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State Aid Investigations in the EU: How the EU Commission Risks the International Consensus on BEPS

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This article provides an overview of the state aid investigations undertaken by the European Commission, and considers how they may jeopardize the international consensus reached on the OECD BEPS project.

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Since June 2013, the European Commission has been investigating the tax ruling practices of Ireland, the Netherlands and Luxembourg with a view to detecting potential state aid concerns. In December 2014, these investigations were extended to the tax ruling systems of all European Union ("EU") Member States. As part of these investigations, the European Commission reviewed tax rulings granted to members of several, mostly U.S., multinational groups. To this day, the European Commission has found state aid to be present in each and every case it has been formally investigating. This article provides an overview of these state aid investigations and considers how these may jeopardize the international consensus reached on the OECD base erosion and profit shifting ("BEPS") project.

I. Introduction

Globalization has led to a tremendous amount of cross-border trade and investment, which supports economic growth, creates jobs and fosters innovation. As with the economy, businesses became more international and today multinational enterprises ("MNEs") represent a large proportion of global business activities.

When investing in a cross-border context, enterprises are regularly subject to tax in different countries. In these circumstances, taxpayers have to cope with inconsistent and complex tax laws which change and evolve on a continuous basis, all the more in the current period. Without effective tax planning, taxpayers are likely to face a high overall tax burden, which may reduce the appeal of doing business in certain jurisdictions and the attractiveness of cross-border investments.

At the same time, the interaction of domestic tax laws may also result in "loopholes" where corporate income is not taxed at all or taxed at nominal rates. There has been a recognition of this, and massive multilateral effort to address these loopholes within the frame of the OECD BEPS project.

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The OECD recognized that these loopholes are perfectly legal and need to be addressed by legal changes with a global coherence. In contrast, the recent state aid investigations of the European Commission seem to suggest that the tax treatment of business activities and intra-group transactions by certain Member States is not legal. However, Member States have the sovereignty to design their own tax rules and state aid cannot be used to undermine this sovereignty.

II. Current State Aid Investigations

A. Overview

In mid-2014, the Commission opened three formal state aid investigations on tax rulings, granted by Ireland to Apple, the Netherlands to Starbucks and Luxembourg to Fiat (now Fiat Chrysler Automobiles). In these cases, the Commission challenged the transfer pricing approaches adopted by the taxpayers.

Further investigations were opened by the Commission later the same year and in 2015 on tax rulings granted by Luxembourg to Amazon and McDonald's and by Belgium in regard to the so-called Excess Profit scheme. On September 19, 2016, the Commission announced the opening of in-depth investigation into Luxembourg's tax treatment of GDF Suez (now Engie), the first non-U.S. MNE in the scope of state aid investigations.

At the end of 2015 and the beginning of 2016, the Commission adopted three negative decisions with recovery regarding the tax ruling granted by the Netherlands to Starbucks, the tax ruling by Luxembourg to Fiat and the Excess Profit Scheme in Belgium. On August 30, 2016, the Commission adopted a negative decision in regard to the tax rulings granted by Ireland to Apple with a spectacular recovery of up to 13 billion euros (plus interest).

The Commission is continuing its investigations concerning the tax treatment of Amazon and McDonald's by Luxembourg. The different cases are outlined in the following sections.

1. The *Starbucks* Case

On June 11, 2014, the Commission initiated an investigation of a tax ruling granted by the Dutch tax authorities in 2008 relating to the transfer pricing of royalties paid by a Dutch subsidiary of Starbucks for coffee-roasting know-how to a U.K. affiliate, as well as the prices paid by a Dutch manufacturing company to a Swiss affiliate for roasting coffee beans.[1] The Commission has issued a final decision in which it concludes that the royalties and the prices paid for green coffee beans exceed the arm's length price. The decision is on appeal to the Court of Justice of the European Union ("CJEU").

2. The *Fiat* Case

On June 11, 2014, the Commission initiated an investigation of an advance pricing agreement ("APA") granted by the Luxembourg tax authorities to a Luxembourg financing company of the Fiat group.[2] The APA confirmed the arm's length character of the margin realized by the company on its financing activities as determined in a transfer pricing study. The Commission has issued a final decision in which it concludes that the financing margin was below the remuneration which would be expected at arm's length. The decision is on appeal to the CJEU.

