.

In any event, it seems clear that for interest income, a 0% effective corporate tax rate is not available in case by any way or form the domestic tax base is protected by taxing deemed profit distributions to the resident shareholders.

Gibraltar introduced a general system of payroll taxes in 2006 as a matter of rollback for certain harmful tax regimes.²³ This tax was applied to in respect of employees in Gibraltar and charged as a sum per annum per employee. The regime was deemed illegal State aid by the European Commission, which was overturned by the European Court of First Instance.²⁴ Although the UK is representative of Gibraltar, Gibraltar does, however, have fiscal autonomy from the UK and can therefore introduce its own individual tax system. Since then, Gibraltar introduced a new corporate tax system with a start-up rate of 10% that will apply to all businesses established in Gibraltar after 1 July 2009. Irrespective of the State aid proceedings, the UK and Gibraltar claimed that with the adoption on the tax package, the Gibraltar reform to payroll taxes had been approved by the EU Member States. If this is the case, one could argue that effectively a payroll tax, from the Code of Conduct perspective in any event, is not harmful and therefore an effective tax rate of 0% on interest income, assuming that the receiving company has no employees, could be acceptable.

In 2006, Belgium presented the so-called notional interest deduction regime as a replacement measure for the Belgian coordination centres which were considered harmful from a Code of Conduct perspective and State aid by the European Commission. Belgium considered the law to be a general measure and accordingly did not notify the measure to the European Commission pursuant to article 107(3) of the TFEU. The notional interest deduction is presented as a deduction for risk capital and aims at reducing the tax discrimination between financing through debt (interest being tax

22. Council document 16766/10, para. 12.

23. Council document 14812/02 Gibraltar – B012 Exempt (offshore) Companies and Captive Insurance.

24. OJ 2005 C228/9 Gibraltar exempt companies and CFI T211/04 and T215/04.

deductible) and financing through equity or shareholders' funds. The notional interest deduction is calculated as a percentage applied to the total of the shareholders' funds of a company (capital, reserves). This percentage corresponds to the rate applicable to the 10-year term OLO bonds (obligations linéaires) issued by the Belgian State. The measure is applicable to all companies established in Belgium, both on existing and new equity either injected into the company by the shareholders or generated by the activities of the company. Since Belgium considered the notional interest deduction to be a general tax measure for State aid purposes and the fact that the European Commission did not formally react upon the introduction, it is safe to assume that the European Commission does not consider this measure to be contrary to State aid principles (general measure). A reasoning could be that, even though the deduction for risk capital clearly constitutes an economic advantage for companies, the scheme in principle applies to all companies operating in Belgium without any restriction in terms of region, sector, legal status or size. There does not seem to be a de jure selectivity. As regards de facto selectivity one could argue that highly capitalized companies in general will benefit from a higher "deduction for risk capital" compared to other Belgian companies. However, companies with a high level of capitalization are not necessarily limited to the former Belgian coordination centres. Also, State aid Notice 1998 states that a Member State can choose to tax one factor of production (the capital factor) less or to reduce certain production costs (costs of equity financing) without this being automatically regarded as State aid even if certain companies – more capital intensive – will benefit more from the measure. The EU Code of Conduct Group did not consider this measure to be potentially harmful since the measure does not appear to be ring-fenced, protecting the Belgian tax base or limiting the potential beneficiaries (companies) from the scheme. The actual effective rate will depend on the capitalization of the company; however, from documentation of the Belgian government, it seems that an effective tax rate between 3% and 4% can be achieved for group financing income in Belgium.

11.2.2. Group coordination or holding regimes

Another category of tax regimes evaluated under Code of Conduct principles and EU State aid provisions is the regimes which offer a specific tax treatment for group coordination or holding activities. The key element in all these cases is a beneficial tax base determination where a reduced taxable base was available for group interest income, amongst other income categories.

Table 11.3.: Group coordination or holding regimes

No.	Country and case	EU Code of Conduct	EC State aid
5	Switzerland Cantonal tax regimes, management, holding and mixed companies	Pending “dialogue” Council 10595/10	State aid EC C2007/411 FTA 1972
6	Belgium coordination centres	Harmful A001 Council 7018/1/03	State aid decision OJ 2003 L282/25
7	Luxembourg 1929 Holding com- panies	Harmful A013 Council 7018/1/03	State aid decision OJ 2006 L366
8	Spain Basque coordination centres	Harmful A004/A005 Council 1 7018/1/03	State aid C48 / 2001

The fact that Switzerland appears in this list might be a surprise, since the harmful tax competition initiative has usually only been focused on EU Member States and their dependent and associated territories. However, in 2007, after numerous complaints from members of the European Parliament, the European Commission, supported by the EU Member States in the EFTA Council, took a State aid decision on the incompatibility of certain Swiss corporate tax regimes with the Agreement between the European Economic Community and the Swiss Confederation of 22 July 1972.²⁵ Already in drafting paragraph M of the EU Code of Conduct in 1997 it was recognized that in order for the fight against harmful tax competition to be effective, it has to apply on as broad a geographical basis as possible. The EU Member States recognized that they should avoid that the results of the Code only leads to companies establishing themselves outside the EU. In 2008, the European Commission managed to put the principles of “good governance” in the tax area on the agenda of the Council, leading to Council Conclusions in which the Council considered that recent events involving tax fraud and evasion have proven the need to tackle this throughout the world and to reinforce efforts to combat cross-border tax fraud and evasion in the area of taxation.²⁶ The aim of the Commission is to implement on as broad a geographical basis as possible, the principles of good governance in the tax area, i.e. the principles of transparency, exchange

25. European Commission C2007/411 based on article 23(1)(III) of the Free Trade Agreement between the European Economic Community and the Swiss Confederation of 1972.

