TEN YEAR THROWBACK

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Two years ago, a U.S. Senate investigation accused Ireland of granting Apple Inc. special tax treatment. This accusation sparked a seemingly never-ending investigation into the state aid granted by certain European countries to specific multinational companies. More recently, Apple, Starbucks, Fiat, and various other companies exposed in the "Luxembourg Leaks" scandal were accused of having paid substandard taxes as a result of agreements between those companies and the Netherlands, Luxembourg, and Ireland, which constituted illegal state aid.[1]

Now, the European Commission (the "Commission") is looking into the penalties that should be levied upon the income earned through these agreements. The Commission's investigations into these advance rulings and advance pricing agreements ("A.P.A.'s") between E.U. member-states and major U.S. multinationals could lead to tax adjustments dating as far back as ten years.

STATE AID

State aid is defined as "an advantage in any form whatsoever conferred on a selective basis to undertakings by national public authorities."[2] This does not include subsidies or tax breaks available to all entities. A measure of state aid constitutes an intervention by a state, or through state resources, that gives specific companies or industry sectors an advantage on a selective basis, thereby distorting competition and affecting trade between E.U. member states.

State aid needs to be regulated so that competition between the member states may remain fair. The Treaty on the Function of the European Union (the "Treaty") generally prohibits state aid unless there is some justifiable economic reason, and the Commission is in charge of ensuring compliance under the Treaty. Since certain policy objectives justify state aid, such measures can be implemented under certain circumstance – but only after they have been approved by the Commission. The Commission holds the power to recover any unapproved state aid that is found to be incompatible.

The Commission alleges that advance rulings and A.P.A.'s between Ireland, the Netherlands, Luxembourg, and certain multinational companies constitute unlawful state aid under the E.U.'s competition rules.

The Treaty outlines four conditions that need to be met in order for an agreement to be considered state aid:

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1 Antebi, Galia, and Rusudan Shervashidze, "A Bad Month for Luxembourg," *Insights* 1, no. 11 (2014).

2 "What is state aid? European Commission," last modified August 8, 2013.

1. It confers a financial advantage;
2. It distorts or threatens to distort competition;
3. It selectively favors specific undertakings or production of certain goods; and
4. It is not justified by the tax system's nature and logic.

DISTORTION

The Commission found that certain A.P.A.'s allowed multinationals to move profits through subsidiaries based in the above-named E.U. member-states in ways that did not correspond with the actual sales that had taken place.

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Since the E.U. has no legal competence to regulate direct taxation, this matter was treated as an issue of distortion of competition. The Commission claims that these A.P.A.'s and rulings affected the decision process for determining the jurisdiction of formation and the location of the seat of management for the multinational groups involved.

The Commission found that multinationals must behave like "prudent independent market operators" and must be treated like individuals. However, this standard will be difficult to determine in practice, as the European Court of Justice is not an expert on transfer pricing.

AMOUNT OWED

If the tax agreements are found to constitute state aid, the member-states must recover the amounts granted to multinationals going back ten years, or incur infringement proceedings. The clock begins to run on this ten-year recovery period on the day when the unlawful state aid is awarded to the company. However, the ten-year limit may be extended by various events throughout the period.

In such cases, the E.U. provisions pre-empt the local four-year statute of limitations, and local authorities have no choice but to comply. The taxpayers cannot claim protection from the agreements if they are found to be state aid because there is no protection under the E.U. rules of competition.

The ten-year retroactive payment with interest may be challenged by the companies on the principles of legitimate expectations and legal certainty. To be successful in their challenge, the taxpayer would have to prove that the aid in question was lawful and that it relied on that aid.[3]

In addition to paying taxes and interest dating back ten years, if the recovered amounts are found to be penalties rather than foreign income taxes, there will be no corresponding U.S. foreign credit whenever profits are taken into account for U.S. income tax purposes. Under U.S. law, creditable foreign taxes must be imposed under local laws. a possible challenge to the status of these payments is that they If these 10-year payments are characterized as penalties charged by the Commission

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[3] "Steptoe & Johnson LLP: EU State Aid Tax Investigations: A New Enforcement Landscape?," October 30, 2014.

to deter improper behavior, they will not be considered to be taxes on income in the U.S. sense.

STATE AID AND B.E.P.S.

This controversy has pushed the Commission toward adopting measures similar to the O.E.C.D.'s B.E.P.S. initiative in order to address double non-taxation. The Commission may use the state aid rules to apply anti-B.E.P.S. measures retroactively to ensure that all activity is taxed at least once.

The Commission issued a draft directive on March 18, 2015[4] that would require countries that issue advance international tax rulings to automatically disclose them to the Commission within three months. This means that although member-states would be allowed to act on mismatches, the Commission will be kept in the loop regarding any such agreements. It is an extension of the so-called "name and shame" strategy to deter tax planning.

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The information disclosed regarding the agreements will include identifying information for the taxpayer and the member states directly involved, the content of the agreement, and the transfer price and how it was determined.[5] Presumably, the government of the state that is an internal counterparty to the corporation that receives the ruling will treat payments to the low tax party as non-arm's length in nature and non-deductible.

This draft directive reinforces a policy of maximum transparency and exchange of information established as part of the B.E.P.S. measures. Application of this draft, with its proposition for a systematic and automatic exchange of international tax rulings, would be a major step toward the aims of the B.E.P.S. program invoked by the harmful state aid practices that have come to light.

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4 European Commission, "Proposal for a Council Directive amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation," March 18, 2015.

5 "Automatic Exchange of Tax Rulings in the EU." *Tax Notes International*, April 20, 2015, pg. 261.