E.U. STATE AID – THE SAGA CONTINUES

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Tags
European Commission
State Aid
T.F.E.U.

The drama continues with the E.U. State Aid[1] investigations by the European Commission for Competition (the "Commission"). In the past month, the competition commissioner, Margrethe Vestager, met with Luxembourg officials to discuss the outcome of the Amazon investigation, and the Commission ordered Fiat Chrysler Automobiles to pay about €30 million in back taxes to Luxembourg and released a public letter regarding the investigation of McDonald's alleged State Aid violations in Luxembourg. An even more bold attack on multinational tax practices came not from the Commission but from the French authorities, who raided the offices of Google and McDonald's in May.

As the Commission's probe expands, E.U. Member States are increasingly expressing objections to being forced to recoup back taxes from multinational enterprises ("M.N.E.'s") that allegedly received illegal State Aid. States, including the United States, question whether the Commission is acting beyond its authority and impeding Member States' sovereignty to directly tax persons within their jurisdictions.

The European Parliament has even formed a special tax committee to investigate the Commission's role, as well as Member States' roles, in failing to enforce laws that would have prevented entities and individuals from sheltering money in offshore havens to avoid paying taxes.[2] Although the Commission itself will be a subject of these investigations, a Commission spokesperson applauded the creation of a special tax committee to assist in combatting harmful tax practices.

The Commission has argued that it is acting within the authority granted by E.U. law and that it has not infringed on the jurisdiction of Member States, the U.S., or any other country. Since 2013, the Commission has been investigating various Member States' individual tax rulings with U.S. companies, including Starbucks in the Netherlands,[3] Apple in Ireland, Google in the U.K., Amazon in Luxembourg, and McDonald's in Luxembourg. The Commission has alleged that these companies' tax arrangements with different Member States amount to unjustifiable State Aid in violation of E.U. anti-competition laws. If the Commission determines that a Member State provided a selective tax advantage, and thus illegal State Aid, to an entity, the Member State is forced to retroactively, not prospectively, recoup taxes from the

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1 For the definition of E.U. State Aid see Beate Erwin and Christine Long, "Apple in Europe – The Uphill Battle Continues," *Insights* 2 (2016), pp. 9-15; and Beate Erwin, "Tax Rulings in the European Union – State Aid as the European Commission's Sword Leading to Transparency on Rulings," Insights 6 (2015), pp. 13-14.

2 Joe Kirwin, "EU Parliament to Probe Intermediaries, Members on Havens," *BNA International Tax Monitor*, June 2, 2016.

3 Although the Commission's ruling was issued In October 2015, the text of its decision was first released in late June 2016.

entity over a ten-year period. Enforcement of this requirement to recoup back taxes is arguably beyond the Commission's regulatory power.

LATEST ON U.S. REACTIONS

The U.S. reaction to the Commission's State Aid investigations has also intensified. Several U.S. senators and Treasury Department officials continue to express concern and frustration with the Commission's probe into U.S. M.N.E.'s, arguing that the Commission has overstepped its bounds, as the retroactive imposition of tax "is improper and plainly undermines legal certainty and the rule of law."[4] In a May 23 letter to the Treasury Department, Senators Hatch, Wyden, Portman, and Schumer contended that the Commission "appears to be ignoring the national practice and law of its Member States and to be imposing its own new standard for transfer pricing determinations."[5] Furthermore, the Commission's actions confirm "our suspicion that these cases are about more than objectively enforcing existing competition policies."[6] The targeting of U.S. enterprises could potentially undermine U.S. rights in bilateral tax treaties with Member States and the retroactive payment for back taxes would likely prevent a U.S. M.N.E. from receiving a tax credit towards its U.S. income.

U.S. officials have been asserting that Commissioner Vestager is unfairly targeting U.S. M.N.E.'s and that the Commission has no right to claim the offshore profits of U.S. companies. Commissioner Vestager has repeatedly rejected such criticism, claiming that potential State Aid violations involving several non-U.S. companies are currently being examined. U.S. senators have been encouraging the U.S. Treasury Department to strike back by increasing taxes on European companies through enforcement of Internal Revenue Code (the "Code") §891.[7] Code §891 was implemented in U.S. tax law in1938, but it has never been invoked.[8] Under this rule, the tax rates for foreign citizens and corporations could be doubled in "retaliation" against unfair treatment of U.S. persons by these countries.

IS THE COMMISSION EXCEEDING ITS AUTHORITY?

