Client Update
European State Aid Cases: 42 Steps to Guide You Through

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One of the difficulties with tax law is that no matter how codified it is, it is virtually impossible to eliminate all of the grey that exists between the black and white. For a multinational operating in Europe, the cry of Vroomfondel the philosopher from The Hitchhiker's Guide to the Galaxy demanding "rigidly defined areas of doubt and uncertainty!" seems eminently reasonable; at least if you know the areas of doubt you can seek a ruling from the local tax authority to provide certainty and allow you to plan accordingly. Unfortunately, following the European Commission's decisions in relation to certain transfer pricing tax rulings given to Starbucks (from the Netherlands) and Fiat (from Luxembourg), tax rulings granted by European Union Member States in the context of transfer pricing do not offer total comfort to their beneficiaries. This Client Update seeks to provide an easily digestible guide to the recent events in Europe and sets out some practical steps that a company operating in Europe should consider.

BACKGROUND

On 21 October 2015 the European Commission announced that, through tax rulings issued by their respective national tax authorities, the Netherlands and Luxembourg had granted selective tax advantages to Starbucks in the case of the Netherlands and Fiat in the case of Luxembourg. Specifically, the European Commission determined that the tax rulings constituted illegal State aid and ordered the Netherlands and Luxembourg to recover unpaid tax from Starbucks and Fiat, respectively.

For the uninitiated, a summary of the key European institutions and concepts necessary to navigate any discussion of the European State aid decisions is included in the Annex to this Client Update.

STATE AID

The concept of State aid was introduced in the 1950s to prevent anti-competitive behavior in the European Economic Community's internal market. Originally thought to capture practices like state subsidies and guarantees, it was later confirmed by the Court of Justice that the regulatory framework governing State aid could be applied and indeed should be applied to tax benefits as well.

For State aid to apply, four factors must be met:

- a **financial benefit** must be present. In a tax context, this is generally that less tax is paid;
- the **benefit must be granted by a Member State** or any lower level of government, which generally catches all tax benefits;
- the benefit must either **threaten or actually distort competition** and affect European Union trade. This is seen as a rather low level test and is pretty much always met; and
- the benefit must be given only to certain undertakings or to the production of certain goods, which is referred to as the **selectivity requirement** and is what actually separates State aid from general tax policy.

The European Commission monitors Member States' activities and where it believes it has identified State aid, will investigate. In an odd twist, if State aid is found to be unlawful, the European Commission will direct the state to recover the aid from the company; in practice this means that the company that received the contentious tax ruling will be required to repay the tax saved (plus interest) to the Member State that granted the ruling in the first place. This repayment can look back for up to ten years' of benefits. Remedial action needs to be prompt and the European Commission historically has taken steps against Member States delaying implementation.

THE RECENT DECISIONS

The Starbucks decision concerns a tax ruling issued by the Netherlands in 2008 to Starbucks Manufacturing EMEA BV ("Starbucks Manufacturing"). Starbucks Manufacturing, based in the Netherlands, sells and distributes roasted coffee, packaged food, and other related products to Starbucks' stores in Europe, the Middle East and Africa. The European Commission's investigation concluded that in allowing Starbucks Manufacturing to pay (i) a substantial royalty for coffee-roasting know-how and (ii) an inflated price for unroasted coffee beans, the ruling artificially lowered taxes paid by Starbucks by €20 - €30 million.

At issue in the Fiat decision is a tax ruling granted by Luxembourg authorities in 2012 to Fiat Finance and Trade, which provides certain financial services to Fiat group companies in Europe. The European Commission concluded that the transfer pricing ruling given by Luxembourg endorsed a complex methodology that used unjustifiable assumptions and adjustments to reduce Fiat Finance and Trade's capital base, and applied remuneration that does not reflect market rates. Similar to the Starbucks case, the European Commission ordered Luxembourg to calculate the back tax owed by Fiat Finance and Trade according to the Commission's methodology. The Commission estimates Luxembourg should recover €20 - €30 million from Fiat Finance and Trade.

