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Commission's tax ruling cases: Fiat and Starbucks decided

"Tax rulings that artificially reduce a company's tax burden are not in line with EU state aid rules. They are illegal. I hope that, with today's decisions, this message will be heard by Member State governments and companies alike. All companies, big or small, multinational or not, should pay their fair share of tax."

Competition Commissioner Margrethe Vestager

In Brief

> On 21 October, the European Commission ("Commission") ordered Luxembourg and the Netherlands to recover EUR20 to EUR30 million from Fiat and Starbucks respectively as unlawful state aid.

> The Commission decisions relate to tax rulings on the transfer pricing applicable to intra-group transactions. The Commission has found that rulings in favour of Fiat and Starbucks endorsed artificial and complex methods to reduce taxable profits without reflecting economic reality.

> This may only be the tip of the iceberg as the Commission has been looking at tax rulings in different Member States for some time. Decisions relating to tax rulings in favour of Apple and Amazon, and a Belgian tax measure, are expected in the weeks/months to come. It is likely that more cases will follow, triggering recovery of more significant amounts.

> These decisions have far-reaching consequences for many multinational corporate groups, which are now at risk of being liable to pay amounts reflecting up to a decade of taxes that they thought were not applicable to them.

> While tax rulings as such are perfectly legal, these decisions cast a shadow of uncertainty over both past and future tax rulings by Member States; companies will need to be more mindful of state aid risk when relying on any such rulings going forward.

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Background

Combating international corporate tax avoidance has long been a focus of the OECD and the G20. In July 2013 they launched a comprehensive action plan intended to address perceived base erosion and profit shifting ("BEPS") by multinational enterprises. More recently, the OECD published its final BEPS reports containing proposed anti-BEPS measures. The final BEPS package was endorsed by the G20 meeting of Finance Ministers in Lima on 8 October 2015.[1]

Against this backdrop, and in light of the public debate in many Member States regarding the tax planning practices of multinational companies operating in the EU, in 2013 the Commission started looking at the tax ruling practices of certain Member States using its state aid powers and, in particular, whether *"competition in the Single Market is being distorted through selective tax advantages*".[2] By December 2014, and following the "Lux Leaks" incident the month before, the Commission had extended its enquiry to practices in all Member States and had opened formal investigations relating to potential unlawful state aid granted through tax rulings to Apple (Ireland), Starbucks (Netherlands), Fiat Finance and Trade ("Fiat") (Luxembourg), Amazon (Luxembourg), and to several companies in the framework of a Belgian tax measure.[3]

The focus of these investigations has been tax rulings endorsing so-called 'advance pricing arrangements' ("APAs") by which the Member States agree with the individual companies on the criteria to be used for determining the transfer prices charged by the relevant multinational companies for their commercial transactions with related enterprises. However, given the breadth of the Commission's enquiry, future cases may well relate to tax rulings regarding other issues.

What is state aid and how can it apply to tax rulings?

EU state aid control is unique in the world and polices Member States' public spending in favour of individual companies. State aid exists where an economic advantage is conferred selectively to companies by a Member State or through Member State resources, and such advantage distorts competition. Such aid must, as a general rule, not be granted unless authorised by the Commission.

Fiscal measures giving rise to a reduced tax liability for certain companies (as opposed to the generally applicable regime) may be caught by the state aid rules. While the practice of giving tax rulings, in itself, does not breach EU state aid rules (indeed, the Commission recognises that for reasons of legal certainty Member States may provide prior administrative rulings on how specific transactions will be treated fiscally), tax rulings through which public

1 "G20 finance ministers endorse reforms to the international tax system for curbing avoidance by multinational enterprises", OECD press release of 9 October 2015, available here.
2 See Commission press release 14/2742, available here.
3 See Linklaters alert of June 2014, available here.

authorities apply the general rules in an inconsistent and/or overly lenient manner may give rise to state aid.

The focus of the Commission's investigation so far has been on transfer pricing rulings granted to multinational companies. Transfer pricing refers to the common practice of setting prices for transactions between related companies: where the related companies are based in different countries, this will be particularly important as it will determine the taxable income in the countries concerned. As a basic rule, transfer prices should be set at market rates (the 'arm's length' principle) in accordance with OECD transfer pricing guidelines.

The Fiat and Starbucks cases and the Commission's findings

In each case, the Commission takes issue with the way the Member State applied the transfer pricing rules in order to calculate the taxable base in their country.

> Fiat: The Commission scrutinised a tax ruling in which the Luxembourg tax authorities confirm the taxable income of a Fiat Chrysler entity based in Luxembourg in relation to the treasury and finance services it provides to other group companies. The taxable income is determined on the basis of the so-called transactional net-margin method ("TNMM"), which is one of the transfer pricing methods provided in the OECD transfer pricing guidelines. In application of the TNMM, the taxable income of Fiat is determined by calculating a required rate of return on its capital at risk, using the Capital Asset Pricing Model. The Commission argues that the *"artificial and extremely complex methodology"* used is not appropriate for calculating taxable profits reflecting market conditions. The Commission takes particular issue with the fact that (i) due to *"a number of economically unjustifiable assumptions and down-ward adjustments"*, the capital base approximated by the tax ruling is much lower than the company's actual capital and (ii) the estimated remuneration applied to this already much lower capital for tax purposes is also *"much lower compared to market rates"*. It concluded that Fiat had only paid taxes on a small portion of its actual accounting capital at a very low remuneration, resulting in taxable profits which are allegedly 20 times lower than appropriate under market conditions.

