The EU Watchdog — Ready To Bite Multinational Companies?

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What do an automotive multinational, an e-commerce company, a multinational coffeehouse and a hi-tech consumer products company have in common? Fiat, Amazon, Starbucks and Apple have been catapulted under the media spotlight and accused of not paying their "fair share of taxes." The ever-increasing focus on these multinational companies has all the attributes of a witch hunt. The recent opening of investigations by the EU Commission in the context of the "state-aid" legal framework adds to this appearance.

On June 11, 2014, the EU Commission formally opened state-aid procedures against Ireland, Luxembourg and the Netherlands, alleging illegal state aid to Apple,[1] Fiat,[2] Amazon[3] and Starbucks.[4] Some brief words are necessary to explain the legal framework surrounding the opening of these procedures.

What is State Aid? Why is it Illegal?

The Treaty on the Functioning of the European Union (TFEU) protects free competition within the European Union. For that purpose, it prohibits illegal state aid.[5] Illegal state aid is defined and prohibited: "any aid granted by a member state or through state resources in any form whatsoever that distorts or threatens to distort competition by favoring certain undertakings or the provision of certain goods shall be incompatible with the common market, in so far as it affects trade between member states." In broad terms, member states are not allowed to grant selective advantages that may distort competition between member states.

Although tax was not the primary focus of the illegal state-aid prohibition, the very broad terms of its definition include tax measures. Any reduction in a firm's tax burden entails a corresponding reduction of tax revenue for the state. If the tax measure is selective, in other terms if it benefits a certain sector or company, the tax measure can be illegal state aid.

What is the Role of the EU Commission?

It is worth recalling the functions of some of the key institutions of the European Union: the Parliament, the EU Council (the "Council"), and the EU Commission (the "Commission") and the European Court of Justice (the "ECJ").

The Council gathers the heads of governments of the respective EU member states. It defines the general orientations of the EU. It can request the EU Commission to forward legislation proposals to the Parliament. Directly elected by the citizens, the EU Parliament is the legislative institution. The EU Commission represents the interests of the European Union and acts as a guardian of the EU Treaty: it proposes draft laws, ensures the enforceability of the EU law (initiating infringement proceedings). As such, the EU Commission is — or at least is supposed to be — politically independent. The ECJ is the court that settles matters of European law and has jurisdiction throughout the EU.

The EU Treaty makes the Commission the competition supervisory authority. It is given the broadest powers as regards to state aid. Not only it has the power to investigate on its own initiative the existence of a potentially illegal state aid[6] but it has the power to decide if the aid is illegal. If it considers an aid to be illegal, it can decide that the state concerned has to abolish it and has to recover the illegal aid from the beneficiary.[7]

In practice, this means that the beneficiary has to reimburse all of the aid received from the state concerned. The commission is allowed to refer to the ECJ if the concerned state does not comply with its decision within the prescribed time.[8] The state concerned is also allowed to bring the decision of the Commission to the ECJ.[9]

An "Initiative" Influenced by the Media?

The Commission is largely dependent on the assistance of other member states in monitoring the correct application of EU competition law. Traditionally, complaints of other EU member states constitute the primary source of information of the EU Commission as regards the existence of a potentially illegal state aid. This is particularly true in tax matters where a member state will consider that the tax measures taken by another member state will have negative impacts on its tax competitiveness.

In the case of the multinationals concerned, nothing suggests that one member state would have lodged an official complaint to the Commission. The Commission appears to have acted here on its own initiative, which is less frequent in tax matters. One can't help but wonder what motivated the action of the EU Commission.

The multinational companies concerned became over the last two years "media-friendly" targets. At a global level, a political consensus to fight "abusive" tax planning has been reached with the Organization for Economic Cooperation and Development being mandated to prepare the BEPS action plan. When the Commission starts four investigations in a row against high-profile media targets, one can't help but wonder if the action of the Commission is inspired by the media as much as any objective criteria.

An Institutionalized Witch Hunt?

From a pure legal standpoint, state-aid investigations are proceedings directed at the state and not at the beneficiary of the alleged aid. That is why the investigations of the EU Commission that mention these multinationals are initiated, formally speaking, against Ireland, Luxembourg and the Netherlands, respectively.

To date, state-aid investigations have been almost entirely directed against specific legal provisions in a state that would favor a type of company or sector. State-aid procedures directed at specific taxpayers have been usually initiated in the context of specific measures disclosed to the EU Commission by the concerned member state itself. The use of state-aid proceedings directed at the taxation of individual taxpayers on the own initiative of the Commission is highly unusual, and the repetitive use of state-aid proceedings naming individual multinationals without a specific tax measure being at stake over the last few months is unprecedented.

The Commission's investigations appear to be directed against the application of transfer pricing principles by the member states in the case of each individual taxpayer selected. The objection of the commission is thus not in relation to the legal system per se but its application to the case of a specific taxpayer. Thus the "selectivity," an essential condition for state aid,[10] would seem in the Commission's eyes to be based on application of general laws to an individual taxpayer.

This seems to put the Commission in the strange position of arguing that application of tax laws to an individual taxpayer, something that tax authorities have to do on a daily basis, is, per se, capable of being selective and can amount to state aid. Every assessment, every advance pricing agreement, every settlement of tax litigation outside court thus becomes potentially suspect.

Objectively, it is hard to see why, on purely legal grounds, the Commission would ever want to pick this particular battle and direct its action to a small high-profile sample of multinationals. It is hard to avoid the conclusion that, influenced by the current media and political context, the Commission felt the need to show it was relevant in the global consensus against base erosion and profit shifting.

