

Agenda

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When tax attacks! Corporate tax arrangements under EU state aid scrutiny

In 2014 the European Commission began in-depth state aid investigations into the corporate tax affairs of well-known multinational companies, including Amazon and Starbucks. If the Commission concludes that these arrangements constitute illegal state aid, its decisions could have far-reaching implications for European companies and their tax authorities. Why are these tax arrangements under investigation, and what are the potential repercussions?

The objective of state aid control is to prevent the distortion of competition when governments grant advantages or incentives to particular companies. The Commission's investigations are focusing on whether the tax base of certain companies has been calculated in a favourable way. If the tax arrangements are found to constitute aid that is incompatible with EU rules, the beneficiary must pay back the aid (with interest) to the relevant member state, subject to a limitation period of ten years.

According to the Commission, any tax ruling that departs from general tax rules, and thereby benefits individual companies, may, in principle, constitute state aid:

Every decision by the administration that departs from the general tax rules and benefits individual undertakings leads in principle to the presumption of state aid and must be analysed in detail.¹

As well as investigating international household names including Amazon, Apple, Starbucks, and Fiat Finance and Trade,² the Commission is scrutinising the tax affairs of a larger number of European companies.³ As the state aid remit is potentially far-reaching, and given that the new President of the Commission has stated that 'the EU and all its Member States should step up their efforts to combat tax evasion and tax fraud', the investigations could have significant consequences for European companies and their tax authorities.⁴ This article explores why the Commission is investigating the tax arrangements of these companies, and considers the investigations' potential repercussions.

Why are corporate tax arrangements under scrutiny?

The Commission's state aid investigations focus on the prices charged for transactions between different

subsidiaries of the same corporate group (known as transfer pricing arrangements), and the corresponding calculation of the taxable bases of the subsidiaries. Transfer pricing influences the allocation of taxable profit between subsidiaries of a corporate group located in different countries.

In the case of Apple, Starbucks and Fiat Finance and Trade, the focus is on tax rulings that validated Advance Pricing Agreements (APAs). An APA sets out the pricing methodology that applies to all subsidiaries of the same corporate group when calculating taxes.

If the tax base of a company is calculated in a 'favourable' way, this may give the company a selective advantage; indeed, the Commission has stated that:

National authorities must not allow selected companies to understate their taxable profits by using favourable calculation methods. It is only fair that subsidiaries of multinational companies pay their share of taxes and do not receive preferential treatment which could amount to hidden subsidies.⁵ [emphasis added]

State aid exists if the following four criteria are all met:⁶

- the state has some involvement in the measure, which is financed through state resources;
- the measure confers an advantage on its recipient;
- the advantage is selective;
- the measure distorts or threatens to distort competition, and has the potential to affect trade between member states.

State aid is illegal unless it can be demonstrated that the aid is compatible with EU rules ('good aid'). As set out by the Commission, good aid is 'well-designed, targeted at identified market failures and objectives of common interest and least distortive'.⁷ Examples include aid that stimulates innovation or green technologies, avoids environmental harm, and promotes growth within the EU.

According to the Commission's Opening Decisions in the tax rulings cases, it is relatively straightforward to demonstrate that the first and last criteria for state aid are met, as follows.⁸

- As the tax rulings have been issued by the tax authorities of the relevant member state, and the rulings have resulted in lower tax revenues than would otherwise have been available to that member state, the first criterion is deemed to be met.
- In terms of the fourth criterion, as the investigations focus on global companies that operate across a number of European countries, any aid is deemed to distort or threaten to distort competition, and has the potential to affect intra-EU trade.

The most contentious question is therefore whether the tax rulings confer a selective economic advantage on the companies concerned by lowering their tax liabilities in certain jurisdictions. This question about whether tax rulings confer an economic advantage is explored below.

Corporate tax arrangements: is there a selective economic advantage?

The Commission applies the market economy operator principle (MEOP; see the box top right) to assess whether the tax arrangements confer an economic advantage on the company concerned. This approach is in line with the General Court's ruling in the 2012 EDF case:

an economic advantage must — even where it has been granted through fiscal means — be assessed inter alia in the light of the private investor test.⁹

To apply the MEOP test, the methodology used to calculate the taxable basis, as validated by the tax rulings by the member state, needs to be compared with the 'prudent behaviour of a hypothetical market operator'.¹⁰ According to the Commission, the tax rulings should not lead to the subsidiaries concerned paying lower tax than other undertakings in a 'similar legal and factual situation'.¹¹

OECD member states have adopted the 'arm's-length principle' to establish commercial conditions between subsidiaries within the same corporate group. According to this principle, commercial and financial relations between associated subsidiaries should not differ from relations between independent companies. The arm's-length principle forms the benchmark for the application of the MEOP test.

