COMMISSION DECISION

of 24 June 2003

on the aid scheme implemented by Belgium — Tax ruling system for United States foreign sales corporations

(notified under document number C(2003) 1868)

(Only the French and Dutch texts are authentic)

(Text with EEA relevance)

(2004/77/EC)

THE COMMISSION OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Community, and in particular the first subparagraph of Article 88(2) thereof,

Having regard to the Agreement on the European Economic Area, and in particular Article 62(1)(a) thereof,

Having called on interested parties to submit their comments pursuant to the provisions cited above [1],

Whereas:

I. PROCEDURE

(1) In 1997 the Ecofin Council adopted a Code of Conduct for business taxation [2] with the objective of tackling harmful tax competition; it subsequently established a Group to assess tax measures that fall within the scope of the Code. In line with the undertaking given in the Code, the Commission published in 1998 a notice on the application of the State aid rules to measures relating to direct business taxation [3] (hereinafter the Notice), stressing its determination to apply them rigorously and to respect the principle of equality of treatment. It was within this framework that the Commission undertook to examine or re-examine on a case-by-case basis, and in the light of the guidelines set out in the Notice, the tax arrangements in force in the Member States.

(2) In this connection, the Commission, by letter dated 23 March 2001 (D/51238), asked the Belgian authorities to provide information on the tax ruling system for United States foreign sales corporations (FSCs) in Belgium. Belgium replied by letter dated 18 May 2001 (A/34107).

(3) By letter dated 12 April 2002 (SG 2002 D/229352), the Commission informed Belgium that it had decided to initiate the procedure laid down in Article 88(2) of the EC Treaty in respect of the Belgian tax ruling system for FSCs. By letter dated 27 May 2002 (A/33959), Belgium submitted its observations.

(4) The Commission decision to initiate the formal investigation procedure was published in the *Official Journal of the European Communities*. The Commission invited interested parties to submit their comments [4]. No comments were received.

II. DESCRIPTION OF THE MEASURE

United States regime for FSCs

(5) A brief description of United States regime for FSCs is necessary in order to understand the operation of the tax ruling system for FSCs in Belgium.

(6) As background, the World Trade Organisation (WTO) has, in a number of rulings, found that the legislation on FSCs provided exporting firms in the United States with a prohibited tax incentive. To be more precise, the

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[1] OJ C 30, 8.2.2003, p. 21.

[2] OJ C 2, 6.1.1998, p. 1.

[3] OJ C 384, 10.12.1998, p. 3.

[4] See footnote 1.

incentive has been found to be, *inter alia*, an export subsidy prohibited under Article 3 of the Agreement on Subsidies and Countervailing Measures (ASCM) and has thus been removed from the United States tax code.

(7) Under the United States regime, an FSC is a foreign corporation — typically a fully owned subsidiary of a United States domestic corporation — that elects to be subject to the FSC rules contained in Sections 921 to 927 of the Internal Revenue Code of 1986 (IRC 1986). The portion of the FSC's income deriving from exporting United States-produced goods is exempt from taxation even if it is normally taxable under United States tax law. In particular, under Section 882(a) of the IRC 1986 the above income would be taxable as 'income of a foreign corporation effectively connected with a trade or business carried on in the United States'. However, under the United States regime for FSCs this income is non-taxable in the United States because it is deemed not to be 'effectively connected' to United States trade or business. The United States regime also modifies the traditional transfer pricing rules under Section 482 of the IRC 1986 by artificially allocating a significant proportion of the income of a United States parent company trading with its FSC to the FSC. As a result, both an FSC and its United States parent company are exempted from United States corporation tax that would be normally borne by companies carrying on a trade or business in the United States.

(8) To complete the description of the relevant provisions of the United States regime, a domestic corporation holding shares in an FSC is allowed a 100 % 'dividends-received deduction' for dividends received from an FSC, in lieu of the traditional 'indirect foreign tax credit' normally applicable under United States law. Thus, a United States corporation holding shares in an FSC does not pay any United States tax on the exempt portion of the foreign trade income, while the non-exempt portion is taxed only once (either in the hands of the FSC or in the hands of the shareholder), instead of being taxed twice under general United States rules ([5]).

(9) Since, under the United States regime, the exempt income was only the 'foreign trade income' associated with the exportation of United States products, in late 1999 a WTO Panel found the scheme to be a 'prohibited' export subsidy in breach of, *inter alia*, Article 3 of the ASCM. In February 2000 an Appellate Body of the WTO definitively ruled that the United States legislation violated the United States' obligations under the WTO. The United States Congress responded to subsequent international pressure and its obligation to implement the WTO finding by repealing the regime on 30 September 2000 ([6]).

(10) Following the repeal, no corporation may, with effect from 30 September 2000, elect to be an FSC. For an FSC in existence on that date, the FSC rules continue to apply only for transactions in the ordinary course of trade and business performed before 2002. However, an existing FSC will continue to benefit from the regime with respect to transactions ongoing after 1 January 2002 pursuant to binding contracts between an FSC and unrelated third parties applicable as at 30 September 2000 and still in force. Consequently, it is only once such contracts have expired that the FSC regime will definitely cease to operate.

