FISCAL STATE AID: WHAT CONCLUSIONS MAY BE DRAWN FROM THE EU'S RESERVATIONS

by **PIERGIORGIO VALENTE**
Chairman IAFEI International Tax Committee Managing Partner of Valente Associati GEB Partners

Introduction

Tax evasion has remained in the top of the "heatedly-debated-issues" charts for several years and is not expected to "drop down" soon. Instead, the intensity in the fight against it seems to be increasing on every occasion (Lux Leaks, Panama Papers etc.). In this "war", European Commission's (EU) decisions on fiscal state aid are beyond doubt the most controversial "weapon". In essence, such decisions invalidate tax rulings issued by Member States since they allow multinationals (MNEs) to pay less tax than standalone companies in comparable situations under Member States' tax laws in violation of state aid rules. Apple[1] , Starbucks[2], Fiat[3] are some of the most striking cases where EU, applying the above rules, ordered payment to the relevant member state of unpaid taxes amounting from € 20-30 million to € 13 billion.
McDonald's[4] and Amazon's cases are still pending while new ones are being opened on an alarmingly regular basis. For MNEs, these imply (i) increased risk of tax rulings becoming subject to investigation as well as (ii) the end of the illusion that tax rulings can actually guarantee immunity agreed transfer prices (TP).

In addition, potential discovery of reasons for the EU to open a case or – worse – to issue a decision on the existence of fiscal state aid means huge costs for the MNE, not only in terms of recovery but also of reputational damage. In light of the above, it is crucial that boards are fully aware of the current developments in the area of fiscal state aid and their implications and take them into account in their tax risk management policies. This article gives an overview of the most recent EU actions in the field and the lessons to be learned therefrom.

Cases: Apple, Starbucks, Fiat

Very recently, Ireland was found to have granted state aid to Apple by virtue of a tax ruling issued in 1991 and revised in 2007. These two tax rulings constitute the agreement between Ireland and Apple on the method for the calculation of the net profit of the Irish PEs of two Apple-group companies[5]. The remaining profit was allocated to the "head offices" of the PEs, which however were found to exist "only on paper"; in fact before the opening of the investigation, Ireland admitted that "the territory of tax residency […] was not identified."

It follows that the residual net profit remained untaxed. The decision opening the case[6] referred to the following discrepancies in the tax rulings in question: (i) inappropriate use of operating costs as net profit indicator for the application of Transactional Net Margin Method (TNMM) where specific know-how is/was identified; (ii) lack of any justification for mark-up on operating costs[7]; (iii) untenable justification for the use of lower mark-up for costs exceeding specified amount[8]; (iv) lack of justification for the existence of a capital allowance claim as well as the limit relating the-

1 http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_SA_38373
2 http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_SA_38374
3 http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_SA_38375
4 http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_SA_38945; http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_SA_38944

5 Apple Operations Europe and Apple Sales International
6 The final decision of the EU is not publicly available yet. We refer to C(2014) 3606 final dated June 11, 2014
7 The mark-up seemed to be the result of reverse engineering, on the basis of the amount of net profit desired as the end result.
8 EC noted that "employment considerations" cannot constitute a valid reason in the context of application of the arm's length principle.

reto; and (v) open-end duration (in fact effectiveness for 15 years) implying lack of adjustment to changing circumstances.
It is worth noting that no TP report had been submitted.
The Netherlands and Luxembourg were also found to have conferred state aid to Starbucks and Fiat accordingly by virtue of tax rulings confirming the TP reports presented.

In particular, the Netherlands affirmed the calculation of the net profit of the Dutch subsidiary[9] applying TNMM and using operating costs - (considered) relevant to value adding activities of such subsidiary as net profit indicator. The remaining profit was paid as royalty to (related) UK partnership, which was not liable to pay corporate tax in the UK. Most strikingly, the amount of the royalty was not itself calculated at arm's length. The EU applied the principle using as comparables agreements concluded either by Starbucks with independent parties or by their competitors on the market; in addition it took into account the lack of (i) any benefit for the Dutch subsidiary from the exploitation of the know-how for which the royalty was paid and (ii) any other justification of the payment (services offered/risks undertaken).

