EUROPEAN COMMISSION ROCKING THE BOAT AT ARM'S LENGTH

Authors
Theo Elshof
Olaf Smits
Mark van Mil

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Theo Elshof is a managing director of Quantera Global with more than 20 years of experience in international tax, transfer pricing, and tax control frameworks. His experience includes active participation in competent authority A.P.A.'s and M.A.P.'s, restructuring projects, and transfer pricing audits. He has master and post-master degrees in tax and controlling.

Olaf Smits is counsel at Quantera Global with over 12 years of experience. His experience covers in a wide variety of industries and the full transfer pricing lifecycle – from planning, design, and implementation to defense and documentation. He has a master degree in tax economics from the University of Amsterdam.

Mark van Mil is tax trainee at Quantera Global. He studies fiscal law and international business law at Tilburg University.

INTRODUCTION

Many may recall the British parliamentary committee that interviewed top managers of the M.N.E.'s Google, Amazon, and Starbucks in 2012. Margaret Hodge, chairman of the committee at the time, together with other members, grilled the top managers over the tax avoidance schemes of their respective companies. The findings of the committee set things into motion and sparked the O.E.C.D. to initiate the B.E.P.S. Project. Its results were published in the autumn of 2015. Soon after, the European Commission (the "Commission") rolled up its sleeves and adopted the Anti-Tax Avoidance Package ("A.T.A.P."). Even before the introduction of the A.T.A.P., the Commission started using another approach to combat the tax avoidance schemes of M.N.E.'s: the State Aid argument. By now, various M.N.E.'s have been accused of receiving State Aid through publications that – to put it mildly – prompted some strong responses.

Because the Commission's decisions seem to be based on certain new transfer pricing rules for checking the fulfilment of the requirements of State Aid, we – as transfer pricing specialists – would like to share with you our current understanding and views on what we can derive from two specific cases: Starbucks and Apple. We will elaborate on these cases and discuss similarities and differences in the approach taken by the Commission and the O.E.C.D.

We will first describe briefly the legal framework of State Aid and our findings on the Commission's general approach to combatting the tax avoidance schemes of M.N.E.'s. Thereafter, we will expound on the Starbucks and Apple cases. We will describe the key facts of each case followed by the Commission's approach and our comments. Before arriving at our conclusion, we will comment on the O.E.C.D.'s interpretation of the arm's length principle ("A.L.P.") versus the Commission's interpretation of the A.L.P. We will conclude by making some final remarks about the Commission's approach in both cases.

LEGAL FRAMEWORK OF STATE AID

Pursuant to Article 107 T.F.E.U., the "Commission Notice on the Notion of State Aid" and the case law of the European Court of Justice, the six constituent elements of the notion of State Aid are as follows:

1. The existence of an undertaking
2. The immutability of the measure to the Member State
3. Its financing through Member State resources

4. The granting of an advantage

5. The selectivity of the measure

6. Its effect on competition and trade between Member States

Each of the constituent elements has always been assessed separately, from one to six, both by the Commission in its decisional practice and by the European Court of Justice in its own cases. In practice, the most disputed elements are economic advantage and selectivity. On the other hand, if the six requirements are met, Article 107 T.F.E.U. stipulates certain exemptions that allow Member States to achieve certain policy objectives. However, these exemptions do not apply to the Apple and Starbucks cases.

THE COMMISSION'S APPROACH

After the publication of the O.E.C.D.'s findings about the 15 B.E.P.S. action items, the Commission pursued its crackdown on tax avoidance schemes by M.N.E.'s. The Commission's insistence on adopting uniform legislative measures in respect of the implementation of Country-by-Country Reporting and the introduction of the A.T.A.P. underlines its goal. Although it is difficult to fully grasp the approach of the Commission in its State Aid decisions, the Commission appears to have chosen favorable Advanced Pricing Agreements ("A.P.A.'s") as the vehicle to set its own approach. This approach focuses on "the market prices that a stand-alone company would pay under normal business circumstances" as a new A.L.P. definition used by the Commission in State Aid cases. The Commission seems to reject the A.L.P. of the O.E.C.D. by arguing that the O.E.C.D.'s A.L.P. only applies to M.N.E.'s. As a result, stand-alone companies, which always have to pay market prices for their individual transactions, are not covered by this A.L.P. Subsequently, a comparison is made between the scrutinized company and a stand-alone company.

