

## E-ALERT | Tax

October 20, 2014

### EUROPEAN STATE AID AND INVESTIGATIONS INTO TAX RULINGS

In June, the European Commission (“EC”) announced the opening of three investigations into tax rulings in Ireland, Luxembourg and the Netherlands and, in particular, into tax rulings applied by Ireland to Apple, by Luxembourg to Fiat Finance and, last, by the Netherlands to Starbucks. In October 2014, the EC announced the opening of a fourth investigation into the application of tax rulings of Luxembourg to Amazon. Most recently, the EC ordered Spain to recover money from companies that benefited from rules that encouraged merger activity outside of the country.

We understand that the EC also has requested that Luxembourg produce all tax rulings that were issued in 2010, 2011, and 2012. Luxembourg has not complied with this request, and the matter will be heard by the EU Court of Justice. Companies with tax rulings that do not withstand challenge can be responsible for up to ten years of tax liabilities.

#### 1. Background information

EU law provides that any selective advantage granted by an EU Member State to an individual company is prohibited – and needs to be reimbursed – if it distorts competition on the European internal market.

In essence, the EC is investigating whether certain tax practices of Member States have conferred prohibited selective advantages on multinational companies via tax reductions.

This issue is of great importance to the EC, given that, in the mission letter that Mr. Juncker sent to the new Commissioner of Competition, Ms. Vestager, in September 2014, “the fight against tax evasion” has been identified as one of the main priorities of the Directorate-General for Competition (DG COMP).<sup>1</sup> Ms. Vestager, during her confirmation hearing before the European Parliament in October 2014, stressed the importance of these investigations as well as the EC’s intention to create deterrence against corporate tax evasion.

#### 2. Issues at stake

##### *a) Pricing methodology or something more?*

The four investigations relate to tax rulings which validate transfer pricing agreements, also referred to as advance pricing agreements (APAs). Transfer pricing relates to the prices charged for commercial transactions between parts of the same corporate group (intra-group commercial transactions) e.g., the prices set for goods sold or services provided by one subsidiary of a corporate group to another subsidiary of the same group. APAs are agreements that determine an appropriate set of criteria, or methodology, for the determination of the transfer pricing for intra-group commercial transactions. Since the prices set for these intra-group transactions will be accepted by

---

<sup>1</sup> Mission letter from Jean-Claude Juncker to Margrethe Vestager, 10 September 2014, Brussels, available at [http://ec.europa.eu/about/juncker-commission/docs/vestager\\_en.pdf](http://ec.europa.eu/about/juncker-commission/docs/vestager_en.pdf)

the taxing authority that enters into the APA, APAs affect indirectly the allocation of taxable profits to that taxing jurisdiction and the tax paid by the corporate group in that jurisdiction.

The four investigations concern the calculation methods of certain APAs as negotiated between Member States and the various affected companies as set out in the tax rulings. In particular, the investigations concern the compatibility of these calculation methods with internationally agreed standards as well as with the arm's length principle.

The EC has announced it will use the "OECD Transfer Pricing Guidelines" as the reference point to assess potential aid. The most important elements that the EC is considering to support its preliminary conclusion that the APAs constitute aid are the following:

- the indefinite duration of an APA: this casts doubt as to the appropriateness of the agreed arrangement for later years, when market conditions may have changed;
- the fact that the taxable basis of the APA was negotiated ("reverse engineering") rather than based on appropriate transfer pricing methods and procedures;
- the appropriateness of a particular transfer pricing method chosen;
- inconsistencies in the implementation of the chosen APA;
- a number of unhelpful statements in interviews and meeting notes which seem to support some of the above allegations.

The transfer pricing analysis of the EC seems to object more to the methods and approaches used to arrive at the APAs in question. The EC does not seem to analyze whether the APAs resulted in the recognition in the jurisdiction of inadequate profits. On its face therefore the analysis of the EC would seem to suffer from some insufficiency.

*b) Something more?*

It is noteworthy that in Amazon's case, the calculation method of the taxable basis is also related to an amount of royalty that Amazon in Luxembourg is paying to a related entity which is tax exempt in Luxembourg. The fact that the amount or royalty is tax deductible and lowers the taxable profits, according to the tax ruling agreed with the State, has drawn the EC's attention. The EC's concerns may in fact be broader in scope than pricing methodology.

### 3. Risks

The risk for the companies involved is that, in case the aid is considered to be incompatible, the Member State is required to claim the financial advantage, including interest, back.

In addition to the companies already under investigation, other companies may well become the target of additional investigations.

### 4. What should a company with an APA from an EU member state do?

- a) First determine – and assess – the State aid risk. The EC is not obliged to open proceedings against all companies potentially involved. How confident is the company of its transfer pricing position? What is the company's public profile?
- b) Consider whether any changes to the company's trading structure may be merited.

- c) Consider alone or with other companies having discussions with the EC to explain why no State aid should be found in the transactions at issue based on the procedural circumstances cited in the EC's decisions. Convince the EC that it lacks the necessary expertise to pursue the theories it is pursuing, that the national authorities have acted appropriately, and that the actions of the EC will create great uncertainty and cause economic harm to the EU.
- d) Consider alone or with other companies, holding discussions with OECD officials to determine the OECD's view of the investigations and whether some support may be found at the OECD.
- e) Consider alone or with other companies, engaging with the national authorities of the company's home country and seek assistance in protecting the company from unfair treatment both substantively and procedurally at the hands of the EC.
- f) If the company becomes, or is, targeted, engage with the APA issuing authority and the EC to present the strongest case possible that the practices are not prohibited State aid, that the concerns of BEPS are not addressed by the EC's activities, and that the actions of the EC will create great uncertainty and cause economic harm to the EU.