They reached the conclusion that no royalty should have been paid. Another discrepancy was the non- application of the arm's length principle on COGS (cost of goods sold) which were however deductible from the accounting profits of the Dutch subsidiary. It is further relevant that the tax ruling would be effective for 10 years. In the Fiat case, EU acknowledged that TNMM is appropriate for the calculation of the arm's length profit of enterprises, such as financial institutions or the Fiat subsidiary, engaging in financial transactions with different counterparties and under different terms; in such cases capital is an appropriate net profit indicator. However, there were derogations from the arm's length principle: (i) underestimation of capital to be remunerated by misapplication; (ii) the capital in excess of the thus (under)estimated figure was inappropriately deducted from the capital to be remunerated as "equity supporting investments in foreign group members" and (iii) return on the thus calculated (hypothetical regulatory) capital was inappropriately estimated on Capital Asset Pricing Model (CAPM), the application of which was not flawless either[10].

9 Starbucks Manufacturing BV

10 According to EC, CAPM should be used on accounting entity and not on regulatory capital; moreover the beta used for the application of CAPM was calculated (i) on the basis of inappropriate comparables; and (ii) without taking into account important functions of the subsidiary.

EU notice on the notion of state aid

Guidance with respect to tax rulings may be found in the notice published in July by the EU on the notion of state aid[11]. The notice clarifies that tax rulings may (only) ascertain TP leading to a "reliable approximation of a market based outcome". Point of reference should be the prices that "would be charged in conditions of free competition between independent undertakings negotiating under comparable circumstances"[12]. The resulting tax liability should not be more favourable compared to standalone companies. As regards OECD TP Guidelines, it is highlighted that tax rulings endorsing TP arrangements (i) complying with such Guidelines, including the guidance on the choice of the most appropriate method and (ii) leading to a reliable approximation of a market-based outcome, are unlikely to be considered as giving rise to state aid.

Implications for MNEs and Conclusion

It is arguable whether the steps taken by the EU in the area of fiscal state aid answer more questions than they raise. Its decisions have been heavily criticized for damaging legal certainty. Indeed MNEs cannot and should not rely on tax rulings as an appropriate defense of their TP practices, regardless of their being acts of sovereign states. With respect to the notice, it is argued – and justifiably so – that it inappropriately focuses on comparability of standalone and group entities[13]. In any case there is room for improvement: transfer pricing is in essence an economic concept requiring precise and economic-scientific rules that would be applied without large margins for appreciation and hence for disagreement. Nevertheless, it cannot be denied that all the above are steps towards a clearer construction of state aid rules, including application of arm's length principle, and there are useful lessons to be learned therefrom:

1. TP reports should be fully substantiated, with reference to any and all factual and economic elements;
2. OECD TP Guidelines should be followed as closely as possible;
3. Practices considered inappropriate or even questionable by the EU in its state aid decisions, such as those mentioned above should be avoided;
4. All results should help to "survive" the scrutiny of the rationale underlying the "prudent independent operator acting under free competition market conditions;"
5. Tax rulings should not be requested or granted for

11 http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.C_.2016.262.01.0001.01.ENG&toc=OJ:C:2016:262:TOC

12 Belgium and Forum 187 v Commission, Joined cases C-182/03 and C-217/03

13 Nicolaides P. State Aid Rules and Transfer Pricing. Available at: http://stateaidhub.eu/blogs/stateaiduncovered/post/6730

more than five (5) years[14] and should be reviewed, if already agreed for such longer period.

As EU has repeatedly noted, “tax rulings as such are perfectly legal” and they have a particularly important function, i.e., “establishment in advance of the application of the ordinary legal system to a particular case in view of its specific facts and circumstances.”

They can and they do provide legal certainty as regards tax treatment of a specific transaction by the issuing member state. They do so more than any other available alternative. What the herein examined developments show is that tax rulings are not immune to scrutiny in marginal cases: unfair arrangements shall be screened and condemned, regardless of any “tax-ruling cover”. The moral of the story may be that MNEs can still rely on tax rulings, provided that all relevant elements are fully and properly justified in accordance with OECD TP Guidelines. On the other hand, EU should not be discouraged from further clarification of the applicable rules.

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14 EC notes in Apple decision (see footnote 1).