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Fiscal subsidy control in the post-Brexit era

UK tax professionals have come to learn in the past few decades of the impact of the EU state aid rules as they apply to fiscal state aid.¹ Though the number of cases involving the UK and fiscal state aid has been quite low—lower than in a number of other EU Member States—the

¹ There are a number of very good texts on EU fiscal state aid law: see, for example, Isabelle Richelle, Wolfgang Schön and Edoardo Traversa (eds), *State Aid Law and Business Taxation* (Springer, 2016).

implications have been significant.² The EU–UK Trade and Cooperation Agreement (TCA)³ introduces a new regime for subsidy control, including fiscal subsidies.⁴ In time, UK tax practitioners will need to become familiar with this new system of fiscal subsidy control. This short note introduces the new system of fiscal subsidy control by reference first to an outline of the general scheme of subsidy control under Chapter three, and then by reference to the specific provisions relating to fiscal subsidies. Finally, some comments are made about how this system for fiscal subsidy control may develop.⁵

Subsidy control under the TCA and Chapter three

Chapter three introduces a new system of subsidy control, so far as it relates to matters covered by the TCA, which replaces the system of state aid control.⁶ The subsidy control system under Chapter three contains provisions which differ in some important respects from the system of state aid control.

Article 3.9 of Chapter three requires that each party to the TCA “shall establish or maintain an operationally independent authority or body with an appropriate role in its subsidy control regime”.⁷ In the case of the UK, this will involve the establishment of an independent body to carry out subsidy control and to replace the role previously fulfilled with respect to state aid control by the European Commission. At the time of writing, the Department for Business, Energy & Industrial Strategy has just published a consultation document, *Subsidy Control:*

² Previous matters that have involved negative decisions (i.e. that impermissible state aid had been granted) include those involving the aggregates levy (state aid case SA.34775), those involving the Gibraltar corporate tax reform and the Gibraltar qualifying companies (state aid case C66/02, C52/01 and C53/01) and the UK controlled foreign company rules (state aid case SA.44896).

³ Trade and Cooperation Agreement between the European Union and the European Atomic Energy Community, of the one part, and the United Kingdom of Great Britain and Northern Ireland, of the other part [2020] OJ L444/14 (31 December 2020). For an introduction to the tax-related provisions of the TCA in general, see Alice Pirlot, “Some observations on the tax-related provisions in the EU–UK Trade and Cooperation Agreement” [2021] B.T.R. 1; and Timothy Lyons, “The EU–UK Trade and Cooperation Agreement: a new world with new rules” [2021] B.T.R. 23.

⁴ The provisions on subsidy control are contained in TCA Chapter three (“Subsidy control”) of Title XI (“Level playing field for open and fair competition and sustainable development”), Heading One, Part Two (referred to in this note throughout as “Chapter three”).

⁵ This short note does not consider either the continuing application of EU state aid rules in respect of matters arising prior to Brexit, or the specific matters relating to the application of the EU state aid rules with regard to Northern Ireland under the Protocol on Ireland/Northern Ireland and the Withdrawal Agreement—Agreement on the Withdrawal of the United Kingdom of Great Britain and Northern Ireland from the European Union and the European Atomic Energy Community [2020] OJ L29/7. The latest consolidated text of the Withdrawal Agreement is available at <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A02020W%2FTXT-20201218> [Accessed 15 March 2021].

⁶ The subsidy control provisions in TCA Chapter three are more elaborate than those contained in other free trade agreements entered into by the UK, but, given the significance of UK–EU trade and of the TCA, the design of the system for subsidy control under the TCA is likely to have a major impact on the control of subsidies in accordance with other agreements. This issue is discussed more broadly in Pirlot, “Some observations on the tax-related provisions in the EU–UK Trade and Cooperation Agreement” [2021] B.T.R. 1.

⁷ TCA Chapter three art.3.9.