The OECD's Transfer Pricing Guidelines provide internationally accepted guidance for establishing the

What is the MEOP test, or private investor test?

The MEOP test, or private investor test, compares the behaviour of public authorities against that of similar private economic operators under normal market conditions to assess whether economic transactions carried out by public authorities confer an advantage.

In relation to the state aid investigations of the tax rulings, the MEOP test determines whether the transfer pricing arrangements between subsidiaries within the same corporate group depart from arrangements that a prudent independent operator acting under normal 'market conditions' would have accepted. In this context, market conditions refer to transfer pricing established at arm's length.

Note: The MEOP test is a general term introduced by the Commission that is synonymous with the market economy investor principle (MEIP). For further details, see European Commission (2014), 'Communication from the Commission, Draft Commission Notice on the notion of State aid pursuant to Article 107(1) TFEU'.

Source: Based on European Commission (2014), 'Communication from the Commission, Draft Commission Notice on the notion of State aid pursuant to Article 107(1) TFEU'; and European Commission (2014), 'State aid SA.38373 (2014/C) (ex 2014/NN)—Alleged aid to Apple', *Official Journal of the European Union*, 17 October, paras 54–55.

arm's-length principle.¹² The OECD distinguishes between traditional methods and transactional profit methods, and regards the former as the most appropriate basis for establishing whether commercial and financial relations between associated subsidiaries are at arm's length. This is shown in Figure 1.

Although the OECD's guidelines are accepted internationally, there are many practical difficulties associated with their application, which complicates the application of the MEOP test. Indeed, the Commission has

Figure 1 How does the OECD recommend that arm's-length pricing is established?

Traditional methods	Transaction profit methods
<ul style="list-style-type: none"> • comparable uncontrolled price method—comparison based on prices charged in similar transactions between independent companies; recommended by the OECD as the most direct and reliable means of establishing arm's-length pricing • cost-plus method—comparison based on costs incurred by suppliers in intra-group transactions, plus a profit mark-up (based on comparable transactions) • resale price method—comparison based on prices at which products/services that have been purchased from an associated enterprise are resold to an independent enterprise, net of selling costs 	<ul style="list-style-type: none"> • transactional net margin method—comparison based on a specific profit indicator (such as the return on assets) • transaction profit split method—benchmarks the division of profits that independent enterprises would have expected from engaging in economic transactions (based on comparable transactions or key allocation drivers such as assets, capital or costs)

Source: Oxera, based on OECD (2010), 'Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations', 22 July.

noted that ‘depending on the facts and circumstances of the taxpayer, not all methods approximate a market outcome in a correct way.’¹³ For example, in the case of Apple, Starbucks and Fiat Finance and Trade, the tax authorities did apply one of the methods from the OECD’s Transfer Pricing Guidelines—the transaction net margin method—yet the companies’ tax rulings are nonetheless under investigation by the Commission.¹⁴ There may also be problems associated with other methods; for example, based on the Commission’s decisional practice in tax state aid cases, which dates back to the early 2000s, rulings allowing taxpayers to use fixed margins for a cost-plus or resale-minus method may also involve state aid.¹⁵

The box below provides an overview of the Commission’s investigation of Apple’s Irish subsidiary.

Under the Commission’s approach, if the method of taxation leads to a taxable base that is lower than the level that would result from the application of the arm’s-length principle, this is deemed to provide an economic advantage to the company concerned. However, as illustrated by a recent judgment from the General Court in relation to Spanish tax cases, as described in the box top right, the assessment of whether an economic advantage is selective can be contentious.

This example illustrates that tax measures that could, in principle, be received by any company are unlikely to be selective unless it can be shown that, in practice, the

Why is the Commission investigating the tax affairs of Apple’s Irish subsidiary?

The Commission is investigating whether the tax rulings concluded between the Irish tax authorities and Apple’s two Irish branches—Apple Sales International and Apple Operations Europe—in 1991 and 2007 respectively depart from market conditions.