3. The *Amazon* Case

On October 7, 2014, the Commission initiated an investigation of a tax ruling granted in 2003 by Luxembourg to Luxembourg subsidiaries of the Amazon group in relation to the transfer pricing of royalties paid by a Luxembourg company.[3] The Commission has not yet issued a final decision in regard to this case. However, the Commission's preliminary view is that the amount of the royalty payments might not be in line with market conditions.

4. Belgium's Excess Profit Rulings

On January 11, 2016, the Commission concluded that tax rulings granted by the Belgian tax authorities in regard to Belgium's "excess profit" tax scheme entailed selective tax advantages which are illegal under EU state aid rules.[4] Under the "excess profit" tax scheme, the actual recorded profit of an MNE is compared with the hypothetical average profit a stand-alone company in a comparable situation would have made. The difference in profit is deemed to be "excess profit" by the Belgian tax authorities which is excluded from the company's taxable basis. The decision of the Commission results in taxes of approximately 700 million euros to be recovered from 35 MNEs.

5. The *McDonald's* Case

On June 7, 2016, the Commission released the non-confidential version of its decision to investigate whether a tax ruling granted by the Luxembourg tax authorities to Luxembourg subsidiaries of the McDonalds's group entailed state aid.[5] One of the Luxembourg companies acquired beneficial ownership of several franchise rights intangibles which it allocated to a branch in the U.S. The royalty income realized by the U.S. branch in respect of the franchise rights has been attributable to the U.S. branch and was exempt under the tax treaty concluded between the U.S. and Luxembourg.

In this case, the Commission analyzed whether it was correct for the Luxembourg tax authorities to apply the exemption method in respect of income realized by the Luxembourg company through its U.S. branch. In its decision, the Commission misinterpreted the applicable tax treaty and wrongly concluded that the income attributable to the U.S. branch should have been taxed in Luxembourg.[6] However, the Commission has not yet issued a final decision.

6. The *Apple* Case

On June 11, 2014, the Commission initiated an investigation of two tax rulings granted by the Irish tax authorities in 1991 and 2007[7] to two Irish-incorporated companies that are fully-owned by the Apple group and ultimately controlled by Apple Inc.[8] The tax rulings concern the attribution of profits to an Irish branch of the Irish incorporated company which was, under Irish law, treated as a nonresident for Irish tax purposes because it was not managed and controlled in Ireland. The part of the income that has been attributed to the company's head office was not subject to tax in Ireland. In August 2016, the Commission concluded that Ireland granted undue tax benefits of up to 13 billion euros to Apple (plus interest).

7. The *GDF Suez* (now *Engie*) Case

On September 19, 2016, the Commission initiated an investigation of tax rulings granted by the Luxembourg tax authorities to GDF Suez (now Engie) in regard to financing activities implemented by the group in Luxembourg.[9] The Commission considers that the Luxembourg tax treatment of the entities involved is not consistent with Luxembourg tax law. The preliminary view of the Commission is that the same financial transaction is treated as equity and debt at the level of different Luxembourg companies. In the authors' view, it seems that the Commission did not fully understand all elements of this financing structure, which has a very robust legal foundation, relying on Luxembourg GAAP and clear provisions of tax law. It remains to be seen whether the Commission will arrive at this conclusion when presenting its final decision.

III. State Aid Considerations

A. Opening Comments

State aid has recently acquired a high profile following the political storm over a perceived bias in the targeting of U.S. MNEs by the EU commission. To anyone not versed in EU law, EU state aid proceedings in tax matters can indeed be hard to understand. While it is not our purpose to examine that topic in detail, a few of the more unusual features help illustrate the difficulty:

- State aid is a competition law matter, not a tax law matter. That has wide-ranging consequences, including the potential recovery of state aid from a legal entity other than the one that benefited from the tax relief but that is part of the same enterprise.
- The proceedings take place between the EU Commission and the Member State, meaning that the taxpayer that can end up bearing the bill is not fully represented.
- When a Member State appeals a state aid finding in tax matters, it finds itself in the unusual position of contesting its obligation to collect taxes.

B. The Concept of State Aid

Under Article 107(1) of the Treaty on the Functioning of the European Union ("TFEU"), any aid granted by a Member State or through state resources in any form whatsoever, including tax measures, which distorts or threatens to distort competition by favoring certain undertakings or the provision of certain goods, shall be incompatible with the internal market, insofar as it affects trade between Member States.