Belgian scheme for FSCs

(11) Under the United States regime, an FSC must be organised or have an office in a foreign country having an agreement with the United States for sharing tax information such as that in force with Belgium ([7]), where the FSC must keep a set of permanent accounts. Also under United States law, a portion of the foreign trade income earned by an FSC or its United States parent is exempt only if certain economic processes take place outside the United States. To provide a legal framework for the activities of FSCs in Belgium, in December 1984, the year preceding the entry into force of the United States regime, the Belgian tax administration issued a circular concerning a special

([5]) In addition, under the United States regime, the 'foreign trade income' of an FSC is excluded from the income of a United States company controlling that FSC, otherwise considered as taxable income under Subpart F of the IRC 1986. More particularly, pursuant to Section 954 (d)-(e) of the IRC 1986, the above income would ordinarily be characterised as deemed dividend income of the controlling United States company and would be subject to tax as 'foreign base company income' of a controlled foreign company (CFC).

([6]) US Pub. L. No. 106-519 (2000). The scheme that replaced the FSC scheme, the Extraterritorial Income Act, was subsequently found to be incompatible with the WTO by the WTO Panel and Appellate Body.

([7]) See, in particular, Article 26 of the United States — Belgium Income Tax Convention signed in Brussels on 9 July 1970, which contains provisions on the 'exchange of information'.

ruling system for FSC activities in Belgium (hereinafter the system).

(12) Under Belgian domestic and conventional law [8], a Belgian subsidiary is taxed in Belgium on its worldwide income while a permanent establishment in Belgium of a foreign company is taxed solely on income earned in Belgium. By way of derogation from the above rule, a Belgian FSC or a Belgian permanent establishment of an FSC is determined by applying a special method (cost-plus method) that consists in applying an 8 % mark-up to certain costs incurred. In particular, a Belgian FSC or a Belgian permanent establishment of an FSC or of its United States parent company can apply to the Belgian tax administration for an individual ruling with a view to determining the taxable profit of the entity in Belgium on the basis of this cost-plus computation. This indirect method of determining the taxable profit of certain taxable entities with respect to certain transactions with associated entities within the same group is designed to assess the correct profit attributable to such entities by adopting the 'arm's-length standard', which is the international standard that the OECD countries have agreed should be used for determining the taxable profit of associated enterprises in their business relations.

(13) Several provisions in Belgium's tax code concerned with potentially abusive transactions apply the arm's-length standard. The bilateral tax conventions concluded by Belgium with other countries also adhere to the principles of Article 9 of the OECD Model Tax Convention concerning the tax administration's right to adjust the profit allocation where transactions have been conducted between associated enterprises on other than arm's-length terms. A brief description of the arm's-length standard is therefore necessary in order to understand the operation of the ruling system for FSCs in Belgium.

(14) When international transactions are carried out between associated enterprises, the OECD member countries have agreed that, for corporation tax purposes, their profits may be adjusted in accordance with the arm's-length principle set out in Article 9 of the OECD Model Tax Convention. The cost-plus method is a transfer pricing method recommended by the OECD for indirectly determining the arm's-length price of an international transaction between associated enterprises operating within a single group, subject to certain conditions. When associated enterprises deal with one other, their commercial relations may be affected by the fact that they may try to manipulate their profit determination for tax reasons. On the other hand, the tax administrations of the different countries exercising their jurisdiction to tax may disallow deductions of certain costs for corporation tax purposes or may adjust the profits deriving from such international transactions between associated entities, thereby giving rise to double taxation.

(15) Unlike other recommended transfer pricing methods, which directly determine the arm's-length price by reference to the prices applied in comparable transactions between independent companies (uncontrolled transactions), the cost-plus method determines the arm's-length price by reference to the cost incurred by the supplier of goods or services in a transaction between two associated enterprises (controlled transaction). Under the cost-plus method, an appropriate mark-up is added to such costs by reference to the profit margin ordinarily charged by suppliers in comparable uncontrolled transactions. Such indirect profit determination is carried on in light of the functions performed by such a supplier, taking into account the assets used, the risks assumed and the market conditions. The results of the computation after adding this mark-up to the costs is regarded as the arm's-length price of the original controlled transaction.

(16) In its 1995 Report on Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration (hereinafter the 1995 OECD Report), the OECD recommends the cost-plus transfer pricing method as an alternative arrangement for computing the tax base for transactions between related companies. In particular, this method is appropriate for suppliers of semi-finished goods where the related parties participating in the transactions have concluded joint facility agreements or long-term buy-and-supply arrangements and where the controlled transactions consist in the supply of services.

(17) The tax scheme for FSCs in Belgium is a special scheme applicable to branches and subsidiaries of FSCs that differs from the general tax scheme applicable to other Belgian subsidiaries or branches of foreign companies. In principle, Belgian subsidiaries or branches determine their taxable profits on the basis of the general accounting principles as corrected by Belgian tax rules. Such rules are also applied to international intra-group transactions carried out between a Belgian subsidiary or

[8] See, in particular, Articles 5 and 7, entitled 'permanent establishments' and 'business profits' respectively, of the aforementioned United States–Belgium Income Tax Convention.

branch and an associated entity within the same group. However, Belgian corporate tax law contains special anti-avoidance provisions that relate to certain specific aspects of transfer pricing. Under the most significant of these provisions (Article 26 of the Belgian Income Tax Code 1992 (CIR 1992)), all 'abnormal and gratuitous advantages' granted by a Belgian enterprise within the framework of a controlled transaction are added to the taxable income of that entity if the beneficiary is a foreign company enjoying a favourable tax status in its country of residence. Belgian tax law also contains anti-avoidance provisions concerning royalties, interest on loans and the income from the transfer of property abroad. Under these provisions, the taxpayer must demonstrate the bona fide nature of such controlled transactions in order to avoid arm's-length price adjustments by the tax administration. Lastly, rulings may be obtained as to whether or not certain controlled transactions are conducted at arm's length or whether a payment constitutes an abnormal or gratuitous advantage.