> Starbucks: The Commission examined a tax ruling in which the Dutch tax authorities concluded on what amounted to an arm's length remuneration for Starbucks' coffee-roasting activities in the Netherlands. Such remuneration is determined on the basis of a transfer pricing report, which also applied the TNMM. It amounts to a fixed percentage of a cost base consisting of all costs to which Starbucks Manufacturing EMEA BV ("Starbucks Manufacturing") itself adds value. Any profits earned by Starbucks Manufacturing in excess of the taxable remuneration agreed in the ruling are paid to a group

entity outside the Netherlands in the form of a tax deductible royalty. The Commission criticises both the fact that Starbucks Manufacturing paid a *"highly inflated price"* for green coffee beans to a Swiss Starbucks entity and that the royalty it paid for coffee-roasting know-how also *"does not adequately reflect market value"*.

According to the Commission, "tax rulings cannot use methodologies, no matter how complex, to establish transfer prices with no economic justification and which unduly shift profits to reduce the taxes paid by the company". The Commission concluded that the tax rulings in these cases "do not reflect economic reality". No further details on the Commission's assessment are currently available and the actual decisions will be published at a later stage.

The Commission has ordered recovery from the relevant aid beneficiaries, and seemingly therefore found that Fiat and Starbucks did not have legitimate reasons to expect that the tax rulings were EU state aid compliant. The methodology for calculating the amount to be recovered has been set out in the Commission's decision and is to be calculated as the difference between the tax actually paid and the tax that would have been payable without the tax ruling, plus interest. The amounts to be recovered are EUR20 to EUR30 million from each of Fiat and Starbucks but the precise amounts must now be determined by the tax authorities in the respective Member States.

Implications

These decisions have far reaching consequences not only for the companies and Member States involved but also for companies which have benefitted from tax rulings more generally.

First of all, these decisions are the **precursor of many more investigations** by the Commission into tax rulings from several Member States with potentially enormous financial consequences. As a result of these investigations, many multinational corporate groups are now at risk of being liable to pay amounts reflecting up to a decade of taxes that they thought were not applicable to them.

Moreover, these decisions also **create legal uncertainty** by seemingly putting into question the interpretation of the OECD transfer pricing guidelines by Member States' tax authorities. In strongly worded language, the Commission has coined the Fiat and Starbucks transfer pricing arrangements as *"artificial and extremely complex"*, *"economically unjustifiable"* and *"not reflecting market reality"*. However, the press release does not refer to the OECD framework in relation to transfer pricing which is the long-established and globally applicable yardstick for transfer pricing arrangements.

It remains to be seen, once the relevant decisions are published, whether the Commission considers that the relevant OECD guidelines have been misapplied, or whether it finds that a state aid compliant ruling requires a comparison with the remuneration that a "hypothetical prudent market operator" unconnected to the company in question and in a similar position would seek, as it suggested in its decisions to open formal investigations into these cases.

It has been announced that more systematic guidance regarding the assessment of tax rulings by the Commission may be launched next year, but the details of this guidance are not yet known. In any event, the Commission's approach as set out in these decisions is likely to be challenged before the EU courts and it will therefore remain uncertain for a number of years.

Companies seeking new tax rulings on transfer pricing matters will therefore need to carefully consider their approach to ensure compliance with EU state aid rules. In this respect, it is crucial that new (transfer pricing) ruling requests are thoroughly substantiated, that they reflect market reality and comply with all relevant OECD guidance. The selection of the most appropriate transfer pricing method should be determined, in particular, through a functional analysis and the availability of reliable comparables. Furthermore, all relevant legal and economic details of the case will need to be considered to avoid allegations that the tax authorities have applied the general rules in an incorrect/discretionary manner to the selective advantage of the company in question. In certain cases, Member States may consider seeking guidance from the Commission regarding the state aid treatment of a prospective ruling to proactively obtain legal certainty.

Companies benefiting from existing transfer pricing tax rulings may also need to reconsider those rulings and their validity under the state aid regime.

Next steps

Clearly this is a bold step in the Commission's investigations into this area and Starbucks has already announced that it will challenge the decision before the EU courts and Fiat may follow.

A number of other cases (with potentially much greater financial impact) are expected to be concluded in the coming weeks and months. These include decisions on tax rulings obtained by Apple and Amazon, which are expected imminently. But there are a number of other cases currently under consideration and the Commission is still processing further information and individual rulings gathered from the various Member States. These decisions are likely to be the crest of a wave of state aid enforcement against tax ruling practices.

The decisions must also be seen as part of a wider EU policy initiative related to harmful tax competition in general and BEPS in particular. One of the most important developments in this respect is the recommendation in the final BEPS package of the introduction of country-by-country reporting of tax information along with the initiative at EU level for the automatic exchange of tax rulings.[4] These developments would, once implemented, make the tax arrangements that companies have in Member States more visible than is the

[4] See the press release by the Commission, available here.

case today. Given the level of uncertainty created by these decisions, additional legislative initiatives in this area cannot be ruled out.

Conclusion

The Commission recognises that tax rulings remain a useful tool for companies to obtain legal certainty on the tax treatment of their envisaged transactions. The current enforcement wave also does not mean that the Member States' freedom to determine their company income tax rates, adopt tax rulings and enter into APAs is being challenged as such. However, these cases could have significant financial impact on multinationals and lead to further political engagement between Member States, the Commission and non-EU governments. For companies themselves, it becomes crucial to ascertain that tax ruling arrangements are fully compliant with the EU state aid rules, to avoid the risk of recovery at a later stage. Companies should therefore carefully assess existing and potential future rulings in light of these developments.

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