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Likely Impact Of The EU's Fiat, Starbucks Tax Rulings

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On Oct. 21, the European Commission declared the tax rulings on transfer pricing granted by Luxembourg to Fiat Finance and Trade and by the Netherlands to Starbucks Manufacturing EMEA BV to be illegal under European Union state aid rules. As a consequence, Luxembourg and the Netherlands must now recover between €20 million and €30 million in unpaid tax considered to be an illegal aid from each of the companies. The exact amounts will be calculated on the basis of methodology established in the commission's decisions.[1]

Background

Since June 2013, the commission has been investigating the tax ruling practice of EU member states under EU state aid rules. In particular, it has been assessing whether certain tax rulings issued to multinational companies by the authorities of EU member states were illegal under EU competition law rules (see here). As a result, the commission opened in-depth investigations in 2014 concerning tax rulings related to transfer pricing practices granted by Ireland in favor of Apple, the Netherlands in favor of Starbucks, and Luxembourg in favor of Amazon and Fiat and in 2015 concerning the Belgian Excess Profits System.

Under EU competition law, EU member states cannot interfere in the economy by granting distortive aid to companies operating on the European market. A company that receives government support may receive an advantage over its competitors that can create distortions on the market. State aid is defined as an advantage, in any form whatsoever, conferred on a selective basis to companies or associations by public authorities. The EU Treaty on the Functioning of the European Union (TFEU) prohibits such state aid, unless it is justified by reasons of general economic development. Subsidies granted to individuals or general measures open to all enterprises are not prohibited and do not constitute illegal state aid. The European Commission is in charge of enforcing this prohibition and of ensuring that any exemptions are applied correctly by member states across the EU.

Main Legal Issues

The commission does not consider tax rulings to be per se illegal under EU state aid law. Tax rulings are decisions through which national authorities confirm the conformity with legal rules of company-specific tax structures presented by multinational companies and their tax advisers, and are necessary for purposes of legal certainty. The commission found that the tax rulings granted to Fiat and Starbucks

constituted illegal state aid as meeting the four cumulative conditions enshrined in Article 107(1) of the TFEU.

The commission found that:

- The tax rulings create an advantage for multinational companies by validating company-specific financing arrangements that result in a very low effective tax rate in the two countries issuing the rulings. This creates in turn an incentive to employ transfer pricing strategies to shift risks, activities and ultimately profits to the country that grants the ruling;
- The advantage is financed through state resources because there is loss of tax revenue that would otherwise be due in the two countries issuing the rulings;
- The rulings distort or threaten to distort intracommunity trade since the companies to which the rulings were granted operate in various EU member states; and
- The advantage granted is selective, because the tax rulings provide the companies with "a more favorable treatment as compared to other companies which are in a similar factual and legal situation," in particular, nonmultinational companies. According to the commission, an advantage is "selective" when the transfer pricing arrangement does not comply with the internationally recognized "arm's-length principle" established by Article 9 of the OECD Model Tax Convention. In the commission's view, when accepting a calculation of the taxable profits proposed by a company, the authorities should compare that method "with the behavior of a prudent hypothetical market operator, which would require a market conform remuneration of a subsidiary or branch, which reflect normal conditions of competition."

The commission maintains that the tax rulings granted to Fiat and Starbucks "endorsed artificial and complex methods to establish taxable profits for the companies" that do not reflect economic reality. This was done "by setting prices for goods and services sold between companies of the Fiat and Starbucks groups (so-called ‘transfer prices') that do not correspond to market conditions."

In Fiat's case, the commission has found that, because its activities are similar to those carried out by a bank, the company's profit must be determined "in a similar way as for a bank, as a calculation of return on capital deployed by the company for its financing activities." However, according to the commission, the tax ruling issued by Luxembourg lowers significantly Fiat's tax burden because it endorses a "set of economically unjustifiable assumptions and down-ward adjustments that result in an approximated capital base much lower than the company's actual capital;" and an "estimated remuneration applied to such lower approximated capital which is not in line with market rates."

By the same token, the commission ruled that the transfer pricing tax ruling granted to Starbuck's Dutch subsidiary artificially lowers the taxes otherwise payable by the company in the Netherlands. Most notably, the commission held that the tax ruling allows Starbucks (1) to pay a very substantial royalty to Alki, a U.K.-based subsidiary of the Starbucks group, which does not adequately reflect market value as "no other Starbucks group company nor independent roasters to which roasting is outsourced are required to pay a royalty for using the same know-how in essentially the same situation," and (2) to pay an inflated price for the green coffee beans to Starbucks' Swiss subsidiary.

Comment

The recent decisions oblige Luxembourg and the Netherlands to recover an amount between €20 million and €30 million in taxes not paid by each of Fiat and Starbucks because of the tax rulings. The

commission did not specify the exact amount due from these companies, but it has made clear that "the precise amounts of tax to be recovered must now be determined by the Luxembourg and Dutch tax authorities on the basis of the methodology established in the decisions." Either the governments of Luxembourg and the Netherlands, as addressees of the commission decisions, or Fiat and Starbucks, as beneficiaries of the tax rulings, may bring an action of annulment under Article 263 TFEU before the General Court of the European Union in Luxembourg, with the possibility of an appeal before the Court of Justice of the EU based on legal grounds.

The decisions are likely to have an impact on the other three tax ruling cases that are still to be decided by the commission. Despite reassurances by Commissioner for Competition Margrethe Vestager that the Fiat and Starbucks cases "do not prejudge the outcome" of the Apple, Amazon and Belgian probes, given the similarity of the tax ruling practice, it would not be a surprise if the commission were to adopt negative decisions under Article 108 TFEU in those cases too.[2]

Moving forward, Vestager has indicated that more investigations are likely to follow if, on the basis of the information provided by the member states, the commission receives "indications that EU State aid rules are not being complied with." Earlier this year, the commission had used new investigative tools introduced by Regulation 734/2013 to obtain further information throughout the EU. It sent out requests for information (or RFIs) to the 28 EU member states in order to compile information on the tax rulings granted to companies between 2010 and 2013. Based on the widespread use of tax rulings for transfer pricing across the EU, the chances of having the commission open new investigations are rather high. Therefore, companies benefiting from tax rulings should seek legal advice to identify possible risks and limit the scope of potential liabilities.

Finally, it should be mentioned that the EU state aid probes into tax rulings are part of a broader tax transparency initiative launched by the commission in March 2015. In this context, on Oct. 6, 2015, EU member states agreed on new legislation to provide for the automatic exchange of information on cross-border tax rulings. The new rules should lead to greater cooperation between member states on tax matters and act as a deterrent from using tax rulings as an instrument for tax abuse.

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[1] The commission's press release can be found here.

[2] See SA.38373 (2014/C) (ex 2014/NN) (ex 2014/CP) — Ireland, Alleged aid to Apple, Commission Decision to initiate a formal investigation procedure, June 11, 2014; SA.38944 (2014/C) — Luxembourg, Alleged aid to Amazon by way of a tax ruling, Commission Decision to initiate a formal investigation procedure, No. 7, 2014; SA.37667 (2015/C ex 2015/NN) — Belgium, Excess profit tax system in Belgium — Art. 185§2 b) CIR92, Commission Decision to initiate a formal investigation procedure, Feb. 3, 2015.

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