(18) The rules whereby an FSC may obtain from the Belgian tax administration an individual ruling on the determination of taxable profits by means of the cost-plus method differ according to whether these profits are generated in Belgium via an independent company residing in Belgium (an FSC or a subsidiary of a United States company) or via a permanent establishment in Belgium of an FSC or of a United States company. If the profits are attributable to a permanent establishment in Belgium (hereinafter the FSC branch), the tax base for corporation tax purposes is determined by using the cost-plus method consisting in applying a mark-up to the costs incurred by the FSC branch. However, these costs do not include direct costs relating to advertising, sales promotion, carriage of goods and credit risks as well as any income tax paid by the FSC branch. Furthermore, the mark-up applied to the total costs computed in this way is fixed at 8 %. Application of the 8 % rate to the cost base yields the taxable profits that are subject to Belgium's standard rate of corporation tax.

(19) If the profits are attributable to an independent company established in Belgium (the FSC subsidiary), its taxable profits are, in principle, determined on the basis of its accounting profits adjusted for tax purposes under the ordinary tax law in Belgium. However, where the profits determined in this way correspond to at least 8 % of the eligible costs incurred by the FSC subsidiary, the Belgian tax administration considers that the operations between the FSC subsidiary and its associated companies have been carried out at arm's length and waives the right to make any adjustment to the value of these controlled transactions. Again, the taxable profits generated in this way are subject to the standard rate of corporation tax in Belgium.

(20) The special scheme allowed by the Belgian tax administration is valid for three years and is renewable tacitly. Each party may give notice of termination six months before the end of the three-year period.

(21) The Belgian authorities have indicated that the legal basis for the ruling system is Article 182(1)(3) of the Royal Decree implementing Article 342(2) of the CIR 1992. These provisions set the minimum taxable amount for foreign commercial companies operating in Belgium. Furthermore, an FSC established in Belgium whose profits are determined under ordinary law rules will go unchallenged by the tax authorities under the 'gratuitous advantages' anti-abuse presumption contained in Article 26 of the CIR 1992 if its profits account for at least 8 % of the costs attributable to the FSC.

III. **GROUNDS FOR INITIATING THE PROCEDURE**

(22) In its decision to initiate the formal investigation procedure, the Commission took the view that the FSC scheme met all the four criteria under Article 87(1) of the EC Treaty, in that it conferred an advantage leading to a reduction in tax revenues for Belgium, affected competition and trade, and was selective in nature. In particular, it took the preliminary view that the regime conferred an advantage on the beneficiaries because:

— the exclusion of certain costs from the cost basis taken into account for the cost-plus method, and

— the application of the fixed 8 % mark-up

could lead to the determination of an artificially lower taxable income for FSC branches and subsidiaries than that which would have been calculated under the ordinary transfer pricing rules for controlled transactions in Belgium, without this difference being justified by the nature or general scheme of the tax system in Belgium.

(23) The Commission also considered that none of the derogations from the general prohibition on aid provided for in Article 87(2) and (3) of the EC Treaty applied and that the measure was therefore incompatible with the common market.

IV. COMMENTS FROM BELGIUM

Preliminary observations

(24) In response to the assessment made by the Commission in its letter initiating the procedure, the Belgian authorities have presented some preliminary observations, claiming that the Belgian scheme for FSC branches remained largely theoretical, the large majority of FSCs in Belgium being permanent establishments of FSCs to which were applied the same rules as those applicable to all other permanent establishments of foreign companies in Belgium.

(25) In addition, Belgium took the view that on 10 June 1985, in an answer to a Parliamentary question concerning the need for harmonisation of Member States' tax rules governing FSCs, the Commission had implicitly considered the scheme to be compatible with the common market ([9]). The measure in question should therefore have been considered to constitute existing aid as defined in Article 1(b) of Council Regulation (EC) No 659/1999 laying down detailed rules for the application of Article 93 of the EC Treaty ([10]). As a result, the Commission would have committed a procedural error by pursuing Belgium for its failure to notify in advance to the Commission the tax scheme applicable to activities carried out by FSCs in Belgium.

Absence of any advantages

(26) With respect to the alleged advantage for FSC branches, Belgium maintains that the scheme corresponds to the ordinary tax regime applicable to any foreign company operating in Belgium. According to it, Article 182(1)(3)(e) of the Royal Decree implementing the CIR 1992 reinstated an administrative presumption originally enacted in 1964 regarding the minimum taxable profits of a permanent establishment of a foreign company carrying on business activities in Belgium. Under this scheme, the minimum taxable profit is set at 8 % of the eligible costs of such an establishment. For Belgium, the 8 % minimum mark-up fixed in advance is designed to relieve the tax administration of the obligation to determine on a case-by-case basis the arm's-length profit to be applied to controlled transactions between a permanent establishment and its foreign head office or other associated companies within the group.