*Designing a New Approach for the UK*⁸ seeking responses to a number of questions relating to the new system of subsidy control to be introduced.⁹

Building on this, article 3.4 of Chapter three requires the UK to have in place and maintain an effective system of subsidy control that ensures that the granting of subsidies respects six principles. These principles are (in summary):

- 1) that the subsidy pursues a specific public policy objective to remedy an identified market failure or to address an equity rationale;
- 2) that the subsidy is proportionate and limited to what is necessary to achieve its objectives;
- 3) that the subsidy is designed to bring about a change of economic behaviour that is conducive to achieving the objectives;
- 4) that the subsidy does not compensate for costs the beneficiary would have otherwise funded;
- 5) that the subsidy is an appropriate policy instrument to achieve a public policy objective; and
- 6) that the subsidy's positive contributions outweigh any negative effects.

Article 3.4(3) requires that the subsidy control system is implemented in law in such a manner that the legality of an individual subsidy is determined by these principles. The requirement of a clear statement of purpose for the grant of a subsidy is underlined by article 3.6 under which each party to the TCA is required to ensure that economic actors use subsidies only for the specific purpose for which they are granted: that can only be monitored if the purpose behind the grant of a subsidy is made clear.

Pausing there for a moment, this will, to the extent that it applies to fiscal subsidies (which is discussed further below) impose an obligation to have a clear and principled policy rationale behind any fiscal subsidy, and to show that the fiscal subsidy respects the six principles listed in article 3.4(1).

In addition to the six principles which are of general application, under article 3.5 certain subsidies are prohibited or are subject to conditions. Most of the categories listed in article 3.5 are unlikely to have direct relevance to fiscal subsidies (for example, the prohibition on unlimited state guarantees). However, fiscal subsidies which are contingent on the use of domestic over imported goods or services, for example, are prohibited.

The system of subsidy control involves a number of further aspects.

First, under article 3.7 there is an obligation of transparency. This obligation requires information about the granting of a subsidy to be made publicly available on an official website—in the case of tax measures the information is to be made public within one year from the date that the tax declaration (presumably by the beneficiary of the subsidy) is due.¹⁰

⁸ Department for Business, Energy & Industrial Strategy, *Subsidy Control: Designing a New Approach for the UK* (2021), https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/957958/subsidy-control-consultation-document.pdf [Accessed 18 February 2021].

⁹ Interestingly, the consultation document, Department for Business, Energy & Industrial Strategy, *Subsidy Control: Designing a New Approach for the UK* (2021), makes virtually no reference to fiscal subsidies other than with regard to energy-related taxes and the publication of information on subsidies in the form of tax measures.

¹⁰ TCA Chapter three art.3.7(2).

Secondly, a significant role in the control of subsidies is given to “interested parties”, defined in article 3.7(6) as

“any natural or legal person, economic actor or association of economic actors whose interest may be affected by the granting of a subsidy, in particular the beneficiary, economic actors competing with the beneficiary or relevant trade associations”.¹¹

Any interested party may communicate to the granting authority that it is considering applying for a review by a court or tribunal of the grant of the subsidy, and may require additional information that allows it to assess the application of the six principles set out above and enable it to make an informed decision as to whether to make a claim in respect of the subsidy.¹²

Thirdly, this brings into play the role of the courts and tribunals under article 3.10. The UK is to ensure that its courts or tribunals are competent to review subsidy decisions (including decisions of the independent authority established to carry out subsidy control and its failure to act) and to impose remedies, including suspension, prohibition, the award of damages and the recovery of subsidies from its beneficiaries.¹³ If an action is brought—and it is likely to be brought by way of judicial review—then article 3.10(2) provides that the EU shall have the right to intervene (with the permission of the court or tribunal concerned) in any case brought. A footnote to article 3.11(1) provides that, in the case of the UK, a new remedy of recovery of the subsidy is required which would be available at the end of a successful judicial review.¹⁴

Fourthly, article 3.11 deals generally with recovery and requires that the UK shall have in place an effective mechanism of recovery in respect of subsidies. The significance of recovery of subsidies is emphasised by article 3.11(7) which states “the Parties recognise that recovery is an important remedial tool in any system of subsidy control.”¹⁵ Article 3.11(2) provides that recovery may be ordered if a court or tribunal makes a finding of a material error of law in that, for example, the grantor of the subsidy failed to apply the six principles discussed above.