## 5. Procedure and process

Unlike most of the provisions related to EU competition law, the EU State aid rules are addressed to and regulate the conduct of governments rather than companies. All the EC's requests for information as well as the investigations as a whole are addressed to the Member States and not to the companies. Therefore, the compliance with the EU State aid rules is predominantly a dialogue between the EC and the Member State concerned, a fact which gives State aid a rather significant political dimension.

Nonetheless, State aid always creates a triangular relationship between the EC, the Member State and the beneficiary of the alleged aid. In most of the cases, the beneficiary is involved in the discussions between the EC and the Member State concerned. Furthermore, following the opening of the EC's investigation, the Member State concerned and interested parties are invited to comment on the case. The beneficiary will normally assist the Member State in preparing its comments as well as its answer to the comments raised by the interested parties. Therefore, the role of the beneficiary is vital, especially following the opening of the investigation.

In terms of timing, the EC, since September 2013, had started looking into tax regimes in several Member States. In one year, four in-depth investigations into the aforementioned tax rulings were initiated. The EC is expected to terminate the investigations and adopt the relevant decisions in one year from the opening of the investigations.

Last, should the EC draw the conclusion that the Member States have granted unlawful State aid to the companies concerned, the latter will be ordered to take all necessary measures to recover the aid.

\*\*\*\*\*

Covington & Burling has deep expertise in the unique business and regulatory environment in which these developments are unfolding, and is well positioned to address both State aid and underlying tax issues.

- Covington’s State aid team in Brussels is led by **Johan Ysewyn**. Johan advises on all aspects of European, International, and Belgian antitrust law. His practice has a strong focus on global and European cartel investigations. He is also one of the leading experts on EU State aid issues, working both for beneficiaries and governments, and he has been practicing antitrust law for 25 years.
- **Sophia Dipla**, also resident in the Brussels office, advises on all aspects of European antitrust law, with a particular focus on EU State aid and EU merger control. She has previously worked at the Commission in the unit dealing with State aid in the financial services sector.
- **Sam Maruca** recently returned to Covington’s Washington, DC office after serving for over three years as the first Director of Transfer Pricing Operations at the IRS. In that capacity Sam was responsible for both domestic and global transfer pricing strategy of the U.S. government, and represented the IRS in OECD matters. Sam has worked extensively in all aspects of transfer pricing, including APAs, for 25 years.
- **Lee Kelley**, a former IRS and Treasury executive, has dealt extensively with the taxation of U.S. multinationals, and in particular the complex interplay between U.S. tax rules and the tax regimes of major U.S. trading partners in the EU.
- **Michael Caballero** served as International Tax Counsel at the Treasury during the first term of President Obama’s Administration and where he was responsible for tax matters involving the EU as well as the U.S. Government’s participation in OECD’s Committee on Fiscal Affairs.
- **William Chip** serves on the Tax Committee of the OECD’s Business and Industry Advisory Committee and has been an active participant in the ongoing debate over Base Erosion and Profit Shifting (BEPS), and also chairs the Tax Treaty Subcommittee of the ABA Tax Section’s Committee on Foreign Activities of U.S. Taxpayers and the Transfer Pricing Subcommittee of the U.S. Council for International Business’s Tax Committee.
- **Reeves Westbrook** has specialized in international tax matters for over 40 years. Reeves is co-chair of the tax section of the International Bar Association and is regularly consulted by major multinationals in connection with OECD initiatives.

---

If you have any questions concerning the material discussed in this client alert, please contact the following members of our firm:

<b>Michael Caballero</b>	+1.202.662.5610	<a href="mailto:mjcaballero@cov.com">mjcaballero@cov.com</a>
<b>William Chip</b>	+1.202.662.5229	<a href="mailto:wchip@cov.com">wchip@cov.com</a>
<b>Sophia Dipla</b>	+32.(0).25495284	<a href="mailto:sdipla@cov.com">sdipla@cov.com</a>
<b>Lee Kelley</b>	+1.202.662.5961	<a href="mailto:lkelley@cov.com">lkelley@cov.com</a>
<b>Samuel Maruca</b>	+1.202.662.5161	<a href="mailto:smaruca@cov.com">smaruca@cov.com</a>
<b>Reeves Westbrook</b>	+1.202.662.5150	<a href="mailto:rwestbrook@cov.com">rwestbrook@cov.com</a>
<b>Johan Ysewyn</b>	+32.(0).25495254	<a href="mailto:jysewyn@cov.com">jysewyn@cov.com</a>

This information is not intended as legal advice. Readers should seek specific legal advice before acting with regard to the subjects mentioned herein.

In an increasingly regulated world, Covington & Burling LLP provides corporate, litigation, and regulatory expertise to help clients navigate through their most complex business problems, deals and disputes. Founded in 1919, the firm has more than 800 lawyers in offices in Beijing, Brussels, London, New York, San Diego, San Francisco, Seoul, Shanghai, Silicon Valley, and Washington. This communication is intended to bring relevant developments to our clients and other interested colleagues. Please send an email to [unsubscribe@cov.com](mailto:unsubscribe@cov.com) if you do not wish to receive future emails or electronic alerts.

© 2014 Covington & Burling LLP, 1201 Pennsylvania Avenue, NW, Washington, DC 20004-2401. All rights reserved.