Absence of reduction in tax revenue for the State

(27) Belgium considers that, since its introduction, the special scheme for FSCs has generated additional tax revenue for the Belgian State with respect to certain items of income that would otherwise have escaped taxation in Belgium. Therefore, the scheme in question would not have led to any reduction in tax revenue for the Belgian State.

Absence of effect on competition and trade between Member States

(28) Belgium first observes that the Commission has not identified the alleged negative impact on intra-Community trade and on competition caused by the scheme in question with regard to the actual activities carried on by FSCs under the relevant United States regime. According to Belgium, the Commission misconstrued legitimate international tax competition as illegitimate national measures in favour of multinational enterprises. More generally, it is claimed that the Commission failed to consider the effects of the non-harmonised tax regimes in force in various Member States on competition between multinationals based there.

(29) In addition, Belgium claims that the Commission did not demonstrate how the fixed 8 % mark-up under the cost-plus method and the exclusion of certain costs from the computation under that same method of taxable profits in Belgium might have resulted in a reduced tax base as compared with that resulting from the ordinary transfer-pricing method generally applicable to controlled transactions.

(30) Belgium also claims that the objective of both the Belgian and the United States arrangements for FSCs is to confer an advantage on United States exporting companies. Thus, the scheme could not affect competition and trade between Member States, but only

([9]) See the answer given on 10 June 1985 by Mr De Clerq on behalf of the Commission to Written Question No 1664/84 by Mrs Marijke Van Hemeldonck (OJ C 197, 5.8.1985, p. 6).

([10]) OJ L 83, 27.3.1999, p. 1.

competition and trade between the United States and the Community. For this reason, according to Belgium and as already mentioned, the Commission has explicitly excluded in the past any anti-competitive effect of the scheme in question on intra-Community trade and competition.

Absence of selectivity

(31) Lastly, Belgium considers that the scheme in question is not selective because its special legal basis formally consisting in a 1984 circular became void when in 2000 the FSC regime was repealed by the United States Congress.

(32) Although the scheme might still be applicable in a very small number of cases concerning certain earlier rulings, such rulings have as their sole legal basis Article 182(1)(3)(e) of the Royal Decree implementing Article 342(2) of the CIR 1992. This is the ordinary tax law to which all permanent establishments of foreign companies in Belgium are subject and so the scheme would not be selective.

(33) Furthermore, according to Belgium, the application of a special method for computing the tax base for FSC branches is justified by the impossibility of determining the taxable profits of a permanent establishment analytically because of the lack of adequate bookkeeping by such branches.

(34) Still according to Belgium, the exclusion of certain expenses (concerning advertising, sales promotion, transport and credit risk insurance) from the cost-plus computation for FSC branches is justified by the limited activities carried out by such branches. In fact, these activities correspond to business transactions whose economic benefit is attributable to the associated foreign entities with which FSC branches deal. As this benefit is attributable to the other party in the transaction, the resulting profits should not be taxable in the hands of the FSC branch in accordance with the arm's-length principle. In this respect, Belgium maintains that the tax scheme for the Belgian activities of FSC branches does not differ from the standard tax arrangements for other controlled cross-border transactions.

Conclusion

(35) The Belgian Government claims that, even if the tax ruling system were to be regarded as state aid, the Commission could not order repayment of the advantages that might have accrued to the beneficiaries by virtue of the principle of legitimate expectation. Furthermore, it would be impossible to compute and claim repayment of advantages allegedly enjoyed by non-resident taxpayers, which fall outside the scope of Belgian jurisdiction. Accordingly, recovery of the presumed aid should be forgone.

V. ASSESSMENT OF THE MEASURE

(36) In its letter opening the formal procedure, the Commission indicated that, in the case of FSC subsidiaries, the advantage conferred by the scheme derives from the way in which the mark-up applied to admissible costs is computed. These admissible costs account, in fact, for only a small portion of the transactions carried out by FSC subsidiaries. Furthermore, the fixed 8 % mark-up appears to be substantially lower than that normally generated by the activities of FSC subsidiaries.

(37) Having considered the comments by the Belgian authorities, the Commission maintains the position it expressed in its letter of 12 April 2002 [11] opening the formal procedure, namely that the scheme under examination constitutes operating aid within the meaning of Article 87(1) of the EC Treaty.

Preliminary observations

(38) The Commission rejects Belgium's remarks that the tax scheme for FSC activities in Belgium has little practical relevance as there are no FSC subsidiaries in Belgium and that the FSC branches were subjected to the same tax treatment as all other permanent establishments of foreign companies in Belgium. These remarks prompt the following observations by the Commission.

(39) Besides being governed by different legal bases, FSC subsidiaries and branches were treated in very similar fashion for corporation tax purposes and, furthermore, no conclusion as to the nature of the scheme can be drawn from the absence of FSC subsidiaries in Belgium.

[11] See footnote 1.

In fact, the scheme could actually confer advantages exclusively on FSC branches and, as such, could constitute incompatible aid.