One point that may be particularly relevant to fiscal subsidies is that article 3.11(5) provides that recovery of a subsidy is not required where the subsidy is granted on the basis of an Act of Parliament.¹⁶ Some clarification may be needed here in the future: suppose that an Act of Parliament imposing a tax provides for certain tax advantages to be granted by election of the taxpayers notified to and accepted by HMRC—is the subsidy granted on the basis of the Act of Parliament or by decision of a public body? If it is considered to have been granted on the basis of the Act, then there may be relatively little scope for recovery in the context of fiscal subsidies. The same issue would arise if, for example, the authorities in a devolved jurisdiction were granted power by Act of Parliament to grant subsidies: is the grant made under the Act (in which case, no recovery can be ordered) or under the discretion of the devolved administration?

¹¹ TCA Chapter three art.3.7(6).

¹² TCA Chapter three art.3.7(5).

¹³ TCA Chapter three art.3.10(1).

¹⁴ See TCA Chapter three art. 3.11(1) fn.58—it is also stated that no beneficiary would be able to raise a legitimate expectation to resist such recovery.

¹⁵ TCA Chapter three art.3.11(7).

¹⁶ The terminology is somewhat unclear here. If recovery is not required, does that mean that no remedy of recovery can be ordered for such subsidies, or that recovery is discretionary? One suspects that the intention is the former: subsidies granted on the basis of an Act of Parliament may be found to be unlawful, but the beneficiaries will not be ordered to repay the aid. The writer is grateful to Alice Pirlot for drawing attention to this point.

Fifthly, aside from actions brought by interested parties and the recovery of subsidies, the system of subsidy control also includes a broader framework of consultation, remedial measures and dispute settlement between the UK and the EU. Article 3.8 provides:

“If a Party considers that a subsidy has been granted by the other Party or that there is clear evidence that the other Party intends to grant a subsidy and that the granting of the subsidy has or could have a negative effect on trade or investment between the Parties, it may request...an explanation of how the Principles [set out above] have been respected....”¹⁷

This request initiates a process of consultation within the Trade Specialised Committee on Level Playing Field for Open and Fair Competition and Sustainable Development.¹⁸

Article 3.12 provides a process under which a party to the TCA may unilaterally adopt “appropriate remedial measures” (in effect, countervailing measures) if there is evidence that a subsidy causes, or there is serious risk that it will cause, a serious negative effect on trade or investment between the parties.¹⁹ The introduction of remedial measures may trigger off a process leading to the establishment of an arbitration tribunal in accordance with article 3.12(9).²⁰ There are specific provisions relating the control of subsidies to the general arrangements for dispute settlement under the TCA.²¹

Before turning to the specific issue of fiscal subsidies, a few brief comments might be made about the difference between the new system of subsidy control and the system of EU state aid. At least so far as the provisions of Chapter three are concerned, there is no process of prior notification and clearance of a proposed subsidy with the European Commission.²² Nor is there a suspensive effect in a fashion similar to that of a negative decision by the European Commission.²³ The circumstances of recovery are more limited under Chapter three than under EU state aid, where recovery is the normal consequence of a negative decision. Subject to the specific prohibitions and conditions for certain subsidies, the approach is very much based on the six principles outlining the conditions for the valid grant of a subsidy, with the onus on the public authority to ensure that any subsidy which is granted respects the six principles discussed above.

With these points in mind it is now possible to turn to look in more detail at the question of fiscal subsidies.

Fiscal subsidies

Having explained in outline the scheme of subsidy control under Chapter three it is now possible to turn to look at the meaning of fiscal subsidies under this chapter.