In addition to the U.S., an increasing number of E.U. Member States are concerned that the Commission is overstepping its bounds by retroactively, rather than prospectively, imposing Member State taxation of M.N.E. earnings, particularly those of U.S. entities. Many states argue that the Commission is using the State Aid investigations as a disguise to impede on Member States' taxing power. Therein lies the difficulty with the E.U. system – balancing the right of Member States to directly tax, with the right of the Commission to protect the E.U. single market from anti-competitive tax practices.

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4 "Hatch, Wyden: EU State Aid Probe Violates Rule of Law," *BNA Daily Tax Report*, May 24, 2016.

5 Letter to Secretary Jacob Lew, U.S. Senate Committee on Finance, May 23, 2016.

6 *Id.*

7 Erwin and Long, "Apple in Europe," pp. 9-15.

8 It appears that this rule was intended rather as a tool in treaty negotiations to achieve reciprocal concessions than a weapon for unilateral use.

The Commission has since argued that it is acting within its authority. As if to justify this position, in May the Commission released "Commission Notice on the Notion of State Aid as Referred to in Article 107(1) TFEU" (the "Notice").[9] The Notice should provide guidance to clarify the definition of State Aid.

The Notice is allegedly a reaction to pleas made by the Netherlands in its appeal of the Starbucks outcome. The Netherlands has argued that the arm's length principle is not covered by E.U. law and, thus, could not be subject to State Aid infringement proceedings. To better understand the context of the Notice, the Commission's investigation of Starbucks's arrangement in the Netherlands is outlined below.

The Starbucks Case

In 2008, the Netherlands issued a tax ruling for Starbucks, approving the company's transfer pricing methods. The Commission alleged that the Dutch transfer pricing ruling provided a selective advantage to Starbucks in violation of E.U. anti-trust laws and began investigating the case in 2013. In October 2015, the Commission issued a final decision, finding that Starbucks received illegal State Aid because the Dutch transfer pricing ruling artificially lowered the company's tax burden in the Netherlands, thereby distorting competition. As a result, the Commission has ordered the Netherlands to recoup between €20 and €30 million in back taxes from Starbucks.[10]

The Dutch Finance Ministry appealed the Commission's decision in December 2015 and argued that Starbucks did not benefit from illegal State Aid. The Dutch appeal included five "pleas in law," alleging:

> (A) Incorrect application of Article 107(1) TFEU to the extent that the European Commission finds that the transfer pricing ruling (specifically, an APA) is selective in nature, as the Commission referenced the wrong Dutch tax legislation and failed to demonstrate that the selectivity criterion was fulfilled;
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> (B) Incorrect application of Article 107(1) TFEU in relation to the European Commission's assessment of the existence of an advantage by reference to the arm's length principle under EU law, as no arm's length principle exists under E.U. law and is not part of the EU State aid assessment;
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> (C) Incorrect application of Article 107(1) TFEU in relation to the European Commission's finding that the transfer pricing ruling confers an advantage on Starbucks due to the selection of the 'Transactional Net Margin Method' to establish pricing;
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> (D) Incorrect application of Article 107(1) TFEU in relation to the European Commission's statement that the transfer pricing ruling confers an advantage on Starbucks as a result of the manner under which the 'Transactional Net Margin Method' was applied; and

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9 European Commission, "Commission Notice on the Notion of State Aid as Referred to in Article 107(1) TFEU," (Brussels: 2016)

10 "European Commission Reclarifies the Scope of EU State Aid Rules," *Checkpoint International Taxes Weekly* 21 (2016).

> (E) Breach of the duty to exercise due care in so far as the European Commission did not assess and include all the relevant information in the decision and also uses as a basis anonymous information, or at least information that has never been shared with the Netherlands government.[11]

The pleas articulated by the Netherlands reflect the positions of other Member States, which argue that, through State Aid decisions, the Commission is acting beyond its capacity and forcing Member States to retroactively impose tax on multinationals. In particular, the fact that pricing methods and the arm's length principle are not doctrines of E.U. law puts them beyond on the scope of the Commission's assessment.

"The Notice is allegedly a reaction to pleas made by the Netherlands in its appeal of the Starbucks outcome."

The Commission Notice on the Notion of State Aid

The Commission published general guidance on all aspects of the definition of State Aid as part of the Notice, which comes under the State Aid Modernisation initiative that was launched in 2012.[12] The Notice clarifies the scope of the State Aid rules, and its stated purpose is to "provide legal certainty and cut red tape for public authorities and companies, and focus the Commission's resources on enforcing State aid rules in cases with the biggest impact on the Single Market."[13] As previously mentioned, the Notice is alleged to have been published in reaction to the Dutch appeal of the Commission's decision in the Starbucks case.