(40) The Commission rejects the Belgian authorities' remark concerning its supposed implicit approval of the tax scheme for FSC activities in Belgium. In its view, the argument that, by answering the abovementioned parliamentary question in 1985, it might have indirectly acknowledged the existence of the Belgian scheme has no bearing whatsoever on the classification of the measure. The Commission notes that it is settled case law that the answer to the question as to whether aid is illegal aid or existing aid cannot depend on a subjective assessment by the Commission ([12]).

(41) The scheme was introduced in 1984 and took effect in 1985 without having been previously notified to the Commission and, as such, the measure has been implemented unlawfully. Accordingly, the scheme may constitute unlawful aid if it fulfils all the four criteria discussed below.

Advantage

(42) First, the measure must confer on beneficiaries an advantage that relieves them of charges normally borne by their budgets. According to point 9 of the Notice ([13]), a tax advantage may be provided through a reduction in the company's tax burden in various ways, including through a reduction in the tax base.

(43) However, the Commission confirms its assessment according to which, by substantially deviating from the profit determination standard used for comparable taxpayers carrying on similar cross-border transactions, the measure constitutes for FSC branches and subsidiaries an advantage consisting in a reduction in their taxable profits as detailed below.

(44) At the time the United States regime for FSCs was set up, the United States took the view that the exemption from United States corporation tax would be given the go-ahead by the GATT provided that the economic activities yielding the exempt income took place outside the United States. Thus, the United States legislation required FSCs to perform substantial economic activities as independent foreign companies. However, the WTO Panel found that the FSC regime constituted a subsidy because it resulted in forgone revenue as compared with the United States general system for taxing the income of foreign subsidiaries. Furthermore, it concluded that the GATT should forbid the subsidy because it was linked to exports since only foreign trade income deriving from 'export property' ([14]) qualified for the measure.

(45) The Commission notes that, under the United States regime, the tax advantages conferred on FSCs specifically concern their 'exempt foreign trade income', which means the portion of the gross foreign trade income of an FSC computed in accordance with one of the special 'administrative pricing rules' ([15]). Such income includes:

— the sale or lease of goods purchased by an FSC from a person under the same control as the FSC (normally its controlling United States company),

— the agency services concerned with such sale or lease of goods, and

— all other services concerned with such sales and lease transactions.

(46) In connection with the United States regime, the Commission observes that the activities of an FSC or of its branch in Belgium correspond to the sale or lease of

([12]) See Case C-295/97 Piaggio [1999] ECR I-3735.

([13]) See footnote 3.

([14]) Under the regime for FSCs, 'export property' means goods that are 1. manufactured, produced, grown or extracted in the United States by a person other than the FSC, 2. held primarily for sale or lease in the ordinary course of FSC business, and 3. sold or leased for direct consumption, use or disposition outside of the United States — Section 927(a)(1) of the IRC 1986. Furthermore, not more than 50 % of the value of export property may be attributed to materials or components imported into the United States — Section 927(a)(1)(C) of the IRC 1986 and Reg. Section 1.927(a)-1T(e).

([15]) Under the United States legislation, the FSC's income from the controlled sale, lease and service transactions is determined using one of the following three inter-company pricing regimes: (a) the combined taxable income method; (b) the gross receipt method; or (c) the arm's-length pricing rule. Whichever method produces the highest taxable income for the FSC is the one accepted. Under the tax exemption, such 'exempt foreign source income' is deemed to be foreign-source income that is 'not effectively connected' with the conduct of an activity in the United States.

goods originating in the United States and purchased from an associated company within the group and to the supply of all the services related to those sales and lease transactions.

(47) Under the regime in question, a fixed 8 % mark-up is applied only to the eligible direct costs borne by an FSC branch or subsidiary to give the amount of taxable profits. The eligible costs do not include the direct costs relating to advertising, sales promotion, carriage of goods and credit risk since, according to Belgium, these expenses are directly imputed to the foreign controlled entities with which the FSC branch or subsidiary is dealing.

(48) The Commission notes, first of all, that the 8 % fixed mark-up may understate the profitability level attributable to the FSC branch or subsidiary relative to the mark-up that would have been applied in a comparable transaction by the same enterprise or by another enterprise with an uncontrolled partner. Under the OECD Report's guidelines on the cost-plus method, an appropriate mark-up is added to the direct and indirect costs incurred by a supplier of property or services in a controlled transaction in order to generate profit that is appropriate in the light of the functions performed and taking into account the assets used, the risks assumed and the market conditions. The Commission concludes that, by setting the mark-up at 8 %, the regime does not take into account all possible factors to arrive to an appropriate profit determination and that, in certain cases, it may therefore understate the taxable profits of an FSC branch or subsidiary.

(49) The Commission also notes that the United States exemption of a portion of the foreign trade income of an FSC is conditional on the fact that the 'economic process with respect to such transactions takes place outside the United States'. Under Section 924(b)(1)(B) of the IRC 1986, this requirement is met only if the FSC participates in the solicitations or negotiations leading to the sale of export property or in making the contract of sale and if at least 50 % of its direct costs for the transactions are incurred outside the United States. Under Section 924(e), direct costs include costs of 1. advertising and sales promotion, 2. processing customer orders and arranging for delivery, 3. transporting the goods, 4. invoicing customers and receiving payment, and 5. assuming credit risks. The Commission considers that these activities could generate considerable streams of income for the supplier. The exclusion of business activities from the cost-plus computation method leads to an artificial reduction in the taxable profit. More particularly, the Commission stresses the similarity between the activities that are expressly attributed to an FSC on the basis of costs incurred under Section 924(e) and the costs that are expressly excluded from the profit computation of FSC branches and subsidiaries under the Belgian scheme. The Commission concludes that, by not taking into account the above costs, the scheme has the effect of exempting most of the income attributable to an FSC branch or subsidiary in Belgium.