The Commission reached a preliminary conclusion that the tax arrangements might constitute illegal state aid, for the following reasons.

- The methods used to determine the profit allocation to the two Irish branches are not supported by an economic assessment, and seem to be driven partly by employment considerations in Cork.
- The taxable basis does not appear to be substantiated by reference to comparable transactions. According to the Commission, the Irish tax authority, Irish Revenue, accepted the calculation of profit attributable to Apple’s Irish branch on the basis of actual costs, without an accompanying explanation.
- The first APA was fixed for 15 years, despite significant changes to the economic environment over this period.

Source: European Commission (2014), ‘State aid SA.38373 (2014/C) (ex 2014/NN)—Alleged aid to Apple’, *Official Journal of the European Union*, 17 October.

What did the General Court conclude in the Spanish cases?

In 2014 the General Court annulled a Commission Decision that the favourable tax treatment of Spanish acquisitions in other member states constituted state aid.¹ The Court concluded that the Spanish scheme was not selective, as all companies satisfying the requirements were entitled to the tax relief.² Furthermore, it concluded that the Commission had to demonstrate that the effect of the measure was to benefit a class of undertakings defined in some way other than their eligibility for the favourable tax treatment.

Source: ¹ European Commission (2011), ‘State aid: Commission requires Spain to abolish tax schemes favouring acquisitions in non EU countries’, 12 January. ² General Court of the European Union (2014), ‘Judgments in Cases T-219/10 Autogrill España SA v Commission and T-399/11 Banco Santander SA and Santusa Holding SL v Commission’, 7 November.

measures are available only to certain categories of firms. However, there is no clear dividing line to determine when a tax measure is considered to be open to only a limited category of firms. Therefore, as recently highlighted by the new President of the Commission, there is likely to be significant focus on the question of whether the tax arrangements are selective.¹⁶

What economic and financial analysis is required in order to apply the MEOP test?

Detailed economic and financial analysis is central to the application of the MEOP test in order to assess whether the tax arrangements confer an economic advantage. The areas of analysis include:

- benchmarking the price of intra-group transactions over time with prices for similar transactions between independent companies (i.e. companies not operating within the same corporate group);
- a comparison of the profitability of the subsidiaries under investigation over time with benchmark profitability metrics.¹⁷ The analysis would consider how the profitability of the subsidiaries has evolved over time, including the drivers of any changes in profitability. The benchmark profitability metrics could include measures of the appropriate return for the subsidiaries in question, taking into account their risk exposure and/or profitability metrics for comparable independent companies that are exposed to similar risks and are operating in a similar geographical area;
- a comparison of the approach to calculating the taxable base of the subsidiaries over time with methods used by comparable independent companies to determine the taxable base and/or comparable corporate groups not under investigation. For example, if the APA stipulates a mark-up above costs, this could include an assessment

of the relevant cost base for the application of the mark-up. The assessment would consider how the taxable base of the subsidiaries under investigation has evolved over time, focusing on the relationship between the evolution of revenues, costs, profits and tax payments of the subsidiaries under investigation. This analysis would identify any material divergences in the trends of key financial metrics of the subsidiaries under investigation relative to those of comparable independent companies or corporate groups not under investigation;

- an assessment of the cost-reflectivity of the transfer prices, by comparing the price of intra-group transactions over time with the costs associated with the transaction, including an appropriate allocation of group overheads, financing costs and profit allowance;
- an examination of the profitability of the subsidiaries within the same corporate group under alternative allocation drivers (including an economic assessment of the most appropriate driver(s) to allocate profit in each case).

Robust economic analysis will therefore be required in order to apply the MEOP test and thereby determine whether the tax arrangements confer an economic advantage.

What are the likely implications of the ongoing tax investigations?

The Court's Decision in *Lufthansa Hahn* set a precedent for a national court to order the recovery of 'aid' at the stage when

the Commission starts a formal investigation (i.e. prior to the Commission reaching a Decision about whether a measure constitutes illegal state aid). In light of the Commission's scrutiny on corporate tax arrangements, and the precedent from *Lufthansa Hahn*, this could lead to a higher number of private actions in front of national courts.¹⁸

If the Commission concludes that the tax arrangements constitute illegal state aid, valuing the advantage for the purposes of recovering the aid is likely to be highly contentious, since the arrangements do not involve an explicit transfer of state resources.

