TREASURY ATTACKS EUROPEAN COMMISSION ON STATE AID – WHAT NEXT?

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On August 30, 2016, the European Commission ("the Commission") ordered Ireland to claw back €13 billion ($14.5 billion) plus interest from Apple after favorable Irish tax rulings were deemed to be illegal State Aid by the Commission. Not only did the Commission issue this decision, but at the same time, it invited other nations to consider whether profits that flowed through Apple's nonresident Irish branch should instead be taxed in their respective jurisdictions.[1]

This interpretation was shared by O.E.C.D. Secretary-General Angel Gurria,[2] and France may follow suit. In a statement on September 9, 2016, French Finance Minister Michel Sapin called the decision against Apple "completely legitimate," but left it open as to whether France would assess back tax on the company.[3]

The offices of Google and McDonald's in France were raided by French authorities in May of this year. In Italy, Apple paid €318 million in a settlement of a ruling by the Italian tax authorities that the company had improperly booked €880 million in profits to an Irish subsidiary from 2008 to 2013. Apple is also believed to be the subject of investigations by Spanish tax authorities.[4]

European Tax Commissioner Pierre Moscovici defended the European Union's Apple ruling as neither "anti-U.S." nor "arbitrary." Upon his arrival in Slovakia for the Economic and Financial Affairs Council ("E.C.O.F.I.N.") meeting at the beginning of September, the commissioner told reporters that the ruling "is based on facts and data which apply to all companies wherever they come from, and especially from European Union countries." On another occasion, Competition Commissioner Vestager pointed out that BP Plc was forced to pay additional taxes, but was reluctant to comment on the investigation into IKEA.[5] Wherever one's the stance on

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1 In particular, two comments by E.U. Competition Commissioner Margrethe Vestager were noted: The first was that "the money belongs to Ireland," and the second was that "anybody who thinks they have a claim, bring the claim forward and tell us why you think you have a claim."

2 Secretary-General Gurria made the comment in response to a question posed during a September 10 news conference held at the conclusion of a two-day meeting of European Union finance ministers in Bratislava.

3 Notably, France has already had internet multinationals on its radar. In 2013, Amazon revealed that it was contesting a French assessment of $252 million in back taxes. In May of this year, the Paris offices of Google were raided by French officials in the course of a probe into whether Google's Irish unit has a permanent establishment in France.

4 Neither Apple nor representatives of the Spanish tax authorities confirmed the existence of a Spanish investigation.

5 Investigations were initiated by the Swedish Green Party, which provided information to the European Commission.

the U.S.-European debate, it is indisputable that, with limited exception,[6] the most recent tax-related State Aid cases ruled upon by the Commission have focused exclusively on U.S. multinationals' European operations.

THE APPLE CASE: BACKGROUND AND FURTHER DEVELOPMENTS

On June 11, 2014, the European Commission initiated an investigation into advance pricing arrangements provided by the Irish tax authorities to Apple, regarding the attribution of profits to an Irish branch of an Irish company that, under Irish law, was treated as nonresident. The company was not managed and controlled in Ireland. According to the E.U., Apple Sales International allocated the vast majority of its profits to a "head office" that, in the European Commission's opinion, was an entity without economic substance. Apple's tax plan reduced its taxable income considerably. The European Commission's view was that these Irish arrangements with Apple constituted State Aid.

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Both Apple and Ireland[7] confirmed that they will appeal the European Commission's decision. It may take years until the case is settled and may ultimately be decided by the European Court of Justice ("E.C.J."). Interestingly, the E.C.J. can merit the Commission's decision or reject it in its entirety, but it cannot revise the amount of the claw-back. It should also be noted that an appeal does not affect the obligation to pay the claw-back amount stipulated in the Commission's decision.[8] To date, the European Commission has initiated State Aid investigations against Apple, Amazon, Starbucks, and Fiat (now Fiat Chrysler Automobiles). Appeals against the Commission's decisions in the Starbucks and Fiat cases are already pending at the European General Court.[9] The Commission has not yet reached a final decision in the Amazon case.

As has been previously noted, the fairness of the European Commission's examination of U.S. multinationals has been questioned. Robert Stack, Deputy Assistant Secretary for International Tax Affairs at the U.S. Treasury Department, believes that American companies are being unfairly targeted in the investigations.

In an unprecedented procedure, the U.S. Treasury Department released a white paper[10] ("White Paper") shortly before the European Commission's Apple decision was issued. It expressed profound concern with the European Commission's

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[6] One case was directed at the Belgian excess profit scheme and not at a particular company. Another case is being pursued against French utility company Engie SA, formerly GDF Suez.