(50) The Commission thus confirms its assessment according to which the scheme confers on FSC branches and subsidiaries an advantage in the form of a reduction in taxable profits for Belgian corporation tax purposes.

State resources

(51) Second, the advantage must be granted by the State or through State resources. A reduction in taxable profits, such as that granted to companies under the fixed 8 % cost-plus method applied to certain eligible costs, is such as to yield a tax reduction for the beneficiaries and hence a reduction in tax revenue for the Belgian treasury.

(52) The Commission cannot accept the argument of the Belgian authorities that the scheme has led to an increase in tax revenues as a result of the establishment of FSC branches or subsidiaries in Belgium. In its analysis, it makes exclusive reference to the tax revenues that would have accrued to the Belgian treasury if the FSC subsidiaries and branches had been taxed under ordinary Belgian tax law. By comparison with the tax normally imposed on the business activities in Belgium of branches and the subsidiaries of foreign companies, the tax imposed on FSCs operating in Belgium is, in fact, reduced under the scheme. According to paragraph 10 of the Notice, this is equivalent to consumption of state resources in the form of fiscal expenditure.

Effects on competition and trade

(53) Third, the measure must affect competition and trade between Member States. Belgium has criticised the Commission for not having specified in its letter of

12 April 2002 ([16]) the negative effect that the scheme would have had on competition in the light of the purpose of the United States regime for FSCs, which is to confer an advantage on United States exporting companies.

(54) As explained in paragraph 11 of the Notice, competition is affected if the position of a company benefiting from the measure is strengthened compared with that of its competitors. From the above analysis of the functioning of the United States regime, it is clear that the application by Belgium of the cost-plus method under the scheme leads to the determination of lower taxable profit compared with other comparable controlled transactions in Belgium. It also appears that an FSC branch or subsidiary may be active in sectors such as advertising, sales promotion, carriage of goods and credit services, all of which are subject to strong intra-Community competition. The advantage that the special ruling system for the activities of United States FSCs in Belgium confers on beneficiaries in the form of a reduction in the tax base is such as to strengthen the position of FSC branches and subsidiaries as well as the position of the group to which they belong, to the detriment of competitors.

(55) Furthermore, as explained in paragraph 11 of the Notice, the above criterion is also fulfilled if a company benefiting from a measure carries on an economic activity involving trade between Member States. The FSC branches and subsidiaries that are granted a reduction in their tax base under the special ruling system for the activities of United States FSCs in Belgium necessarily form part of international groups that take part in international trade, including Community trade. The Commission concludes that, by conferring an advantage on certain group members, the scheme strengthens the trading position of the group to which the beneficiaries belong as compared with other groups that may also be actively involved in Community trade.

Selectivity

(56) Lastly, the measure must be specific or selective in that it favours 'certain undertakings or the production of certain goods'. The Belgian authorities maintain that, since the circular setting up the scheme has become void, the ruling system for FSCs in Belgium does not differ from the system applicable to any other Belgian subsidiary or branch of a foreign company and would not, therefore, be specific. Accordingly, the fixed 8 % cost-plus method would determine the minimum taxable income deriving from the exercise of commercial activities by a foreign company in Belgium (under Article 182(1)(3)(e) of the Royal Decree implementing Article 342(2) of the CIR 1992), irrespective of whether such activities are exercised by an FSC subsidiary, an FSC branch or any other subsidiary or branch of a foreign company. The exclusion of certain direct costs such as those relating to advertising, sales promotion, carriage of goods and credit risks from the basis for computing the taxable profits of an FSC subsidiary or branch using the cost-plus method would be justified by the fact that the costs relating to such activities constitute the associated company's revenues and, as such, are taxable in the foreign jurisdiction where that associated company is established. The Belgian activities of an FSC branch or subsidiary are only administrative and ancillary in nature, while advertising, sales promotion, carriage of goods and credit-risk costs are attributable to the foreign entities of the group.

(57) After close scrutiny of Belgium's arguments, the Commission confirms its opinion that the ruling system for the Belgian activities of FSCs constitutes a specific scheme applicable exclusively to FSC branches and subsidiaries, and this for the following reasons.

(58) Under ordinary Belgian law (Article 342(1) of the CIR 1992), if a taxpayer is unable to provide evidence of its taxable profits to the tax administration, the latter is to determine such profits by making a comparison with three other similar taxpayers having comparable invested capital, turnover, staff and other relevant elements. In such circumstances (taxpayer unable to substantiate its taxable profits to the authorities), specific rules may be enacted by royal decree in order to fix the minimum taxable profits of foreign companies operating in Belgium (Article 342(2) of the CIR 1992). Article 182(1)(3)(e) of the Royal Decree implementing Article 342(2) sets the minimum taxable profits of foreign companies supplying services not otherwise taxed at 10 % of the gross turnover deriving from such supplies.