The Notice simplifies the interpretation of T.F.E.U. Article 107(1), as established by the E.U. Court of Justice and the General Court. The Notice explains the Commission's decision-making practice and how the Commission construes the notion of State Aid when issues have not yet been interpreted by the courts.[14] The Notice elaborates on the following fundamental notions of State Aid:

- The presence of a State Aid undertaking with respect to economic activity
- The imputability of a state measure to the Member State in question
- The notion of advantage and financing through State resources
- The selectivity, *i.e.*, selective advantage of the state measure
- The effect of a state measure on trade and competition between Member States[15]

To date, the Commission's State Aid investigations have focused on tax rulings granted by Member States to M.N.E.'s. However, the Commission is expected to expand its State Aid investigations to tax settlements. This adds to the uncertainty taxpayers face when operating within an E.U. Member State.[16]

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11 *Id.*

12 European Commission, "State Aid: Commission Clarifies Scope of E.U. State Aid Rules to Facilitate Public Investment," press release, May 19, 2016.

13 *Id.*

14 "Commission Notice on the Notion of State Aid."

15 *Id.*; "European Commission Reclarifies the Scope of EU State Aid Rules."

16 Ali Qassim, "Uncertainty Ahead: Tax Settlements Seen as Next EU State Aid

Authority of Tax Rulings

A Member State's grant of a tax ruling to a company must respect the State Aid rules. Tax rulings, such as A.P.A.'s or comfort letters, enable Member States to provide taxpayers with legal certainty and predictability on the application of a Member State's general tax rules. The Notice points out that a Member State's tax rulings are best ensured if its administrative ruling practice is transparent and the rulings are published. The Notice reiterates that the Commission has authority where a tax ruling may confer a selective advantage upon a company, in so far as that selective treatment results in a lowering of that company's tax liability in the Member State as compared to companies in a similar factual and legal situation.[17]

The Notice refers to the Court of Justice's rulings as support for the Commission's rationale for investigating individual rulings issued by Member States. The Court of Justice's rulings on transfer pricing cases have held that a Member State's tax ruling which endorses a transfer pricing methodology for determining a corporate group entity's taxable profit that does not result in a reliable approximation of a market-based outcome in line with the arm's length principle confers a selective advantage upon its recipient. The Notice elaborates on the phrase "reliable approximation of a market-based outcome," interpreting it to mean any deviation from the best estimate of a market-based outcome must be limited and proportionate to the uncertainty inherent in the transfer pricing method chosen or the statistical tools employed for that approximation exercise.[18]

"If a transfer pricing arrangement complies with the provisions of the O.E.C.D. Transfer Pricing Guidelines . . . a tax ruling endorsing that arrangement is unlikely to give rise to State Aid."

According to the Notice, this arm's length principle necessarily forms part of the Commission's assessment of tax measures granted to group companies under T.F.E.U. Article 107(1), independent of whether a Member State has incorporated this principle into its national legal system and, if so, in what form. A tax ruling that approves of a methodology that produces a reliable approximation of a market-based outcome, ensures that that company is not treated favorably under the ordinary rules of corporate taxation of profits in the Member State as compared to standalone companies that are taxed on accounting profit. The arm's length principle the Commission applies in assessing transfer pricing rulings under the State Aid rules is therefore an application of T.F.E.U. Article 107(1), which prohibits unequal treatment in taxation of undertakings in a similar factual and legal situation. This principle binds the Member States, and the national tax rules are not excluded from its scope.[19]

The Notice explains that, when the Commission examines whether a transfer pricing ruling complies with the arm's length principle inherent in T.F.E.U. Article 107(1), the Commission may refer to the guidance provided by the O.E.C.D., in particular the "O.E.C.D. Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations" (the "O.E.C.D. Transfer Pricing Guidelines"). Those guidelines do not deal with matters of State Aid per se, but they capture the international consensus on transfer pricing. The guidelines also direct tax administrations and M.N.E.'s on how to ensure that a transfer pricing methodology produces an outcome in line with market conditions. Consequently, if a transfer pricing arrangement complies with

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Inquiry Target," *Checkpoint International Tax Monitor*, June 7, 2016.

17 "Commission Notice on the Notion of State Aid," p. 50.

18 *Id.*, p. 51.

