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Discussion Paper

The economics behind the EU tax ruling investigations

Abstract

In October, the Commission ordered Amazon to pay back €250 m in taxes to Luxembourg. Already in 2016, the Commission shocked the world by demanding Ireland to recover €13.6 bn in illegal state aid from Apple and earlier that year, Belgium had to recover €700 m in tax support from 35 multinationals. In 2015, the Netherlands and Luxembourg were demanded to recover €20 – 30 m in illegal State aid from Starbucks and Fiat respectively.

Decisions on McDonald's, GDF Suez (now Engie), and Gibraltar are still expected and there will be more investigations into tax rulings, as the Commission has a database of more than 1,000 tax rulings. These investigations undermine the purpose of tax rulings: for multinationals to gain legal certainty on the right application of national tax laws to their context. Understanding the economics behind these investigations can help restoring this legal certainty in the future.

Record recovery of €13.6 bn from Apple, only the beginning?

In recent years, the European Commission ("the Commission") started investigating tax practices in Europe, to limit distortion of competition in the internal market through tax systems or tax rulings by Member States. The decisions on Amazon, Apple and Starbucks have created political tension between the EU and the US, and the investigation on McDonald's, amongst others, is still ongoing.

More investigations are likely to follow, as the Commission created a database of more than 1,000 tax rulings for multinationals by Member States. This database is reviewed based on an "outlier first" approach.

Tax rules have always been a potential source of State aid.[1] What is new is that rules are now being tested based on practical concepts such as transfer pricing. The Commission is not questioning tax rulings *per se*, the aim of which is to clarify the application of tax rules to a certain company's context. They want to prevent multinationals from taking advantage of tax systems by aggressive tax planning.

Tax rulings are meant to increase legal certainty, which is undermined by the uncertainty regarding future investigations. This is why the analytical approach by the Commission merits attention; understanding it will be key to ensuring legal certainty of tax rulings in the future.

[1] In 1974, the Court of Justice of the EU clarified that European State aid control also covers direct business taxation (Case 173/73, Italy vs. Commission).

Tax rules can constitute State aid by granting a selective advantage

To understand the assessment by the Commission, let us start with the legal framework. According to Article 107(1) TFEU:

> *"… any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings […] shall, in so far as it affects trade between Member States, be incompatible with the internal market."*

This boils down to five cumulative criteria which need to be met, for aid to be incompatible with the internal market. We already apply all but two (3 and 4) to the case of taxation of multinationals:

1. Existence of an undertaking, which holds for multinationals;
2. Imputability and financed by state resources, both applies to taxation;
3. Existence of an economic advantage that an undertaking would not have obtained under market circumstances;
4. Selectivity of the measure, a measure needs to favour a certain undertaking or groups of undertakings; and
5. Effect of trade between Member States, which is the case with multinationals.

With three out of five criteria being met by nature of tax rulings for multinationals, the focus is on the assessment of an economic advantage (3) and selectivity (4).

For other State aid measures *"the identification of the economic advantage is, in principle, sufficient to support the presumption that it is selective"*[2]. For fiscal measures however, it is difficult to assess the existence of an economic advantage as there is no comparable market situation; businesses cannot tax each other.

Yet, *"(n)ot only the granting of positive economic advantages is relevant for the notion of State aid, but relief from economic burdens can also constitute an advantage"*.[3] By lowering the tax burden for an undertaking or a group of undertakings, a tax ruling or system can confer an advantage. The Commission combines the two criteria and assesses the existence of a selective advantage. This is done in a 3-step approach:

1. Identifying the system of reference;
2. Assessing whether there is a derogation from that system; and
3. Identifying whether a derogation is justified by the nature of the system.

An unjustified derogation from the reference system implies an illegal selective advantage to the multinational. If this was the case, the aid received under such tax rulings has to be recovered by the Member State.

In practice, selectivity is assessed based on the arm's length principle

So far, from the investigation into tax rulings and tax systems, the Commission has issued five decisions:

- Apple (SA.38373), Aug 2016: illegal State aid to Apple with recovery of €13.6 bn[4]
- Amazon (SA.38944), Oct 2017: illegal State aid to Amazon with recovery of €250 m
- Belgian excess profit tax scheme (SA.37667), Jan 2016: illegal State aid, recovery of €700 m from 35 companies
- Starbucks (SA.38374), Oct 2015: recovery of illegal State aid of €20 – 30 m
- Fiat (SA.38375), Oct 2015: decision to recover illegal State aid of €20 – 30 m

[2] Decision by the European Court of Justice, Case C-270/15 P Belgium v Commission para 49

[3] Commission Notice on the Notion of State aid, 2016/C 262/01, para 68.

[4] On 4 Oct 2017, more than a year after this decision, the Commission referred Ireland to the European Court of Justice for failure to recover this amount.

What these decisions have in common is the economic analysis applied in the assessment of a selective advantage. The way this is done is by establishing whether the method of profit allocation approved with the tax ruling departs from a market-based outcome in line with the arm's length principle.