¹⁷ TCA Chapter three art.3.8.

¹⁸ TCA Chapter three art.3.8(4).

¹⁹ TCA Chapter three art.3.12(3)—it is interesting that under art.3.12(5) and (6) the existence of a significant negative effect on trade or investment has to be based on reliable evidence and not merely on conjecture or remote possibility.

²⁰ Though there are limits to the role of the arbitration tribunal in this context—see TCA Chapter three art.3.12(2).

²¹ TCA Chapter three art.3.13.

²² It should be emphasised that such a process is not a requirement of TCA Chapter three: it remains to be seen whether it may be part of the procedure introduced in the UK involving the independent authority that implements the subsidy control regime.

²³ Again subject to the comment made in the previous footnote.

Under article 3.1(1)(b), the term “subsidy” means

“financial assistance which...arises from the resources of the Parties, including...the *forgoing of revenue that is otherwise due*...; confers an economic advantage on one or more economic actors; is specific insofar as it benefits...certain economic actors over others in relation to the production of certain goods or services; and...has, or could have, an effect on trade or investment between the Parties.”²⁴

The reference to “the forgoing of revenue that is otherwise due” clearly brings fiscal subsidies within scope.

The four elements of the definition (assistance out of state resources; conferring an economic advantage; specific benefit to certain economic actors; and affecting trade or investment) use different terminology, but have a good deal in common with the elements of state aid in article 107 of the Treaty on the Functioning of the European Union (TFEU).²⁵ Article 107 provides as follows:

“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, insofar as it affects trade between Member States, be incompatible with the internal market”.²⁶

While care appears to have been taken not to employ identical terminology to article 107 TFEU, one may well ask what in practice is the difference between the conferral of an economic advantage which benefits “certain economic actors over others in relation to the production of certain goods or services” and the concept of selective advantage in EU state aid law.

One point that may be crucial with regard to the scope of the future subsidy control regime is the requirement that the subsidy “has, or could have, an effect on trade or investment between” the UK and the EU. The equivalent requirement in the state aid sphere—aid that “affects trade between the Member States”—is often assumed to exist in the context of the Single Market and larger businesses, especially those operating cross-border. The UK is concerned not with the Single Market but the internal market of the UK. However, in an open economy, it may be difficult to argue that a subsidy—if it is designed to affect behaviour of economic actors—will not affect trade or investment between the UK and the EU. One can imagine this being a future battleground in the control of subsidies, including fiscal subsidies.

So far as fiscal subsidies are concerned, these are specifically discussed in greater detail in article 3.1(2). That paragraph elaborates on the meaning of “specific” financial assistance in article 3.1(1)(b)(iii) and provides that a tax measure shall not be considered as specific unless it meets certain criteria.

The first criterion for a tax measure to be considered as specific is that “certain economic actors obtain a reduction in the tax liability that they otherwise would have borne under the *normal taxation regime*”.²⁷ This is a codification of the reference system approach developed by

²⁴ TCA Chapter three art.3.1(1)(b), emphasis added.

²⁵ Consolidated version of the Treaty on the Functioning of the European Union (TFEU) [2016] OJ C202/47.

²⁶ TFEU art.107.

²⁷ TCA Chapter three art.3.1(2)(a)(i), emphasis added.

the European Court and Commission with regard to the identification of state aid by reference to departures from the tax liability normally applicable under the reference system. For a tax measure to confer a specific benefit, economic actors must be “treated more advantageously than others in a comparable position within the normal taxation regime”.²⁸

The subparagraph then continues by explaining that “a normal taxation regime” is defined by “its internal objective...its features (such as the tax base, the taxable person, the taxable event or the tax rate)” and by an authority which is “autonomous institutionally, procedurally, economically and financially and has the competence to design the features of the taxation regime”.²⁹ Thus, the identification of the normal taxation regime involves an assessment of the objective of the regime, the normal elements constituting a tax regime, and the fact that it is enacted by an autonomous authority. The devolved governments in Scotland and Northern Ireland, for example, would have autonomous authority to design the features of the taxation regime within the scope of devolved legislative powers with regard to taxation. While the wording here provides some guidance as to the identification of the reference system/“normal taxation regime”, there may still be scope for argument as to whether, for example, the entire legislative body introducing a particular tax is the normal taxation regime, or whether a self-contained part of that regime—such as, for example, the transfer pricing regime—might constitute the normal taxation regime from which there is a departure.