The reading of the letters addressed to the states concerned is particularly interesting. We will focus below on the letter addressed to Luxembourg by reason of its alleged aid to "FFT."[11] It is interesting to note as an introductory remark that the Commission took the highly unusual step of assuming that the company described as "FFT" in an anonymized response from Luxembourg was in fact Fiat Finance and Trade Ltd. SA and proceeded to publicly open an investigation naming Fiat before it had received any official confirmation of the point.

Luxembourg had refused to provide the name of the taxpayer on the grounds of confidentiality, and this refusal is the subject of separate ECJ litigation. This litigation would normally have proceeded and both Luxembourg and the Commission would be bound by its findings in due course.

From an administrative and legal perspective, there was no urgency to advance pending resolution of this point. That the Commission felt the need to preempt the finding of the ECJ and proceed to publicly name Fiat is peculiar to say the least, and adds to the impression of an action based on politics as much as on law.

A Supranational Tax Inspector?

The Luxembourg Tax Authority agreed on an advance pricing agreement (APA) with FFT on Sept. 3, 2012. The pricing applied by FFT and agreed on by Luxembourg tax authorities was documented in a detailed manner and justified by reference to the OECD principles. The letter of the EU Commission that reviews the details of the transfer pricing (TP) methodology applied and its criticisms of the methodology is about 30 pages long. We are far from the cliche of the multinational company that applies a discretionary pricing with the overt or covert blessing of passive tax authorities.

The multinational company had a detailed transfer pricing analysis performed by its advisers, documented and justified by reference to OECD principles. The EU Commission itself admits that the methods explained in the OECD principles can give a wide range of taxable bases.

The EU Commission "has some doubts" about the method applied. The whole letter is about the doubts the EU Commission has about the methods employed, about what would have seemed the best for the LTA to do. The doubts expressed are highly technical, covering appropriate comparable enterprises and sectors, how to apply Basel II principles by analogy in nonbank financing, what beta to use in calculating target returns on equity, whether or not capital invested in shareholdings should have a separate return on equity, etc. As a TP specialist, one could certainly sympathize with some of the Commission's doubts, but essentially they can all be argued in a number of ways with different results.

So what are Luxembourg/FFT being investigated for? Applying OECD principles that don't meet the Commission's approval? The OECD and its members (including the current EU member states) took years to define TP guidelines and the work is still in progress. TP is not an exact science — it seeks to get close to the "arm's-length" standard in an non-arm's-length context.

By using proxies, such as "comparable uncontrolled price," transfer pricing allows taxpayers and tax authorities to agree a price close to the arm's-length standard, but by essence, it will always be an approximation. The approximation will also necessarily involve an element of subjectivity in deciding the transfer price; this subjectivity may drive the choice of certain features of the comparables being used to set a transfer price, features such as the reference period, the sample size, the reference population of companies, the reference industries, geographies, etc. This subjectivity also means that disputes between taxpayers and tax authorities, or between tax authorities in different states, are common.

Can a member state be blamed for approving a documented transfer pricing method and in particular, does approving a transfer pricing report presented by a taxpayer constitute state aid in the sense that the state is "favoring certain undertakings"? The Commission, fortunately, is not of the view that any approval of a transfer pricing policy is selective and can therefore constitute state aid. The Commission draws a distinction[12] between:

a) "simple interpretation of tax provisions without diverging from habitual administrative practice" (no presumption of selectivity); and

b) "decisions which diverge from this habitual administrative practice" (selective).

However in reading the Commission's letter, this seems to be a distinction without a difference. The Commission does not seek to consider whether the LTA's decision in the FFT case diverges from the LTA's habitual practice, or from any other tax authorities' habitual practice or from OECD standards, but merely concludes that, based on the Commission's TP analysis, the APA does not respect the arm's-length standard. The Commission thus seems to be reserving itself a new role as arbiter of acceptable TP and/or creating a body of TP rules alongside the existing OECD ones.

Conclusion

The action of the EU Commission is comprehensible as a political act, but much less so as a legal or administrative act. The underlying political idea is to make multinationals pay in response to public perception that they are not paying enough. Using the state-aid proceedings in TP matters and targeting a sample of high-profile taxpayers, the EU Commission seems to be going far beyond the terms of its mandate.

The stakes are high not only in terms of cash impacts for the multinationals concerned but also in terms of transfer pricing practice for both taxpayers and local tax authorities. The sovereign right of a state to assess its taxpayers in line with its TP laws would now, in the Commission's view, be subject to review under state-aid provisions. The EU Commission has thus hung a sword of Damocles over the heads of taxpayers and EU member states. We would expect the matter to reach the ECJ sooner rather than later.

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[1] C (204) 3606, June 11, 2014, State Aid SA38373

[2] C(2014) 3627, June 11, 2014, State Aid SA 38375

[3] State Aid SA 38944

[4] State Aid SA 38374

[5] Articles 107, 108 and 109 of the TFEU

[6] Article 10 of Council Regulation of March 22, 1999, laying down rules for the application of article 108 of the TFEU. "… the Commission may on its own initiative examine information regarding alleged unlawful aid from whatever source."

[7] Article 14 of Council Regulation of March 22, 1999, laying down rules for the application of

article 108 of the TFEU." Where negative decisions are taken in cases of unlawful aid, the Commission shall decide that the Member State concerned shall take all necessary measures to recover the aid from the beneficiary (…)."

[8] Article 108 2 of the TFEU

[9] Article 263 paragraph 2 of the TFEU

[10] C-143/99 - Adria-Wien Pipeline and Wietersdorfer & Peggauer Zementwerke, par 41 and 42.

[11] C(2014) 3267, June 11, 2014, State Aid SA 38375

[12] C(2014) 3267, June 11, 2014, State Aid SA 38375, para (82)