The arm's length principle is originally a valuation principle applied to commercial and financial transactions between related companies; it is the international consensus on transfer pricing, that is valuation of cross-border transactions between associated enterprises or within multinationals for tax purposes.[5] The arm's length principle implies that prices charged between intra-group companies should be in line with what independent companies, each acting in its own best interest, would negotiate under comparable market circumstances.

If a tax ruling endorses a method that departs from this principle, it is found to confer a selective advantage in the meaning of Article 107(1) and therefore constitutes State aid.

In the Apple case, two tax rulings granted by Irish Revenue to two Irish incorporated subsidiaries of Apple – Apple Sales International (ASI) and Apple Operations Europe (AOE) – were found to have breached the arm's-length principle and conveyed a selective advantage based on three lines of reasoning.

First, the tax ruling endorsed a one-sided profit allocation approach, looking only at the Irish operations of ASI and AOE even though both subsidiaries had head offices or management "nowhere" outside of Ireland (EC decision in case SA 38373, para 276). Hence, the Commission argued that all profits should have been allocated to Ireland.

Secondly, the tax ruling endorsed a profit allocation method – based on operating costs – which did not reflect the sales and manufacturing activities performed by ASI and AOE. The Commission argued that a method that reflects the functions provided and risks borne, such as a sales-based profit allocation, would have been more appropriate.

Thirdly, the Commission argued that even applying the same method, higher profit levels should have been allocated for Ireland. The subsidiaries performed R&D and other value creating activities for the Apple brand (e.g. Apple care services) within Ireland, so allocating all profits from IP licenses outside of Ireland was not at arm's length.

The tax rulings were found to derogate from the reference system. Further, this derogation was not justified as no profit allocation or transfer pricing report was provided or considered *ex ante*, at the time the tax rulings were agreed. All reports provided by the Irish authorities were prepared after the beginning of the investigation.

In the other five decisions, the arm's-length principle is also at the core of the analysis.

The official decision on Amazon is not out yet, but from the press release it seems that Commission found that a tax ruling granted by Luxembourg to Amazon endorsed royalty payments from the operating company to a holding company, which were not in line with the arm's-length principle. Similar to the Apple case, the holding company is not subject to business taxation in Luxembourg and has no business activity other than holding IP rights for Europe, which are granted to the operating company. Under a cost-sharing agreement, almost three quarters of the profits of the operating company were allocated to the holding company and hence not taxed. The Commission found that this profit allocation is not in line with economic reality.

In the Belgian excess profit tax scheme case, the tax system in itself was found to

[5] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010.

constitute a deviation from the arm's-length principle by allowing the exclusion from taxation of profits earned above the profits of comparable Belgian companies operating on a stand-alone basis. This is not in line with what independent companies would negotiate, as it allowed for some profits of multinationals to be allocated nowhere.

In the Starbucks case, the Commission found that an advance pricing agreement (APA) granted by the Netherlands confers a selective advantage for two reasons. Firstly, the Dutch subsidiary paid royalties for roasting IP to a UK subsidiary, so roasting IP profits were not taxed in the Netherlands. However, no similar payments were made between Starbucks and third parties, the IP was not exploited in the Netherlands, and the level of the payments was not justified. Secondly, intercompany payments for beans from the Dutch to another Swiss subsidiary were found to be unjustifiably high. Both resulted in lower than market-based profits being reported in the Netherlands and profits not being allocated at arm's length.

In the Fiat case, the Commission found that an APA with Luxembourg conferred a selective advantage on Fiat. Firstly, the use of hypothetical regulated capital as profit level indicator was found not to be market-based, as it was not in line with the functions performed and risks borne and led to an artificially low remuneration. Secondly, even if it was, the capital was underestimated by using arbitrary and low risk weightings and several deductions from assets; resulting in too low profits being allocated to the Luxembourg part of the company.

Hence, in theory, the relevant assessment is whether a tax ruling endorses a derogation from the relevant national reference system. However, in practice, the reference system is defined wider, namely based on the international consensus of transfer pricing: the arm's-length principle.

Comparison with classical State aid assessment

The aim of the European State aid rules is to enable a level playing field for competition in the internal market. In the case of tax rulings and tax systems, competition can be distorted by conferring a selective advantage to an undertaking or a group of undertakings. The analysis above has shown that in all cases, the same analytical framework is applied: to assess whether the tax ruling endorses transfer prices that deviate from a market-based outcome.

The profit allocation method itself as well as the way the method is applied to the intercompany context, should reflect the economic reality. Transfer prices between associated enterprises for the purpose of business taxation should reflect the functions performed and the risks borne in different tax jurisdictions, in line with what independent companies would negotiate.

This test is essentially an economic test. Competition economists and lawyers have applied similar assessments since the early years of State aid investigations.

In other cases, generally cases in which State resources are being transferred to an undertaking or a group of undertakings, the common test applied is to assess whether the public authority provided support at terms that would have been accepted by a private operator operating in a competitive market. If this is not the case, the aid confers an economic advantage. This is the Market Economy Operator ("MEO") test.[6]

The MEO test and the selective advantage analysis have the same aim: to assess whether an undertaking was granted an

[6] Commission Notice on the Notion of State aid, 2016/C 262/01, Section 4.2

economic advantage that it would not have gained otherwise.