According to the settled case law of the CJEU, for a measure to be categorized as aid within the meaning of Article 107(1) of the TFEU, all conditions set out in that provision must be fulfilled. Hence, for a measure to be categorized as state aid, the following cumulative conditions have to be met:

(i) the measure has to be granted by state resources;
(ii) it has to confer an advantage to undertakings;
(iii) the advantage has to be selective; and
(iv) the measure has to affect trade between Member States and to distort or threaten to distort competition.[10]

According to CJEU case law, Article 107(1) of the TFEU requires it to be determined whether, within the context of a particular legal system, a measure constitutes an advantage for certain undertakings in comparison with others in a comparable legal and factual situation.[11] For that purpose, the CJEU developed the following three-step analysis to determine whether a particular tax measure is selective:

(i) identification of the reference legal system (e.g. the corporate income tax system);
(ii) assessment as to whether the measure derogates from that common regime inasmuch as it differentiates between economic operators who, in the light of the objective assigned to the tax system, are in a comparable factual and legal situation ("comparability test"). In other words, it has to be analyzed whether the tax treatment of a taxpayer is more beneficial than that of other undertakings that are factually and legally in a similar situation; and
(iii) according to the jurisprudence of the CJEU, a measure found to be selective on the basis of the "comparability test" can still be found to fall outside the scope of the state aid rules if it is justified by the nature or the general scheme of the system ("justification test").

State aid cases in tax matters usually fail because it cannot be evidenced that an advantage granted to an undertaking is of a selective nature.

C. The Commission's New Approach to State Aid

The more recent decisions of the Commission seem to depart from established CJEU case law and EU state aid law. Although the concepts of "advantage" and "selectivity" are distinct requirements under state aid law, the Commission appears to have collapsed both concepts, as it merely examines whether the measures under investigation entailed a "selective advantage" rather than analyzing both requirements separately.

Here, the Commission deviates from its previous practice where it consistently assessed separately the existence of (i) an advantage, and (ii) the selective nature thereof. Furthermore, in previous state aid investigations, the Commission never challenged how a Member State applied its own transfer pricing rules in granting a specific advance pricing agreement.

The new approach of the Commission has a significant impact in practice. In state aid cases concerning transfer pricing, it now suffices that the Commission disagrees with the application of the arm's length principle. Notably, the Commission does not challenge the transfer pricing laws of the countries involved or the fact that rulings have been granted. Instead, it challenges that transfer prices agreed to in tax rulings (likely in respect of cases with complex factual circumstances) are not consistent with its own interpretation of the arm's length standard. This ignores that transfer pricing is not an exact science but requires the exercise of judgement and that there is commonly not one single arm's length price but a range of arm's length prices which are all at arm's length.

Likewise, in state aid cases concerning the application of domestic tax law or tax treaty law, the Commission appears to consider an advantage to exist (and therefore state aid), whenever it does not like the overall outcome of an investment structure. While in the McDonald's case it has been claimed that Luxembourg misapplied the tax treaty concluded between the U.S. and Luxembourg,[12] in the GDF Suez (now Engie) case the Commission maintains to have found an inconsistent tax treatment at the level of different entities in Luxembourg.

In all these cases, the Commission second guesses the tax officials and, arriving at a different conclusion, which the Commission seems to regard as an absolute truth, concludes that the local officials' decision amounts to a selective advantage, without any consideration of whether the same decision would have been taken in comparable circumstances. The consequence is that any administrative decision in tax matters (which the Commission might in future disagree with) is subject to a 10-year period of uncertainty.

D. The State Aid Procedure

The Commission's state aid investigations into tax rulings follow a two-step approach. The Commission first asks the Member State for a description of its tax ruling practices and relevant documents, together with a list of all tax rulings issued during a specific period (mainly 2010–2013). It then selects tax rulings from that list for a case-by-case review as part of a non-public preliminary investigation. When the preliminary investigation leads to the conclusion that illegal state aid has been granted, the Commission may decide to open a formal investigation that allows it to collect information from all interested parties, including the taxpayer, other Member States, and potential competitors.

If it does open a formal investigation, the decision to initiate the procedure is sent to the relevant Member State. At the end of the formal investigation, for which there is no legal deadline, the Commission adopts a final decision. A negative decision in the context of state aid requires the Member State to recover the aid with interest for the period the illegal aid is granted until the aid is recovered from the beneficiary. These amounts can be significant as there is a limitation period of 10 years for recovery (plus interest).