The second criterion of specificity is a negative one: a subsidy is not regarded as specific if it is “justified by principles inherent to the design of the general system”.³⁰ The subparagraph then continues to say that

“examples of such inherent principles are the need to fight fraud or tax evasion, administrative manageability, the avoidance of double taxation, the principle of tax neutrality, the progressive nature of income tax and its redistributive purpose, or the need to respect taxpayers’ ability to pay”.³¹

This list of inherent principles reflects the approach taken by EU state aid law under which fiscal state aid might be justified on the grounds of the general scheme and nature of the tax system.

The inherent principles listed here are examples and are clearly not exhaustive. The inherent principles are, however, a fairly good list of justifications that might be put forward to justify tax measures that would otherwise be regarded as discriminatory. No doubt issues will arise in the future as to whether, for example, special tax regimes that benefit disadvantaged parts of the country might be justified on grounds of the need to respect taxpayers’ ability to pay. It seems more likely that such provisions would be regarded as specific benefits, but arguably justifiable in accordance with the general principles listed in article 3.1 of Chapter three (and discussed above).

Finally, and thirdly, article 3.1(2)(c) expressly provides that “special purpose levies” are not to be regarded as specific

²⁸ TCA Chapter three art.3.1(2)(a)(ii).

²⁹ TCA Chapter three art.3.1(2)(a)(ii).

³⁰ TCA Chapter three art.3.1(2)(b).

³¹ TCA Chapter three art.3.1(2)(b).

“if their design is required by non-economic public policy objectives, such as the need to limit the negative impacts of certain activities or products on the environment or human health, insofar as the public policy objectives are not discriminatory”.³²

A footnote to the paragraph explains that

“for this purpose, discrimination means that there is less favourable treatment of an economic actor compared with others in like situations and that that differential treatment is not justified by objective criteria”.³³

This definition of discrimination covers only less favourable treatment of those in like situations and not differentiated treatment between those in unlike situations (i.e. it preserves horizontal equity and not vertical equity). On the basis of this provision, for example, a special levy on certain beverages that have a negative impact on human health might be seen as non-specific, in so far as the public policy objectives are not discriminatory (i.e. they seek to improve the health of all and not to have discriminatory health objectives).

Clearly, some detailed thought and attention has been given to the specific area of fiscal subsidies. Either in the EU negotiating team or the UK negotiating team, at least some persons were concerned to ensure that there was more precise guidance with regard to fiscal subsidies than the general rules applicable to non-fiscal subsidies. There is still room for debate, however, whether a fiscal advantage may be specific in so far as it departs from the normative tax regime, and whether it may be non-specific (i.e. justified) by reference to the inherent principles of a good tax regime.

Having considered the definition of fiscal subsidies, it is now possible to put together the two parts of this note so far and consider fiscal subsidies and the new system of subsidy control.

Fiscal subsidies and the new system of subsidy control

First, it is clear that fiscal preferences—“the forgoing of revenue that is otherwise due”—come within the scope of subsidy control, if they meet the other criteria, including that they are seen to present a credible risk of impacting trade and investment between the UK and EU. As such, specific tax expenditures will come within the purview of the general scheme of Chapter three, including within the remit of the “operationally independent authority” to be established to operate the subsidy control regime.