While the two types of assessment are applied in different contexts and are technically different, the MEO test and the selective advantage analysis applied by the Commission in the tax ruling investigations use the same methodological approach.

In case of the MEO test, first the baseline scenario with State support is identified. Then, a hypothetical scenario with a market operator acting under normal market circumstances – the counterfactual – is defined. Thirdly, it is assessed whether there is a derogation from this scenario by which the State accepts lower return or lower value than a private operator would have. If this is the case, the measure constitutes State aid.

It does not have to be incompatible State aid though. A support measure could still be compatible, if it meets other terms and conditions of the State aid framework. This assessment goes beyond the MEO test.

The previous two sections have shown that the approach taken to assessing whether tax rulings constitute a selective advantage is very similar to this classical approach.

The baseline scenario – the first step of the classical analysis – in case of tax rulings is the transfer pricing method suggested by the multinational under the tax ruling.

Assessing the counterfactual – the second step of the classical analysis – is the first step of the selective advantage analysis: assessing the relevant reference system. In practice this turns out to be assessing how independent companies each acting in its own best interest would have negotiated transfer prices under normal market conditions.

The second step is assessing whether the baseline scenario with the tax ruling in place deviates from this market-based outcome – similar to the third step of the classical analysis. If this is the case, as in all five investigations discussed above, the aid is likely to constitute State aid.

The third step of the selective advantage analysis, assessing whether the derogation is justified based on the nature of the reference tax system, goes beyond the classical MEO test. It is similar to the analysis of whether a measure, although constituting State aid, can be justified by other parts of the State aid framework so that it is compatible with the internal market.

In case of the selective advantage analysis, the three criteria have to be met or violated (as for criterion 3) cumulatively for the tax ruling to constitute illegal State aid. Hence, a measure is only incompatible, if it is not justified by nature of the reference system.

It is crucial though that such justification is provided on a case-by-case basis and *ex ante,* at the time the tax ruling is granted. As with the classical MEO test, granting a tax ruling that deviates from a market-based profit allocation without justification is found to be a *per se* infringement of State aid rules.[7]

Thus, though technically very different from the classical assessment of the existence of an economic advantage (MEO test), which applies to different contexts, the analytical approach is similar to the way competition economists have assessed State aid cases since the beginning. Key to both is (i) the identification of the right counterfactual, a hypothetical market-based outcome, and (ii) in case the measure deviates from this outcome, an assessment of why a deviation is justified in the case at hand.

[7] Commission Notice on the Notion of State aid, 2016/C 262/01, Section 4.2 - The market economy operator (MEO) test, para 78: *"Whether a State intervention is in line with market conditions must be examined on an ex-ante basis, having regard to the information available at the time the intervention was decided upon. [...] It is not enough to rely on ex-post economic evaluation entailing a retrospective finding that the investment made by the Member State concerned was actually profitable."*

Way forward

Tax rulings will continue to be granted, they are not illegal. However, so far, transfer pricing is done by tax advisors with the aim to minimise the tax burden of multinationals in line with different national tax rules and regulations. The economic reality of what a market-based outcome would look like (the counterfactual) should however not be ignored, as doing so risks an investigation and undermines the aim of tax rulings: to provide legal certainty.

In the context of multinationals, the right standard to assess the counterfactual are the OECD's transfer pricing guidelines. As far as the legal certainty of tax rulings is concerned, any deviation from these guidelines endorsed by tax rulings or systems puts the multinational at risk of tax repayment. The Commission acknowledges this in their Notice on the Notion of State aid:

> *"Those guidelines do not deal with matters of State aid per se, but they capture the international consensus on transfer pricing and provide useful guidance to tax administrations and multinational enterprises on how to ensure that a transfer pricing method produces an outcome in line with market conditions. Consequently, if a transfer pricing arrangement complies with the guidance provided by the OECD Transfer Pricing Guidelines, including the guidance on the choice of the most appropriate method and leading to a reliable approximation of a market based outcome, a tax ruling endorsing that arrangement is unlikely to give rise to State aid."*[8]

The analysis of the five cases on which decisions have been published so far showed that the Commission's view on how to apply these guidelines might differ from the view of tax advisors and national authorities.

While the OECD guidelines endorse different transfer pricing methods, the Commission might find that in the context of a particular tax ruling, some methods better reflect the economic reality of the associated enterprises than others. Thus, while theoretically a wide variety of methodological choices is allowed, in practice some might constitute a selective advantage.

Going forward, in order to ensure or maintain legal certainty of tax rulings, it is essential that multinationals and national authorities no longer simply select the transfer pricing method that minimises the tax burden. In addition, it should be assessed whether the chosen method also reflects the economic reality of the multinational and the reference tax system. Any derogation from the reference tax system should be justified *ex ante*, based on the economic reality of the multinational so that it does not confer a selective advantage.

About the Author

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[8] Commission Notice on the Notion of State aid, 2016/C 262/01, para 173.