When the Commission finds that there was illegal state aid, the Member State concerned may appeal the case to the CJEU. As of today, all cases negatively decided by the Commission have been taken to the CJEU, the Supreme Court in these matters that is binding on the Commission and EU States. However, it will take years until we will have clarity from the CJEU: this means that the coming years will continue to be characterized by extreme legal uncertainty in tax matters.

IV. Concerns about the Commission's Current Actions

State aid is a tool to address instances where a Member State has made exceptions to its own rules and given a specific company an advantage. As such, this tool is not suited to deal with complex tax and transfer pricing situations that are covered in tax rulings. The current state aid investigations of the Commission therefore raise a number of concerns.

A. Question of Legal Certainty

To begin with, a fundamental principle of tax law is that changes will only apply for the future and not retroactively. Companies have to know their tax obligations before they structure investments and should be able to plan with them in mind. In this respect, tax rulings only confirm the application of domestic tax law, and potentially treaty law, to a specific investment structure or business activity. Changing tax rules through state aid investigations and asking for retroactive recovery of unpaid taxes for up to 10 years raises questions about legal certainty and the rule of law.

The BEPS Action Plan in its basic premises concluded that the way to address the loopholes in the global tax system is by legal change with a global coherence, while giving business certainty and predictability. The Commission's actions and findings fail to respect these basic premises as they lack a global coherence and have created a complete lack of predictability. Is each and every authority decision now subject to a potential change by the Commission? What is the arm's length principle applied by the Commission? And why was the BEPS project even necessary if the perceived tax avoidance could already be tackled on grounds of the previously existing tax rules?

EU Member States have the sovereignty to design their own tax rules. Furthermore, the Commission does not call into question the granting of tax rulings by the tax administrations of the Member States. It even recognises the importance of advance rulings as a tool to provide legal certainty to taxpayers. State aid cannot be used to undermine this sovereignty: nevertheless, this is exactly what the current state aid investigations in tax rulings appear to be doing.

B. Consensus-Based Framework Undermined

In its BEPS Action Plan, the OECD voiced concerns over the emergence of competing sets of international standards and the replacement of the current consensus-based framework by unilateral measures, which could lead to global tax chaos marked by legal uncertainty and the massive re-emergence of double taxation. Therefore, the OECD adhered to an extremely ambitious schedule when providing its recommendations for a coordinated international approach to combat perceived tax avoidance by MNEs. However, the current actions of the Commission undermine the efforts of the OECD to establish a consensus-based framework for the post-BEPS era.

C. U.S. Concerns

Moreover, the Commission's aggressive investigations of tax rulings granted to members of U.S. MNEs have not passed unnoticed in the U.S. Indeed, when reviewing the list of MNEs involved, one cannot deny that most of them are prominent U.S. groups with strongly identifiable brands. As a response to the EU state aid investigations, the U.S. Department of the Treasury on August 24, 2016 released a white paper entitled "*The European Commission's Recent State Aid Investigations of Transfer Pricing Rulings*" in which concerns were expressed that the EU Commission was extending state aid law beyond enforcement of competition and, in fact, behaving like a supranational tax authority.

The white paper further stated that the Commission applies new approaches that are inconsistent with international standards. Instead of adhering to the OECD transfer pricing guidelines, the Commission asserts it is employing a different arm's length principle that is derived from the EU treaty law. Here, the paper states that whether or not a transfer pricing ruling is consistent with the arm's length standard is being judged by a non-tax agency that generally is not tasked with applying the OECD Transfer Pricing Guidelines and was not involved in their development.

The white paper observed that retrospectivity would undermine the G-20's efforts to improve tax certainty and would set an undesirable precedent for tax authorities in other countries. Indeed, there exists a serious risk that tax authorities around the globe may take similar retroactive actions that could negatively affect U.S. and EU MNEs alike. The white paper further states that these investigations undermine the multilateral progress made towards developing transfer pricing norms and the implementation of the OECD BEPS recommendations.

Given that the additional taxes levied in Europe are, in principle, fully creditable against the company's U.S. tax liability, it is evident that the current practice of the European Commission may create severe political tensions between the U.S. and Europe with the potential to create some kind of "tit for tat" with the application of penalties for EU MNEs in the U.S.[13] Interest to be charged on the state aid should not be creditable against the U.S. tax liability and, thus, result in double taxation.