The Commission's decisions could have implications for any multinational company whose applicable tax rate in any EU country has been reduced by a tax ruling. As the OECD Guidelines allow taxpayers to select the transfer pricing method, provided it results in arm's-length pricing, it may be more challenging for companies to be confident that the tax rulings received will not be subject to state aid challenge without a robust economic assessment.

With recent reports that the tax affairs of an additional 300 multinationals could potentially come under the Commission's scrutiny, ensuring compliance with state aid rules is likely to become increasingly important in corporate tax planning.¹⁹

¹ European Commission (2014), 'Communication from the Commission, Draft Commission Notice on the notion of State aid pursuant to Article 107(1) TFEU', para. 171.

² European Commission (2014), 'State aid SA.38374 (2014/C) (ex 2014/NN) (ex 2014/CP)—Netherlands, Alleged aid to Starbucks', *Official Journal of the European Union*, 11 June; European Commission (2014), 'State aid SA.38373 (2014/C) (ex 2014/NN)—Alleged aid to Apple', *Official Journal of the European Union*, 17 October; European Commission (2014), 'State aid SA.38375 (2014/C) (ex 2014/NN)—Alleged aid to FFT', *Official Journal of the European Union*, 17 October; and European Commission (2014), 'State aid: Commission investigates transfer pricing arrangements on corporate taxation of Amazon in Luxembourg', 7 October.

³ For further details, see, for example, European Commission (2014), 'State aid: Commission extends in-depth investigation into Gibraltar corporate tax regime to include tax rulings practice', 1 October; and European Commission (2014), 'State aid: Commission questions tax exemptions for Dutch public companies and takes steps to ensure fair competition between EU ports', 9 July.

⁴ For further details, see Juncker, J.-C. (2014), 'Juncker Speech at G20 in Brisbane', *EU Today*, 15 November.

⁵ European Commission (2014), 'State aid: Commission investigates transfer pricing arrangements on corporate taxation of Amazon in Luxembourg', press release, 7 October.

⁶ Based on European Commission (2014), 'State aid SA.38374 (2014/C) (ex 2014/NN) (ex 2014/CP)—Netherlands, Alleged aid to Starbucks', *Official Journal of the European Union*, 11 June, para. 68; and European Commission (2014), 'State aid SA.38373 (2014/C) (ex 2014/NN)—Alleged aid to Apple', *Official Journal of the European Union*, 17 October, para. 47.

⁷ European Commission (2012), 'Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions', 8 May, para. 12.

⁸ European Commission (2014), 'State aid SA.38373 (2014/C) (ex 2014/NN)—Alleged aid to Apple', *Official Journal of the European Union*, 17 October, paras 47–48.

⁹ Case C-124/10 P *Commission v EDF* [2012] EC, para. 92. Oxera is advising EDF on this case.

- ¹⁰ European Commission (2014), 'State aid SA.38373 (2014/C) (ex 2014/NN)—Alleged aid to Apple', *Official Journal of the European Union*, 17 October, para. 563.
- ¹¹ European Commission (2014), 'State aid SA.38373 (2014/C) (ex 2014/NN)—Alleged aid to Apple', *Official Journal of the European Union*, 17 October, para. 53.
- ¹² OECD (2010), 'Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations', 22 July.
- ¹³ European Commission (2014), 'State aid SA.38375 (2014/C) (ex 2014/NN)—Alleged Aid to FFT', *Official Journal of the European Union*, 17 October, para. 62.
- ¹⁴ European Commission (2014), 'State aid SA.38375 (2014/C) (ex 2014/NN)—Alleged Aid to FFT', *Official Journal of the European Union*, 17 October, para. 65.
- ¹⁵ European Commission (2014), 'Communication from the Commission, Draft Commission Notice on the notion of state aid pursuant to Article 107(1) TFEU', para. 176.
- ¹⁶ For further details, see Competition Policy International (2014), 'EU: Vestager braces for legal challenges to tax probe', 16 December.
- ¹⁷ For example, if the APA stipulates a mark-up above costs, this mark-up could be compared with benchmark profitability metrics for independent companies.
- ¹⁸ Case 284/12 *Lufthansa v Flughafen Frankfurt-Hahn*.
- ¹⁹ See Houlder, V. (2014), 'State aid probes set to intensify in wake of leaks?', *Financial Times*, 6 November.