The general approach of the Commission's assessment regarding State Aid may be described as follows:

- The basis for a State Aid analysis is the local regulations (tax law and guidance) of the Member State, the so-called reference system.
- The Commission considers that the O.E.C.D.'s A.L.P. is only applicable for M.N.E.'s and does not apply to independent stand-alone companies. Therefore, this principle must be replaced with the Commission's own principle: the market conditions of a stand-alone company under similar business circumstances. As such, the Commission applies its own definition of the A.L.P. when performing its State Aid analyses.
- Based on this set of principles, the State Aid analysis is performed.

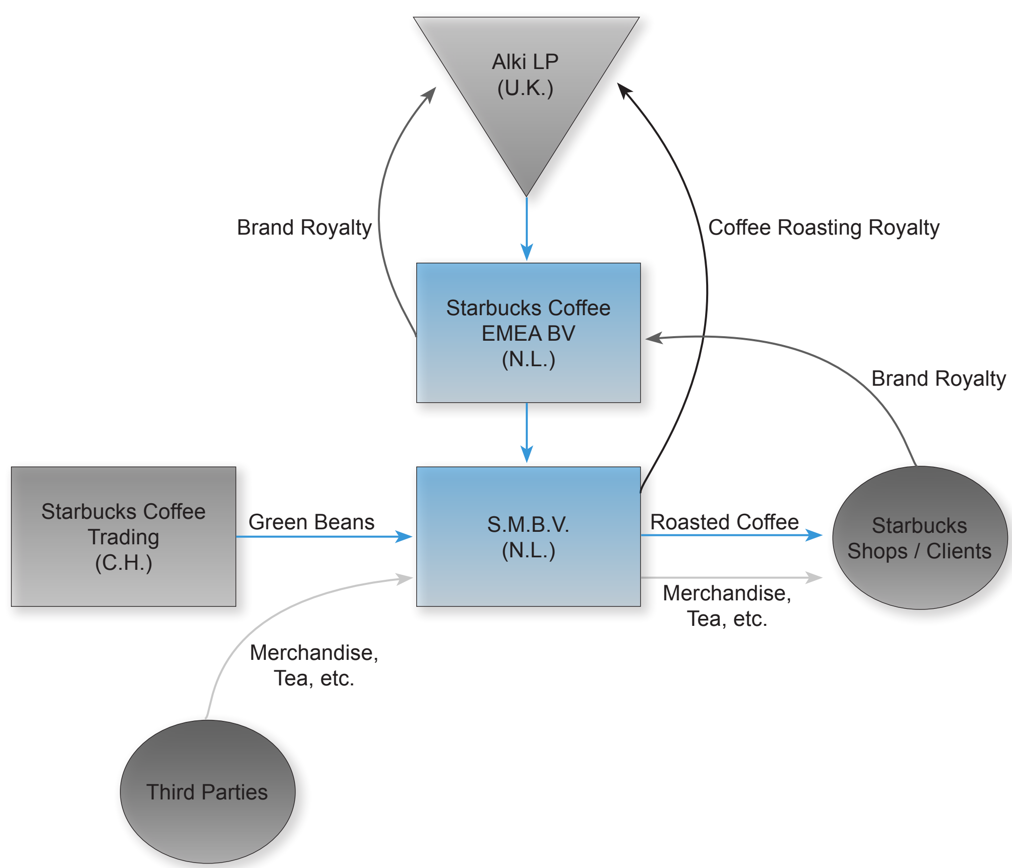
The State Aid instrument grants the Commission the authority to influence the corporate income tax paragraph within the E.U. The Commission uses that grant of authority to set aside the O.E.C.D. guidance provided in the B.E.P.S. reports and the A.L.P., and replaces that guidance with its own version (the "E.U. A.L.P."). The Commission has explicitly stated that the E.U. A.L.P. is not based on Article 9 of the O.E.C.D. Model Convention, as is the A.L.P. supported by the O.E.C.D. In other words, according to the Commission, the battle against State Aid overrides the standard of Article 9.