26. ECOFIN Council Conclusions 14 May 2008.

of information and fair tax competition (i.e. adhering to the EU Code of Conduct principles and to the EU State aid provisions), as subscribed to by Member States at Community level. This EU Council commitment led to the European Commission Communication on EU good governance in the tax area in 2009.²⁷ This Communication outlines the need to include in relevant agreements to be concluded with third countries by the Community and its Member States, a specific provision on good governance in the tax area. The European Commission furthermore stated that in the EEA area (Liechtenstein, Iceland and Norway) State aid rules from the EEA Agreement should be enforced by the EFTA Surveillance Authority. Specific cases against Liechtenstein (captive insurance and holding companies) have been opened. Apart from the State aid case against Switzerland, the EU Member States concluded in 2010 that the application of the EU Code of Conduct should be brought forward towards third countries and identified Switzerland and Liechtenstein as the first countries that a “dialogue” should be started with.²⁸

The scrutinized Swiss cantonal corporate tax regimes (notably in the cantons Zug and Schwyz) provide for beneficial tax treatment for certain types of companies. In principle, all companies are obliged to pay corporate income tax at federal level. However, on a cantonal level the taxation might vary leading to a beneficial tax treatment for non-resident investors in Switzerland. Three specific regimes were included in the State aid decision: the holding companies, management companies and mixed companies. The key element of the regimes is that they are wholly or partly exempt from cantonal tax on foreign-source income combined with a requirement that the company is not (or limited) engaged in any other business activity in Switzerland. It seems clear that the tax incentive is focused on attracting foreign investors and providing for offshore opportunities for non-resident multinationals to allocate some of their mobile activities in Switzerland. This case is still pending; however, from an EU perspective, one could argue that the interest income excluding (all or part) of foreign-source interest income from the taxable base is considered a harmful feature from a Code perspective and can lead to a selective advantage for State aid purposes.

The Belgium coordination centres were considered harmful tax competition and State aid. The coordination centres carried on financial and ad-

27. European Commission COM(2009)201 Promoting Good Governance in Tax Matters.

28. Council document 17380/10, 10595/10 and ECOFIN conclusions 7 Dec. ECOFIN 2010

ministrative coordination activities of multinational businesses. The coordination centres could conduct only a number of authorized activities, which should be limited to intra-group transactions (including insurance and reinsurance, the centralizing of financial operations). Belgian coordination centres were liable to corporate income tax at the normal rate (at that time 40.17%), but (instead of the actual profits as shown in its financial statements) only a notional taxable base was determined as a percentage of certain operating costs incurred. Certain items such as personnel costs and financing costs were excluded from this base. The percentage depended on the markup charged to the affiliated group companies and on the type and nature of the coordination centre's activities. In the absence of objective criteria, the markup percentage was fixed at 8%. For this measure, the Code of Conduct Group concluded that the measure should be considered harmful in the context of the Code of Conduct since it provided for a substantially reduced tax base with a fixed markup, excluding income on activities going beyond the preparatory and auxiliary nature, combined with a requirement to be part of an international group.

Based on the Code of Conduct Group results it seems that for group coordination and conduit services providing auxiliary and preparatory (limited) functions for the a multinational group the Group will not accept a lower effective tax rate compared to the normal tax rate applicable by means of a reduced taxable base combined with a fixed margin. All income related to non-preparatory or non-auxiliary income (including interest income) should be taxed normally and cannot be included in the "cost-plus" method. The Group based its work on the OECD Transfer Pricing Guidelines and concluded that a case-by-case approach should be introduced (no standard rulings or standard spreads allowed), and full (legal and practical) commitment to the OECD Transfer Pricing Guidelines, meaning that where a comparable uncontrolled price might reasonably be obtained a cost-plus or resale minus method cannot be used. Furthermore, no reduction in the expense base should be taken into account for the purposes of determining taxable income. And, finally, the Group agreed that effective exchange of information should be provided for (upon request and individual APA notifications). In this context, the ECOFIN Council agreed the notification procedure for unilateral APAs in 2003.²⁹

Also for the Luxembourg 1929 Holding companies, both procedures (EU Code of Conduct A13) and EC State aid came to a conclusion that the regime was contrary to EU law. The tax-exempt 1929 holding companies are

29. Council document 11077/02.

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