V. Conclusion

More than three years after the beginning of the OECD BEPS project, the current international tax environment is characterized by an unprecedented level of legal uncertainty. Countries around the globe are implementing tax law changes, cherry-picking the BEPS recommendations of the OECD. Although the final reports on the 15 Actions of the OECD BEPS project have been released in October 2015, it will take several years until we have clarity on how countries will adapt their tax systems against the backdrop of the BEPS consensus.

The current state aid investigations undermine the multilateral progress made towards developing transfer pricing norms and the implementation of the consensus reached on BEPS. In the authors' view, the states concerned rightly believe that they were correctly applying their tax laws in line with their administrative practice. All of this is in line with the state's national sovereignty and tax treaty obligations. The Commission disagrees with this. The next step in this disagreement is to take the matter to the CJEU that is binding on the Commission and EU Member States, a common step in state aid matters. For a state not to do this in a matter as important as these cases would be a unilateral surrender of sovereignty.

With these actions, Europe risks becoming an unattractive place for international investment and doing business. Not only did the EU adopt an Anti-Tax Avoidance Directive that was gold-plating the OECD BEPS recommendations (going far beyond the minimum standard defined in the final BEPS reports): with the current state aid investigations, the Commission has created a lack of predictability in tax matters which will harm competition, growth and, therefore, tax revenue in Europe. Ultimately, rather than pursuing a couple of countries and companies for the past, the focus should be on the implementation of the international consensus on BEPS for the future.

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NOTES

[1] Commission Decision of June 11, 2014, Case SA.38374 Alleged aid to Starbucks, Decision of June 11, 2014 available at http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_SA_38374.

[2] Commission Decision of June 11, 2014, Case SA.38375 Alleged aid to FFT, Decision of June 11, 2014 available at http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_SA_38375

[3] Commission Decision of October 7, 2014, Case SA.38944 Alleged aid to Amazon, available at http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_SA_38944.

[4] Commission Decision of February 3, 2015, Case SA.37667 Excess profit tax ruling system in Belgium available at http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_SA_37667.

[5] Commission Decision of December 3, 2015, Case SA.38945 Alleged aid to McDonald's, available at http://ec.europa.eu/competition/state_aid/cases/261647/261647_1756438_84_2.pdf.

[6] See Oliver R. Hoor, Keith O'Donnell, "McDonald's State Aid Investigation: What the EU Commission Got Wrong", Tax Notes International, September 2016, p. 975–983.

[7] The 1991 tax ruling was replaced by a similar ruling obtained in 2007.

[8] Commission Decision of June 11, 2014, Case SA.38373 Alleged aid to Apple, available at http://ec.europa.eu/competition/state_aid/cases/253200/253200_1582634_87_2.pdf

[9] See press release available at http://europa.eu/rapid/press-release_IP-16-3085_en.htm.

[10] See Claire Micheau and Gauthier Charles de la Brousse "Case Studies of Tax Issues on Selectivity: Analysis of the Patent Box Scheme and the Reduced Taxation of Foreign-Source Interest Income" in "State Aid and Tax Law", Kluwer Law International, Netherlands 2013, p. 167.

[11] See, for example, CJEU, *British Aggregates v. Commission of the European Communities*, Case No. C-387/06P (2008) ECR I-10515, para. 82; CJEU, *Kingdom of Spain v. Commission of the European Communities*, Case No. C-409/00 (2003) ECR I-1487, para. 47; CJEU, *Portuguese Republic v. Commission of the European Communities*, Case No. C-88/03 (2006) ECR I-7115, para. 54; see Claire Micheau and Gauthier Charles de la Brousse "Case Studies of Tax Issues on Selectivity: Analysis of the Patent Box Scheme and the Reduced Taxation of Foreign-Source Interest Income" in "State Aid and Tax Law", Kluwer Law International, Netherlands 2013, p. 168.

[12] See Oliver R. Hoor, Keith O'Donnell, "McDonald's State Aid Investigation: What the EU Commission Got Wrong", Tax Notes International, September 2016, p. 975–983 with a detailed analysis of the McDonald's case.

[13] Deutsche Bank, for example, received a $14 billion claim by the U.S. Department of Justice to settle an investigation into its selling of mortgage-backed securities.