19 *Id.*, pp. 51-52.

the provisions of the O.E.C.D. Transfer Pricing Guidelines, including guidance on selecting the most appropriate method that leads to a reliable approximation of a market-based outcome, a tax ruling endorsing that arrangement is unlikely to give rise to State Aid.[20]

The Notice summarizes that, in particular, a tax ruling confers a selective advantage on an entity where

- the ruling misapplies national tax law, and this results in a lower amount of tax;
- the ruling is not available to undertakings in a similar legal and factual situation;[21] or
- the Member State's administration applies a more favorable tax treatment compared with other taxpayers in a similar factual and legal situation.[22]

The Notice's clarification of a selective advantage supports the Commission's argument that it has legal authority to enforce the State Aid decisions. The bulk of the Commission's State Aid investigations have been on transfer pricing rulings, with a focus on the arm's length principle. Although the arm's length principle may not be codified under E.U. law, it is established in the O.E.C.D. Transfer Pricing Guidelines, which have been adopted by the Member States. The Commission has already decreed that the Starbucks's transfer pricing ruling from the Netherlands amounted to unlawful State Aid, but the Commission is still investigating transfer pricing rulings between Ireland and Apple, Luxembourg and Amazon, and Luxembourg and McDonald's.

Authority of Tax Settlements

The Notice also justifies the Commission's authority to investigate tax settlements between Member States and taxpaying entities, by clarifying the scope of these settlements under E.U. law. Tax settlements have yet to be the subject of State Aid investigations, but the Notice's explanation of how tax settlements provide a selective advantage establishes grounds for future Commission investigations.

The Notice defines tax settlements as a common practice in many Member States that generally occurs in the context of disputes between taxpayers and the tax authorities concerning the amount of tax owed. Tax settlements allow tax authorities to avoid long-standing disputes before the domestic courts and ensure quick recovery

[20] *Id.*, p. 52.

[21] The Notice provides, as an example, that this would be the case if some undertakings involved in transactions with controlled entities are not allowed to request tax rulings, contrary to a pre-defined category of undertakings.

[22] For instance, this will be the case where the tax authority accepts a transfer pricing arrangement that is not at arm's-length, because the methodology endorsed by that ruling produces an outcome that departs from a reliable approximation of a market-based outcome (as in the Starbucks decision). The same applies if the ruling allows the taxpaying entity to use alternative, more indirect methods for calculating taxable profits (*e.g.*, the use of fixed margins for a cost-plus or resale-minus method for determining an appropriate transfer pricing, while more direct ones are available). ("Commission Notice on the Notion of State Aid," p. 54.)

of the tax due. While the competence of Member States in this field is not in dispute, State Aid may be involved in the conclusion of a tax settlement. In particular, it may arise where the amount of tax appears to have been reduced without clear justification (such as optimizing the recovery of debt) or in a manner that is disproportionately beneficial to the taxpayer.[23]

"As the Commission's State Aid investigations into tax rulings become more robust, it is only a matter of time before the investigations extend to tax settlements."

The Notice explains that a transaction between a Member State's tax administration and a taxpayer may, in particular, entail a selective advantage in the following situations:

> (a) in making disproportionate concessions to a taxpayer, the [Member State's] administration applies a more 'favourable' discretionary tax treatment compared to other taxpayers in a similar factual and legal situation;
>
> (b) the settlement is contrary to the applicable tax provisions and has resulted in a lower amount of tax, outside a reasonable range. This might be the case, for example, where established facts should have led to a different assessment of the tax on the basis of the applicable provisions (but the amount of tax due has been unlawfully reduced).[24]

The Commission is expected to start investigating tax settlements between Member States and multinational taxpayers. For example, many thought the multimillion-pound tax settlement between the U.K. and Google should have been several billion pounds instead. Such tax settlements could be construed as sweetheart tax deals that provide favorable treatment, and thus unlawful State Aid, to multinational taxpayers.[25] The Notice lays out the legal authority for the Commission to examine such settlements. As the Commission's State Aid investigations into tax rulings become more robust, it is only a matter of time before the investigations extend to tax settlements.

OBSERVATIONS FROM A U.S. PERSPECTIVE

The Commission's State Aid decisions raise various complex issues with significant importance to U.S. companies currently or potentially under investigation.

E.U. Law Superseding Income Tax Treaties with Non-E.U. Countries

Within the E.U., E.U. law supersedes the domestic laws of the Member States. If the Commission finds that a Member State provided a taxpayer with illegal State Aid, that state must act without delay to recover that aid from the taxpayer.[26] Generally, rules on State Aid therefore trump bilateral income tax treaties. From a U.S. legal perspective, the T.F.E.U. and State Aid-related rules are not, and cannot, be granted this quasi-constitutional status.

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23 *Id.*, p. 53.