There are also still open investigations into tax rulings granted by Ireland to Apple and Luxembourg to Amazon. These decisions are expected before the end of the year.

PRACTICAL IMPACT

In its initial investigation into tax rulings, the European Commission identified several "red flag" indicators which led them to initially conclude that there was unlawful State aid, including:

- whether the company's activities generate sufficient profits to pay inter-group royalties;
- whether royalty, or other, payments are reverse engineered (*i.e.* does the taxable base determine the facts or do the facts lead to the taxable amount);
- tax rulings granted for a long period or worse, open-ended rulings without any review;
- no underlying transfer pricing documents;
- whether there is any connection between the taxable base and certain minimum investment (employees, capital or other suitable resource);
- the process of applying for the tax ruling, in particular the quality of the documentation that was submitted and whether this documentation was actually considered by the tax authority; and
- whether facts and circumstances are consistent with the ruling.

Any company that currently operates under a transfer pricing tax ruling (or has done so in the past 10 years) should undertake a "red flag" review. Further red flags may come to light following the European Commission's findings in the Apple and Amazon cases.

If this red flag review identifies any risks, as is inscribed onto the cover of the Hitchhiker's Guide to the Galaxy, "DON'T PANIC":

- it may be that you have defences available to you for example, you may not fall foul of the selectivity requirement;
- consider taking appropriate remedial action, such as preparing a detailed transfer pricing report;
- if you are still not comfortable, depending on what is causing your discomfort, you may wish to apply for "refresher" tax rulings or look at restructuring your operations and then re-applying; and
- whilst undertaking this analysis remember that as of 1 January 2017 all European Union Member States have agreed automatically to exchange information on their tax rulings with each other. The exchange will take place every six months and will cover existing rulings for the past five years. The OECD BEPS Action Plan also contemplates automatic exchange of information on tax rulings.

For anyone considering an investment into or acquisition in a European country, the implications of these decisions should be taken into account when undertaking tax due diligence and particular care should be taken when drafting the tax indemnity provisions to ensure that potential losses arising from adverse State aid decisions are covered.

Please do contact a member of our tax team if you would like to discuss any of these issues further or require assistance in undertaking any part of this red flag review.

"So long, and thanks for all the [red flags]".

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Please do not hesitate to contact us with any questions.

ANNEX
KEY EUROPEAN UNION INSITITIONS AND CONCEPTS

What is the European Union?

The European Union is the current day iteration of a European trading alliance that was formed after the Second World War to improve cooperation between the largest European countries. Since its inception the European community has expanded both geographically and in its scope; from a trading alliance it grew into being an Economic Community in the 1950s and then a single market in the 1990s. Known as the European Union, this single market still exists today and consists of 28 Member States.

What are the main European Union institutions?

- **European Council** consisting of heads of state of the Member States, it sets the political agenda for the Union.
- **European Parliament** is a directly elected body representing citizens' rights and is part of the executive.
- **Council of the European Union** part of the executive and is formed of ministers from the Member States and changes depending on the topic under discussion (for example, if foreign policy is to be discussed, the relevant foreign policy ministers will attend).
- **European Commission** represents the interests of the Union in proposing new laws and monitoring Member States' compliance.
- **Court of Justice of the European Union** overall judicial body of the Union.

How are laws made?

The European Commission proposes all new laws, the European Parliament and the Council of the European Commission adopt the law and then the European Commission together with the Member States implements the legislation. The European Commission then has a role as ongoing monitor.

Can the European Union make tax laws?

In general, direct taxation is an area which is off-limits to the European Union legislature; however Member States are bound by the treaties that form the constitutional basis of the European Union. The treaties set out the broad principles that govern the European Union such as the principle of non-discrimination on the grounds of nationality and the fundamental freedoms; the freedom of establishment, the free movement of capital, the free movement of goods, the freedom to provide services and the free movement of persons. Therefore, all direct taxation must be implemented and interpreted against this background.