HOW DOES THE COMMISSION APPROACH WORK OUT IN THE CASES OF STARBUCKS AND APPLE?

The Starbucks Case

Facts

Starbucks started its activities as a coffee-roasting facility in the Netherlands in 2002, through its subsidiary Starbucks Manufacturing BV ("S.M.B.V."). The main activities of S.M.B.V. are the roasting of green coffee beans and the packaging, storage, and sale of roasted beans to Starbucks shops across Europe. S.M.B.V. purchased green coffee beans from a Swiss associated company and paid a royalty to a U.K.-based group company ("Alki LP") for licensing intellectual property rights, which are necessary for the production process and the supply to shop operators. The picture below provides a simplified overview of the transactions relevant to the Dutch A.P.A.



In 2008, an A.P.A. was granted by the Dutch tax authorities to S.M.B.V. for the arm's length remuneration of its main activity as a coffee roasting facility. The Commission concluded that the A.P.A. violated Article 107 T.F.E.U.

“The Commission defines its own principle – the E.U. A.L.P. – from the perspective of a stand-alone company, which always pays market prices for all its individual transactions.”

The Commission’s Decision

In the case of Starbucks, the report of the Commission began with an analysis of the Dutch system of corporate tax and the A.L.P. that is incorporated in Article 8(b) of the Dutch Corporate Income Tax Act (“C.I.T.A.”). In its analysis, the Commission appears to have accepted the Dutch system of corporate tax as the reference system but not the incorporated A.L.P. of the O.E.C.D. The Commission defines its own principle – the E.U. A.L.P. – from the perspective of a stand-alone company, which always pays market prices for all its individual transactions. Therefore, the E.U. A.L.P. criteria can be described as “the market prices a stand-alone company pays under similar business circumstances.” The Commission determined the market prices through the use of information requested from Starbucks’ competitors.

Based on the E.U. A.L.P., the Commission rejected the use of the transactional net margin method (“T.N.M.M.”) to determine an A.L.P., since this O.E.C.D. method can only be applied by M.N.E.’s and not by stand-alone companies that must always pay market prices. Instead, the Commission separately scrutinized all identified intercompany transactions and endeavoured to identify and apply market prices. Available market information was gathered, and competitors of Starbucks were requested to provide relevant information to determine market prices. Without going into specific details, the conclusion of the Commission was that the intercompany transactions of S.M.B.V. did not meet the E.U. A.L.P. applicable to State Aid cases.

The Commission concluded that State Aid was granted to Starbucks for the following reasons. First, the intercompany prices and recent price increases for the green beans from the associated Swiss entity could not be explained when compared to market prices. Second, a stand-alone company would not have paid any royalty to Alki LP since the latter company had virtually no business substance when measured by people and facilities. In that respect, the Commission noted that a license agreement is not an ordinary transaction for a coffee roaster.

Apparently, the granted State Aid was calculated by multiplying the differences in the pricing of green beans and the royalty payment with the Dutch tax rate. As a result, the Commission reasoned that the ruling constituted a form of State Aid that amounted to €20 to €30 million.

Our Remarks

The rejection of the O.E.C.D.’s A.L.P. in State Aid cases raises questions about the formal positioning of the E.U. A.L.P. and its effects on daily discussions between M.N.E.’s and national tax authorities.

Such questions should be handled with great care. The O.E.C.D.’s A.L.P. has been developed over a period of more than 50 years and through the recent work of the O.E.C.D. on B.E.P.S. Thus, it is more than suitable to face challenges and offer solutions to M.N.E.’s and tax authorities. The basis of the O.E.C.D.’s A.L.P. is a thorough understanding of the relevant facts to determine and test the comparability of the conditions of intercompany transactions with transactions between comparable third parties. Therefore, there is no need for another A.L.P. We even regard the creation of the Commission’s own E.U. A.L.P. as a missed opportunity to utilize the full potential of the O.E.C.D. guidance on transfer pricing.