[7] On September 7, 2016, Irish Finance Minister Michael Noonan issued a statement to the House of Representatives (*Dáil Éireann*), seeking support to appeal the European Commission's decision that tax rulings issued by Ireland to Apple in 1991 and 2007 constituted illegal State Aid. On the same date, the Irish Department of Finance issued an explanatory memorandum for Parliament detailing House support of the Irish government's plans to appeal the decision.

[8] The amount may be held in escrow until the final decision.

[9] Prior to the Lisbon Treaty becoming effective on December 9, 2009, known as Court of First Instance.

[10] U.S. Department of the Treasury, "The European Commission's Recent State Aid Investigations of Transfer Pricing Rulings," August 24, 2016.

investigations. The White Paper focused on three points:

- The investigations departed from prior E.U. case law and decisions.
- Retroactive recoveries through the investigation process is inappropriate.
- The European Commission's approach is inconsistent with O.E.C.D. transfer pricing guidelines.

The U.S. Treasury Department believes that the European Commission's investigations undermine the development of transfer pricing norms, the B.E.P.S. Project, and the ability of countries to honor their bilateral tax treaties with the U.S. It additionally notes that any repayment ordered by the European Commission will be entitled to a foreign tax credit in the U.S., thereby reducing U.S. tax liability and effectively transferring tax revenue from the U.S. to the E.U. Finally, the U.S. Treasury Department believes that the investigations will freeze cross-border investment between the E.U. and the U.S. and that retroactive penalties will hinder the ability for companies to plan for the future.

TREASURY'S ANALYSIS OF STATE AID AND THE EUROPEAN COMMISSION INVESTIGATIONS

State Aid exists when a national measure is financed by the state or through state resources in a way that (i) provides an advantage for a business undertaking, (ii) is selective in its application, and (iii) as a result, affects trade between member states by distorting competition.[11] The White Paper focuses primarily on the selectivity and business advantage elements of the definition.

"Advantage" was defined in prior case law to mean "any economic benefit which an undertaking could not have obtained under normal market conditions." For an advantage to be found, it had to be granted in a "selective way to certain undertakings of categories or to certain economic sectors."[12] According to the White Paper, once an advantage has been found, an analysis must be performed to determine whether the advantage is "selective." To be selective, a measure must provide a benefit to certain undertakings in comparison with other comparable undertakings.[13]

The White Paper concludes that prior European Commission rulings stated that measures available to companies with foreign affiliates but not available to domestic companies without foreign affiliates did not constitute "selective measures." Based on these prior rulings, a U.S. multinational would reasonably assume that a transfer pricing ruling granted in good faith by an E.U. Member State would not constitute a "selective measure" simply because a multinational has foreign affiliates whereas a

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[11] *Air Liquide Industries Belgium SA v. Ville de Seraing a.o.*, Joined Cases C-393/04 & C-41/05, ECLI:EU:C:2006:403, ¶28. See also "Tax Rulings in the European Union – State Aid as the European Commission's Sword Leading to Transparency on Rulings," *Insights* 6 (2015).

[12] Commission Notice on the notion of state aid as referred to in Article 107(1) of the TFEU, 2016 O.J. C 262/1, ¶¶5, 66 and 117.

[13] *Portugal v. Commission*, Case C-88/03, ECLI:EU:C:2006:511, ¶54 (citing, among others, *Adria-Wien Pipeline*, Case C-143/99, ECLI:EU:C:2001:598, ¶41).

standalone European company has no affiliates.[14]

The White Paper notes that the European Commission previously separated its advantage analysis from its selective analysis in 65 prior cases. Now, however, in cases involving U.S.-based multinationals, the European Commission has merged the concepts of advantage and selectivity to conclude that a transfer pricing ruling is a selective advantage for a company that is part of a multinational group. According to the U.S. Treasury, the European Commission expanded protection of local companies because "selectivity" was often the largest barrier to finding the existence of a State Aid violation.

Observation

On this point, the U.S. Treasury Department is in line with the applicants in their appeal against the Commission's decisions in Starbucks and Fiat, focusing on the Commission's assessment of the two key State Aid conditions, *i.e.* advantage and selectivity. The Commission's new approach of collapsing the advantage and selectivity requirements has important substantive significance. Now, the Commission can find advantage if it disagrees with the Member State's application of the arm's length principle to a particular set of facts that are often highly complicated. The Commission's new approach reduces a State Aid inquiry to the question of whether the Commission believes that a transfer pricing ruling satisfies its view of the arm's length principle.[15]

RETROACTIVE RECOVERY

For a violation of State Aid regulations, the European Commission may require recovery for up to 10 years, with interest accruing for the period that the illegal aid was granted until the aid is recovered. According to the White Paper, U.S. multinational groups could not have foreseen the European Commission's new approach. Consequently, the recovery amount is a retroactive penalty.