24 *Id.*, p. 55.

25 Ali Qassim, "Uncertainty Ahead."

26 "Council Regulation (EC) No 659/1999 of 22 March 1999 laying down detailed rules for the application of Article 93 of the EC Treaty," *Official Journal of the European Communities* L 083 (1999), art. 14, para. 3.

U.S. Foreign Tax Credit on State Aid Assessment Payments – Timing

Under U.S. Federal income tax law, a foreign tax credit is subject to the condition that all legal remedies, including appeals, have been exhausted.[27] Consequently, a foreign tax credit, if deemed applicable in this context,[28] may not be available under U.S. tax rules as long as the appeals procedures are pending. Another interesting aspect is that, upon an appeal of the Commission's State Aid decision, the courts may only accept or reject the Commission's decision in its entirety. If the decision is accepted, the courts are not entitled to decide on adjustments of the amount of State Aid that must be recovered by the Member State.

A New Arm's Length Standard Introduced by the Commission

In the Commission's decisions on Belgian tax rulings and the Luxembourg Fiat case, it made a notable statement, which based on the Netherland's reaction, also appears in the Starbucks decision:

> The arm's length principle therefore necessarily forms part of the Commission's assessment under Article 107(1) of the TFEU of tax measures granted to group companies, independently of whether a Member State has incorporated this principle into its national legal system. It is used to establish whether the taxable profits of a group company for corporate income tax purposes has been determined on the basis of a methodology that approximates market conditions, so that that company is not treated favourably under the general corporate income tax system as compared to non-integrated companies whose taxable profit is determined by the market.[29] *Thus, for any avoidance of doubt, the arm's length principle that the Commission applies in its State aid assessment is not that derived from Article 9 of the OECD Model Tax Convention, which is a non-binding instrument, but is a general principle of equal treatment in taxation falling within the application of Article 107(1) of the TFEU, which binds the Member States and from whose scope the national tax rules are not excluded.*[30] [emphasis added]

Does this mean the European Commission introduces a new arm's length standard? If so, how would it deviate from the standard found in the O.E.C.D. Model Convention and O.E.C.D. Tranfer Pricing Guidelines? Does the T.F.E.U. provide authority for the Commission on Competition – previously a non-tax focused body – to set forth an arm's length standard for transfer pricing (*i.e.*, tax purposes)? According to

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27 Treas. Reg. §1.901-2(e)(5).

28 Note that it is still unclear whether assessment payments under State Aid procedures should qualify as creditable tax payments for U.S. foreign tax credit purposes or as (non-creditable) damages.

29 The same language appears in Commission Decision no. SA.37667 (*Belgium*), para. 150 (January 1201, 16), except that it refers to the O.E.C.D. Transfer Pricing Guidelines in addition to Article 9 of the O.E.C.D. Model Convention.

30 "See Joined Cases C-182/03 and C-217/03, *Belgium and Forum 187 v. Commission*, ASBL ECLI:EU:C:2006:416, paragraph 81. See also Case T-538/11 *Belgium v. Commission* EU:T:2015:188, paragraphs 65 and 66 and the case-law cited." (Commission Decision no. SA.38375 (*Luxembourg Fiat*), para. 228 (October 21, 2015))

the view held by the Netherlands in its appeal, this is definitely not the case. That the Notice includes clarifications in this respect is unlikely to provide sufficient legal basis and thus change the Dutch view. The constraints that the State Aid decisions put on the taxing authority of the Member States have already been pointed out. With these State Aid decisions, this would rise to another – international – level, in particular in view of dismantling competent authority procedures with non-E.U. countries.

"The only certainty for M.N.E.'s operating in the E.U. is that there is uncertainty in the outcome of any tax ruling or tax settlement that these entities may have with Member States."

CONCLUSION

The Commission has great latitude in investigating all aspects of State Aid, including when a Member State provides an individual tax ruling or tax settlement to a multinational taxpayer. As the Commission's State Aid probe expands, more Member States are taking the position that the Commission is impeding domestic sovereignty and acting beyond the scope of E.U. law. The tension is growing between protecting the right of a Member State to directly tax its constituents and the Commission's mandate to protect the E.U. single market from anti-competitive tax practices. From a U.S. legal perspective, the impact of the State Aid decisions is far reaching – timing of foreign tax credits, if applicable at all; dismantling of income tax treaties; and a new arm's length standard are just some examples. The only *certainty* for M.N.E.'s operating in the E.U. is that there is *uncertainty* in the outcome of any tax ruling or tax settlement that these entities may have with Member States.

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