The Commission is not primarily a tax body. Its goal is to ensure a level playing field within the European Single Market, and its officials are sensitive to *sub rosa* government actions that distort trade. In comparison, the standard of the O.E.C.D. reflects the life experience of government officials who have devoted their careers to matters related to tax policy. It should not be unexpected that tax professionals are sympathetic to tax concepts and trade administrators are sympathetic to trade law. Seen in this light, the Starbucks case indicates that winning arguments in one forum – where all M.N.E.'s can obtain comparable tax rulings – turn out to be losers in the other forum – where the business model of the smaller company sets the standard to be followed by M.N.E.'s.

Ultimately, the problem encountered by Starbucks reflects a bureaucratic disjuncture: Which of two competing competencies will control? Still to be heard are anti-trust administrators who may have a third view when an entire industry carries on business in a uniform way.

A disturbing aspect of the Commission's approach in determining market prices is the active participation of competitors in determining an acceptable business model to be imposed on Starbucks. For Starbucks, information from competitors would normally not be available. In O.E.C.D. Transfer Pricing Guidelines parlance, the use of information that is not available to taxpayers is called secret comparables. The Commission's approach leads, from a pure transfer pricing perspective, to all kinds of concerns about the comparability, intercompany effects, and lack of a more detailed understanding of the facts presented by these competitors. As a result, it is hard to determine a correct market price. Furthermore, the comparables, in this case, were not only secret but also tainted – because the comparable information was introduced by competitors responding to a request that would affect Starbucks. Therefore, the O.E.C.D. has stipulated in its Transfer Pricing Guidelines to take caution with the use of secret comparables.

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The Apple Case

Facts

Apple has two subsidiaries in Ireland, namely Apple Sales International and Apple Operations Europe. Both manufacture Apple products in Europe and hold the right to use Apple's intellectual property, for which they contribute considerable amounts for research and development ("R&D") to their U.S. parent company. The sales structure was set up in such a way that customers were contractually buying products from Apple Sales International. The Irish tax authorities granted a similar A.P.A. to both entities. The A.P.A. endorsed a split of the profits for tax purposes in Ireland between the head offices and Irish branches. The vast majority of the profits was allocated to the head offices, which did not have any employees or own premises. The head offices only held occasional board meetings. Moreover, only the Irish branches were subject to tax in Ireland. The head offices were not located in Ireland and, hence, not subjected to tax in Ireland.

The Commission's Approach

Until now, the Commission published only a summary of its reasoning to conclude that the Irish tax rulings amount to State Aid. The full reasoning is not expected to become public before 2017.

In the Apple case, two entities were under scrutiny. The Commission started by analysing the Irish system and determined that the two entities made use of sliding scale pricing. The two head offices seemed to exist on paper only, and as a result, it was unclear where they actually were located. Additionally, the head offices lacked any relevant substance. Consequently, the Commission reasoned that the A.P.A.'s provide an economic benefit to the two entities, because the branches in Ireland never would have paid that amount of profit to a third party, given the lack of relevant substance in the head offices. Finally, the Commission based the amount of State Aid on the Irish corporate income tax rate on the profits allocated by the branches to the residual Irish entities minus the minor functions, which can be allocated to the head offices.

What the Commission refused to accept is the concept that actual services were provided by affiliates in the U.S., or elsewhere, so that at the level of the Irish branches the expenses reflected value provided by the affiliates. Looked at in this manner, the issue was not an Irish issue but an issue at the level of the head offices and, in that jurisdiction, the methodology was accepted pursuant to a qualified joint cost sharing agreement.

Before issuing its decision, the Commission stated that the amount of State Aid could be lowered if more profit was allocated to the sales entities or more costs for the R&D activities were allocated in the U.S. It seems that an "always-somewhere principle" was used by the Commission, entailing that the profits should always be taxed somewhere and, if not, they will be allocated to the jurisdiction that provides the greatest tax within the E.U.