In effect, because the transfer pricing was held to be valid in certain countries and due to the fact that the European Commission had tacitly accepted such arrangements for a long period, multinationals could not know that they would be considered to be infringing E.U. law. The U.S. Treasury Department notes that such a retroactive penalty is a fundamental violation of the principles stated by the G-20, the E.U., and the B.E.P.S. Project, which provide certainty to taxpayers while respecting each country's domestic transfer pricing agreements.

Finally, while the European Commission rulings make reference to an "arm's length principle," the U.S. Treasury Department notes that such a term remains undefined in the rulings. The White Paper implies what most U.S. tax advisers believe: that the

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[14] Treatment by the Netherlands tax authorities of a technolease agreement between Philips and Rabobank, Commission Decision 2000/735/EC, 2000 O.J. L 297/13, ¶36

[15] In a summary of its claims, Fiat stated:

> The contested decision breaches the principle of legal certainty since the commission's novel formulation of the arm's length principle introduces complete uncertainty and confusion as to when an advance pricing agreement, and indeed any transfer pricing analysis, might breach EU state aid rules.

investigations are politically motivated to punish E.U. countries with low tax rates or favorable practices, and multinationals that plan structures using those jurisdictions.

Observation

The introduction of a new arm's length standard by the European Commission has been previously noted in *Insights*.[16] The U.S. is joined in this assessment by Fiat and the Netherlands. In their appeals, Fiat touched the heart of the matter when it accused the Commission of failing to show how it derived the arm's length principle from Union law, or even what the principle is. These are harsh words, and a similar argument was put forward by the Netherlands in an even more unequivocal manner, when it was argued that there is no arm's length principle in E.U. law and that that principle is not part of a State Aid assessment.

In addition, the claw-back of taxes poses the following question: who is bearing the cost? Eventually, it will be the U.S. taxpayer, due to the foreign tax credit system in effect in the U.S. Under the U.S. tax system, foreign income taxes imposed on foreign subsidiaries of U.S. companies may be credited by their U.S. parent company when dividends are paid.[17] Within the limitations of U.S. tax law,[18] the credit reduces U.S. tax imposed on foreign-source income.

Some believe that the State Aid cases brought by the European Commission will invite a transatlantic trade war, which is of concern to the U.S. Treasury Department. In the White Paper, the following comment was made:[19]

> A strongly preferred and mutually beneficial outcome would be a return to the system of international tax cooperation that has long fostered cross border investment between the United States and EU Member States. The U.S. Treasury Department remains ready and willing to look for a path forward that achieves the shared objective of preventing the continued erosion of the corporate tax base while ensuring our international tax system is fair for all.

A similar statement was made by a spokesman for the U.S. Treasury Department:

> The Commission's actions could threaten to undermine foreign investment, the business climate in Europe, and the important spirit of economic partnership between the U.S. and the EU. We will continue to monitor these cases as they progress, and we will continue to work with the Commission toward our shared objective of preventing the erosion of our corporate tax bases.

In an article published in the *Wall Street Journal* on September 13, 2016, Treasury Secretary Jack Lew called for a U.S. tax reform in view of "Europe's Bite Out of Apple."

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[16] Beate Erwin and Christine Long, "E.U. State Aid – The Saga Continues," *Insights* 6 (2016).

[17] In addition, a credit may apply when a U.S. shareholder of a controlled foreign corporation includes in income an item of Subpart F income. Code §960.

[18] Primarily, Code §904.

[19] U.S. Department of the Treasury, "Treasury Releases White Paper on European Commission's State Aid Investigations into Transfer Pricing Rulings," accessed September 26, 2016..

CONCLUSION

The U.S. Treasury Department notes that the European Commission's interference in Member States' tax authority effectively undermines relations among those countries and with the U.S. More importantly, if domestic decisions can be overridden using a European Commission ruling, an E.U. Member State's power to enter into a bilateral income tax treaty is ultimately dismantled. On a practical level, U.S. multinational groups will have no interest in obtaining advance pricing agreements with an E.U. Member State which makes all pricing arrangements subject to audit in the U.S. and Europe.

The decision of the General Court in the State Aid cases will have far-reaching consequences. Should the court reject one of the Commission's main arguments, most notably its assertion that a deviation from the Commission's interpretation of the arm's length principle confers a "selective advantage" on the recipient, then it is likely that all of its final decisions will be annulled, since they are based on the same doctrinal "pillars." Moreover, if the E.C.J. does not support the Commission's approach on appeal, the Commission's use of the State Aid mechanism to crack down on tax avoidance will have failed dramatically. However, it will take years before certainty is reached on this level.

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Until then, it remains to be seen whether pressure by the U.S. tax authorities will restrain the European Commission, or whether the European Commission will expand its investigations to include other U.S. multinationals. At this stage, with both the U.S. and the European Commission adamant in their respective positions, the stage is set for a prolonged battle. Meanwhile, U.S. multinationals are faced with difficult decisions on pricing and must carefully consider their European strategies.

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