Tax expenditures are therefore subject to the rules with regard to transparency.³⁴ It will be possible for an interested party to apply for further information about a tax measure in order to decide whether that interested party (perhaps a competitor of the beneficiary who has received the subsidy) might make a claim or not. It is reasonable to foresee going forward the publication of information about specific tax subsidies being followed by requests for information from advisors to competitors seeking information to determine whether or not to bring a claim against the measure.

³² TCA Chapter three art.3.1(2)(c).

³³ TCA Chapter three art.3.1(2)(c) fn.53.

³⁴ And that is very clear from TCA Chapter three art.3.7(2) which extends the period of time for making information public with respect to tax measures.

Fiscal subsidies will come within the competence of the courts or tribunals to review subsidy decisions, to impose remedies, to hear claims from interested parties and to order recovery. Subject to the specific exception from recovery for a subsidy granted on the basis of an Act of Parliament, fiscal subsidies will also be subject to the general provisions on recovery. Under the EU system of state aid, a competitor might inform the Commission who might initiate an enquiry into a particular measure. Potentially this role may be fulfilled in the future in part by the independent body responsible for subsidy control. However, it will also be open to an interested party to consider an action for judicial review of an alleged fiscal subsidy. One can again foresee a judicial review application brought by a competitor to challenge a measure, defended by the beneficiary, with the body granting the fiscal advantage (perhaps HMRC) intervening, together with the EU also exercising its right to apply to intervene. The issues for the trial judge may depend on: 1) evidence of negative impact on trade and investment between the UK and EU; 2) whether the measure is non-specific as part of the general tax system; 3) whether the measure is non-specific and justifiable in accordance with the inherent principles such as ability to pay; 4) whether, if it does constitute a specific fiscal subsidy, the principles that are to be observed with respect to all forms of subsidies have been respected; and 5) that may ultimately turn on the statement of the rationale produced (and underlying projections and analysis) when the subsidy was introduced.

The granting of fiscal subsidies—to the extent that they are not prohibited under article 3.5—will be subject to the obligation to respect the principles contained in article 3.4(1). That is likely to place a burden on the public body that introduces a fiscal subsidy to provide a clear and explicit explanation of: the public policy objectives; the identified market failure or equity rationale; in what way the subsidy is proportionate and limited; what economic behaviour is being sought to be changed; and how the subsidy satisfies the other applicable principles. This suggests that tax measures that might constitute fiscal subsidies will need to be accompanied by much clearer and fact-based policy justifications than have traditionally accompanied new tax proposals.

It will be particularly important going forward to determine what tax expenditures are not considered to be specific in accordance with article 3.1(2) as explained above. That in turn puts pressure on the identification of the normal taxation regime, as well as the justification of tax measures on the basis of the principles inherent to the design of the general tax system. One can imagine circumstances arising in the future where, for example, a competitor of a beneficiary of a fiscal subsidy seeks to challenge the subsidy, and the recipient seeks to argue that the subsidy is justified by principles inherent to the design of the general tax system. This will make for some very interesting litigation, particularly when judges are called upon to give practical impact to general principles such as tax neutrality or the need to respect taxpayers' ability to pay.

Unlike many countries with a written constitution, the UK has no constitutionally-enshrined principles applicable to the design or operation of the tax system. However, some of those principles—such as the ability to pay, the principle of tax neutrality—will now come into operation through the back door (so to speak), at least with regard to tax expenditures, through the fiscal subsidies rules and the UK subsidy control system. This will raise some very interesting new issues for tax practitioners in the future, who will have to start grappling with these inherent principles which have not in the past appeared so directly in the tax system and in legal form.

Strictly speaking, the system for control of fiscal subsidies discussed here arises under the TCA with respect to trade and investment between the UK and the EU. Other trade agreements concluded so far have not contained such explicit provisions. However, given the importance of trade and investment between the UK and the EU, it is reasonable to suppose that the general system of subsidy control, and of fiscal subsidies specifically, will be designed in large part around the requirements of the TCA and Chapter three. This will involve the development of a whole new area of understanding and practice for tax advisers.

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