Our Remarks

To date, a complete assessment of the Apple case cannot be made because too many questions remain unanswered in the absence of a published report. Where are the head offices located? If in the U.S., a trade or business should exist. If none existed, an unacceptable tax gap has likely occurred because neither Ireland nor the U.S. levied tax. But is the existence of a tax gap sufficient justification to conclude that Ireland has granted State Aid to Apple? If the head offices are not located in the U.S., on what basis did the Commission determine that State Aid existed in Ireland?

At this point, it is not clear whether the Commission's decision is aligned with the O.E.C.D. guidelines on profit attribution with regard to allocations between head offices and branches, and how this interacts with the analysis of State Aid. Furthermore, the suggestion of the Commission to make use of an always-somewhere principle suggests that the Commission is mostly concerned that the profits are taxed and less concerned with where the profits are taxed and whether double taxation exists.

Finally, the Commission again seems to have use its own A.L.P., as it did in the Starbucks case. Remarkably, it did not scrutinize all the other intercompany transactions – like the royalties received or the lack of payments to other group companies in Europe or the U.S.

THE O.E.C.D. V. THE COMMISSION

Back in 2013, the O.E.C.D. was requested by the G-20 to start the B.E.P.S. Project. This request came after the U.K. hearings to which we referred at the beginning of this article. While the O.E.C.D. was working hard at developing its 15 B.E.P.S.

action items, the Commission did not want to wait for the outcomes and implementation. Therefore, the Commission adopted the A.T.A.P. The A.T.A.P. is meant as a B.E.P.S.-plus package and, therefore, goes even further than the outcomes of the B.E.P.S. Project.

The O.E.C.D., as the guardian of the A.L.P., seems to struggle with the recent State Aid cases of the Commission. In a recent news article, Pascal Saint-Amans, the director of the Centre for Tax Policy and Administration of the O.E.C.D., mentioned that the bulk of Apple's profits belongs in the U.S., as the profits should be aligned to R&D. Although the O.E.C.D. only provided high-level input on the recent cases, it seems that the O.E.C.D. does not agree with the new E.U. A.L.P. introduced in the State Aid cases, and it has pointed out that the functions, assets, and risks of an entity should be remunerated according to the A.L.P. established by the O.E.C.D.

"By defining a separate E.U. A.L.P. and going its own way, the Commission creates undesired confusion."

FINAL REMARKS AND CONCLUSION

We would like to add a few general comments to the Commission's approach. First, the Commission states that, as a condition for the State Aid to exist, the targeted company should be evaluated on a stand-alone basis. By doing so, the Commission ignores, or even disqualifies, the T.N.M.M. and would throw taxpayers back to the time when searches were required for exact comparables to measure the arm's length price. Thus, it regards all facts it deems to be relevant and not just specific transactions. Consequently, a similar discussion would ensue based on transfer pricing rules.

Second, the Commission focuses solely on the economic advantage criterion and disregards the criterion of selectivity. It states that the granted rulings are selective, because the economic advantage can be provided only to M.N.E.'s and not to stand-alone companies. In this way, the Commission deems the selectivity requirement fulfilled if the economic advantage requirement is met, and as a result, these two criteria are merged. The reason why the Commission has merged these two criteria is evident: It has always been difficult to prove the selectivity of rulings because they are available to everyone that applies. The current approach of the Commission has created significant uncertainty for M.N.E.'s worldwide. This has led to concerns that investments in the E.U. will be withheld.

Finally, the Commission's use of its State Aid instrument as grounds for a new definition of an A.L.P. could be viewed as a politically driven act. The Commission is seemingly grabbing the power to control direct taxes. To date, this power remains with the sovereign members of the E.U. The transfer of sovereignty regarding direct taxes has been consistently opposed by the Member States. The Commission would do well to remember that the *raison d'être* of the State Aid tool is to prevent Member States from providing special advantages to domestic companies. The use of an A.P.A. is an excellent instrument for M.N.E.'s and tax authorities to safeguard arm's length remunerations and positions, based on robust transfer pricing documentation and professional judgments. By defining a separate E.U. A.L.P. and going its own way, the Commission creates undesired confusion in this field.

In conclusion, an old saying with roots in team play comes to mind: It is better to row together than each rock the boat separately. It is not clear that the Commission understands the true meaning of this saying.