(59) The Commission also observes that the arrangements laid down in Article 182(1)(3)(e) do not justify the special tax scheme applicable to FSC activities in Belgium. Furthermore, the flat-rate computation provided for by that Article allows the minimum taxable

([16]) See footnote 1.

profits to be fixed at 10 % applying the 'resale-minus method', as opposed to the fixed 8 % under the cost-plus method.

(60) As indicated above, both under Belgian domestic law and under the tax treaties concluded by Belgium, the tax administration has the power to adjust the book profits of a Belgian taxpayer, whether a separate company or a permanent establishment of a foreign company, that derive from controlled transactions with foreign taxable entities in cases where these profits do not comply with the arm's-length principle.

(61) The Commission recognises that the uncertainty attaching to the determination of arm's-length profit has contributed to the development of an advance ruling practice in Belgium under Article 345(1) of the CIR 1992 designed to ascertain whether certain controlled transactions are conducted at arm's length. Such a general ruling practice is consistent with the principles spelt out in the 1995 OECD Report, which authorises the indirect cost-plus profit determination method provided that it is applied in light of the functions performed by the taxpayer and takes into account the assets used, the risks assumed and the specific market conditions.

(62) The Commission finds that, by setting the appropriate taxable profit level calculated using the method with a fixed 8 % rate, the resulting profit does not take into account the relevant factors verified as part of an arm's-length analysis, such as the functions performed by the taxpayer, the assets used, the risks assumed and the market conditions. It concludes that the scheme for FSCs operating in Belgium is a specific tax scheme which diverges from the ordinary tax arrangements applicable to any other Belgian subsidiary or branch of a foreign company.

Justification by the nature or general scheme of the system

(63) Belgium also maintains that the scheme applies to all foreign enterprises operating in Belgium and not in a position to determine their taxable profits analytically and that this characteristic justifies the application of a special profit computation method.

(64) However, the impossibility of determining profit analytically is not a characteristic peculiar to an FSC subsidiary or branch. The Commission observes that, under the United States legislation, an FSC must be organised or have an office in a foreign country that has an agreement with the United States on sharing tax information, as is the case with Belgium ([17]), where the FSC must keep a set of permanent accounts. Thus, if to benefit from the United States tax incentives, the activities of an FSC must be determined on the basis of separate accounting records, the same records should be taken into account in substantiating before the tax administration in Belgium the FSC's profit deriving from the activities performed in Belgium.

(65) The Commission regards as unjustified Belgium's exclusion of certain direct costs such as advertising, sales promotion, carriage of goods and credit risks from the cost-plus computation basis for taxable profit. As indicated above, these costs relate to business activities normally carried on by FSC branches and subsidiaries in order for the FSC group to benefit from the partial exemption of FSC income from United States tax.

(66) Contrary to what was indicated by Belgium, the profits deriving from such activities are not normally taxed by the foreign jurisdictions in which the business partner of the Belgian FSC is based. The Commission notes that excluding the above-mentioned costs from the profit computation would result in the non-taxation of the corresponding profits both in Belgium and the United States, which is not justified under the international tax principles set out in Article 7(1) of the OECD Model Tax Convention:

'The profits of an enterprise of a Contracting State shall be taxable only in that State, unless an enterprise carries on a business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.'

Furthermore, the Commission observes that the same principles are applied under Belgian domestic law, which stipulates that resident companies are subject to Belgian tax on their worldwide income, while non-resident companies operating in Belgium are subject to tax on the income arising in Belgium.

([17]) See footnote 7.

The Commission concludes that, with respect to the business profits of an FSC subsidiary, the right to tax would arise in the State of residence of such a subsidiary, namely Belgium, while in the case of the profits of an FSC branch the right would arise in the State of the branch, again Belgium. A different allocation of the rights of taxation, as proposed by Belgium, would be an exception under both Belgian tax law and the tax treaties concluded by Belgium. Accordingly, the Commission rejects the justification given by Belgium and based on the fact that it would not have the right to tax FSC activities in Belgium. It thus confirms the specificity of the scheme in question.

Compatibility

(67) The Belgian authorities have not challenged the Commission's assessment in its letter of 12 April 2002 ([18]) that none of the derogations provided for in Article 87(2) and (3) of the EC Treaty, under which State aid may be considered compatible with the common market, applies in the present case. Accordingly, the Commission confirms its assessment, which can be summed up as follows.

(68) In so far as the Belgian scheme for FSCs constitutes state aid within the meaning of Article 87(1) of the EC Treaty, its compatibility must be evaluated in the light of the derogations provided for in Article 87(2) and (3) of the EC Treaty.

(69) The derogations in Article 87(2), which concern aid of a social character granted to individual consumers, aid to make good the damage caused by natural disasters or exceptional occurrences and aid granted to certain areas of the Federal Republic of Germany, do not apply in this case.

(70) Nor does the exception provided for in Article 87(3)(a) apply, which authorises aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment.

(71) In the same way, the scheme cannot be regarded as promoting the execution of a project of common European interest or remedying a serious disturbance in the economy of Belgium, as provided for in Article 87(3)(b). Nor does it have as its object the promotion of culture and heritage conservation as provided for in Article 87(3)(d).

