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European Commission adopts first two decisions in EU tax probe in push for corporate tax reform

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On 21 October, the European Commission ("EC") adopted its first decisions in its investigation into Member States' tax rulings. The investigation, which began in June 2013, has also targeted tax rulings given to Apple and Amazon as well as Belgium's so-called "excess profits regime". Although the investigation is conducted under EU State aid rules, it is part of a broader strategy by the EC to reform corporate taxation in the EU to make it "fairer, more efficient and more growth-friendly".

This week's decisions concern Fiat Chrysler Finance Europe S.A. ("FCF") in Luxembourg and Starbucks Manufacturing EMEA BV ("Starbucks Manufacturing") in the Netherlands. Both companies had agreed Advance Pricing Agreements ("APAs") with the Luxembourg and Dutch tax authorities, respectively, which govern certain inter-company pricing within the Fiat and Starbucks corporate groups. The EC disagreed with the methodology contained in the APAs and, as such, concluded that the APAs artificially reduced the tax burden on both companies, contrary to the EU rules on State aid.

Through these decisions, along with those expected in the other pending cases, the EC appears to be seeking to set precedents for the future assessment under State aid rules of similar measures in favour of other multinational companies. Commissioner for Competition, Margrethe Vestager, said that the decisions were intended to send a clear message to all Member States, and to multinational companies:

> *"National tax authorities cannot give any company, however large or powerful, an unfair competitive advantage compared to others … Our decisions today show that artificial and complex methods endorsed by tax rulings cannot mask the actual profits of a company, which must be properly and fully taxed … [To allow these methods] would disadvantage all the stand-alone companies that are not part of a group."*[1]

Although the legality of tax rulings on transfer pricing arrangements is not affected *per se* by these decisions, multi-national companies with operations in the EU should review their transfer pricing methodologies in light of the full text of the EC's decisions, when they are published, and evaluate their compatibility with EU State aid rules. The decisions may also have a chilling effect on the negotiation of new APAs with the tax authorities of EU Member States.

1 Statement of Margrethe Vestager on 21 October 2015, STATEMENT/15/5881.

The measures targeted

The Commission's decisions focus on transfer pricing, namely the methodologies used by the companies for pricing intra-group transactions. The prices at which intra-group sales are made are very important for tax purposes, since they directly affect a company's taxable profits. The international standard for setting the transfer price is known as the 'arm's length standard', by which the company's profits are taxed as if the intra-group transactions had taken place on terms that would have been agreed to by unrelated parties.[2] Establishing an arm's length price is often challenging and open to differing interpretation. Taxpayers and tax authorities around the world use APAs to establish an agreed level of certainty over the transactions subject to the APA. By its very nature, an APA is an agreement between the taxpayer and the tax authority regarding the arm's length nature of the intra-group transactions. APAs reduce tax controversies, provide certainty to the taxpayer and the tax authority and allow the tax authority to focus enforcement resources more effectively. Thousands of APAs have been agreed between taxpayers and tax authorities around the world.

The EU State Aid Decisions

National tax practices (including APAs) are caught by EU State aid rules when these are deemed to confer an economic advantage, granted from State resources, to certain undertakings or sectors, affecting intra-EU trade and threatening to distort competition. The key question in tax cases – and a point on which the Member States will likely decide to appeal the decision – is whether the measure confers a "selective advantage".

Starbucks and Fiat entered into APAs with the Dutch and Luxembourg tax authorities, respectively. The APAs were based on extensive economic analysis provided by the taxpayers and agreed by the respective tax authorities. The EC's view is that, in these cases, the tax authorities failed to apply the arm's length standard and instead allowed the companies to calculate their taxable profits by relying on artificial and excessively complex methods which were out of line with economic reality. The EC found that the Luxembourg tax authorities allowed FCF to rely on economically unjustifiable assumptions that resulted in FCF's taxable profits in Luxembourg being reduced to a mere 1/20th of what they would have been had the transfer prices corresponded to market conditions. As for Starbucks Manufacturing, the EC concluded that the Dutch authorities allowed it to pay inflated prices for coffee beans and royalties to sister companies based in Switzerland and the UK, thereby artificially reducing profits.

The EU's State aid rules require that the Netherlands and Luxembourg recover the incompatible State aid from the beneficiaries in order to reduce the distortion of competition generated by the aid. In the decisions, the EC provides a detailed formula that Netherlands and Luxembourg will have to apply in order to calculate the amount to be recovered from Starbucks and Fiat, and estimates that this will amount to EUR 20-30 million from each company. However, recovering the alleged State aid could raise issues about the Member States' obligations under applicable Income Tax Treaties and it is an open question which obligation would prevail.

The EC's decisions will most likely be challenged before the EU General Court. Both Luxembourg and the Netherlands have issued formal statements taking issue with the EC decisions.[3] Luxembourg states that the EC used "unprecedented criteria" to establish State aid and "has not established in any way that Fiat Finance and Trade received selective advantages with reference to Luxembourg's national legal framework". It insists that it adheres to international standards, in particular the arm's length principle applicable to transfer pricing. The Netherlands also stated its conviction that international standards were applied and that the transfer pricing methodologies used for Starbucks resulted in the same pricing that would have been used between independent parties.

2 As set out in Article 9 of the OECD Model Tax Convention, and the OECD Transfer Pricing Guidelines.

3 The Luxembourg statement is available here, and the Netherlands statement is available here.

The Bigger Picture

These decisions form part of the EC's strategy to reform corporate taxation in the EU to make it, in its words, "fairer, more efficient and more growth-friendly".[4]

In March 2015, the EC presented a package of tax transparency measures, including a proposal to introduce the automatic exchange of information between Member States on their tax rulings. This was followed in June 2015, with the announcement by the EC of an Action Plan for fair and efficient corporate taxation. During 2016, the EC will relaunch its proposal for the EU to adopt a Common Consolidated Corporate Tax Base, which would, if the 28 Member States can reach agreement, create a single set of rules that companies operating within the EU could use to calculate their taxable profits.

In the coming years, the EU will also have to decide how to implement the OECD's new initiative to attack base erosion and profit shifting ("BEPS"). The objective of the OECD's BEPS initiative is to arm tax authorities with tools to review and attack structures that are perceived as aggressive and enable tax authorities to collect what they believe to be their fair share of tax. On October 5, the OECD released the final version of its comprehensive BEPS package which was immediately endorsed by the G-20 on October 8. The BEPS package is a wide-ranging set of 15 Action Plans addressing every key aspect of international taxation. One of the Action Plans deals specifically with Harmful Tax Practices, namely, tax incentives and other programs designed to encourage investment but also create tax competition. The Action Plan includes detailed recommendations on transparency and encourages tax authorities to share information regarding tax rulings such as APAs. A number of EU Member States have already enacted legislation implementing aspects of the BEPS initiative but it remains to be seen whether BEPS will be fully implemented by EU Member States individually, or in a coherent and coordinated way through legally binding EU rules, as desired by the EC.

The EC's decisions on Starbucks and Fiat, together with the OECD BEPS initiative, clearly indicate that the global environment for international tax has changed. Multinationals must be prepared to respond to these challenges.

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4 European Commission Press release of 17 June 2015 "Commission presents Action Plan for Fair and Efficient Corporate Taxation in the EU", available here.