(72) Lastly, the scheme must be examined in the light of Article 87(3)(c), which authorises aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest. The tax advantages granted under the scheme are not related to investment, job creation or specific projects. They simply relieve the firms concerned of charges normally borne by their budgets and must therefore be considered as operating aid the benefits of which cease as soon as the aid is withdrawn. In line with the standard practice of the Commission, such aid could not be considered to facilitate the development of certain activities or of certain economic areas.

Final observations on classification as State aid

(73) The Commission confirms the assessment made in its letter of 12 April 2002 ([19]) to the effect that the scheme for FSC activities in Belgium constitutes aid incompatible with the single market. As indicated above, the scheme entered into force in 1984 without prior notification to the Commission and is therefore considered to be unlawful State aid.

Legitimate expectation

(74) Where unlawfully granted State aid is found to be incompatible with the common market, it must be recovered from the beneficiary. Through recovery of the aid, the competitive position that existed before it was granted is restored as far as is possible. However, Article 14(1) of Regulation (EC) No 659/1999 of 22 March 1999 states that 'the Commission shall not require the recovery of the aid if this would be contrary to a general principle of Community law'. The case-law of the Court of Justice and the Commission's own decision-making practice have established that, where, as a result of the Commission's actions, a legitimate

([18]) See footnote 1.

([19]) See footnote 1.

expectation exists on the part of the beneficiary of a measure that the aid has been granted in accordance with Community law, then an order to recover the aid would infringe a general principle of Community law.

(75) In the judgment in Van den Bergh en Jurgens ([20]), the Court ruled:

'The Court has consistently held that any trader in regard to whom an institution has given rise to justified hopes may rely on the principle of protection of legitimate expectation. On the other hand, if a prudent and discriminating trader could have foreseen the adoption of a Community measure likely to affect his interests, he cannot plead that principle if the measure is adopted.'

(76) Belgium has invoked the legitimate expectation of the beneficiaries with respect to a tax scheme in existence since 1984 and which in 1985 the Commission had considered to have a minimal effect on employment in the Community and thus, according to Belgium, on competition in general ([21]). In any event, Belgium has announced its willingness to dismantle the scheme as soon as the United States definitively complies with the WTO rulings and by 31 December 2003 at the latest.

(77) Pursuant to Article 14(1) of Council Regulation (EC) No 659/1999, the Commission takes into account the exceptional circumstances justifying non-recovery of aid unlawfully granted to the beneficiary of a scheme where this would be contrary to a general principle of Community law such as respect for legitimate expectation. In the present case, it notes that the scheme for FSC activities in Belgium bears a close resemblance in many respects to the scheme introduced in Belgium by Royal Decree No 187 of 30 December 1982 on the tax treatment of coordination centres. Both schemes concern intra-group activities and both use the cost-plus method to determine the tax base. In its decision of 2 May 1984, the Commission considered the scheme not to be aid within the meaning of Article 92(1) of the Treaty (now Article 87(1)). Even if this decision was not published, the fact that the Commission did not raise any objections to the Belgian coordination centres scheme was mentioned both in the Fourteenth Report on Competition Policy and in an answer to a parliamentary question ([22]).

(78) In this context, the Commission notes that its decision on the Belgian coordination centres scheme was taken before the entry into force of the scheme for FSC activities in Belgium. It thus considers that the beneficiaries of the scheme had a legitimate expectation that, at the time they benefited from the scheme, it did not constitute aid, thereby preventing the Commission from ordering the recovery of any aid granted.

(79) With reference to Belgium's willingness to dismantle the scheme by December 2003 at the latest, the Commission considers that the principle of legitimate expectation would cover enterprises approved under the scheme before the opening of the formal investigation procedure in respect of any aid granted up to the end of the tax year in which the procedure is closed.

VI. **CONCLUSIONS**

(80) The Commission finds that Belgium has, in breach of Article 88(3) of the Treaty, unlawfully implemented the tax ruling system for the business activities of FSCs as applied by the Belgian tax administration since January 1985. It concludes that the tax reliefs accorded under the scheme constitute State aid that is not covered by any of the derogations from the prohibition of such aid and is therefore incompatible with the common market.

(81) The Commission also finds that the enterprises approved under the scheme had a legitimate expectation that, at the time they benefited from such a scheme, it did not constitute aid. Accordingly, it will not require recovery of the aid,

HAS ADOPTED THIS DECISION:

Article 1

The State aid scheme implemented by Belgium in the form of the special ruling system for the business activities of United States foreign sales corporations in Belgium is incompatible with the common market.

([20]) Case C-265/85 Van den Bergh en Jurgens BV v Commission [1987] ECR 1155, paragraph 44.
([21]) See footnote 9.
([22]) Written Question No 1735/90 (OJ C 63, 11.3.1991).

Article 2

Belgium shall abolish the aid scheme referred to in Article 1 with effect from the first tax year following the date of notification of the present decision.

Article 3

Belgium shall inform the Commission, within two months of the date of notification of this decision, of the measures taken to comply with it.

Article 4

This decision is addressed to the Kingdom of Belgium.

Done at Brussels, 24 June 2003.

For the Commission

Mario MONTI

Member of the Commission