JONES DAY

NOVEMBER 2014

COMMENTARY

Luxembourg Leaks: Potential Risks to Companies Whose Luxembourg Tax Rulings Have Been Released to the Public

This week, the so-called "International Consortium of Investigative Journalists" ("ICIJ"), on its website, leaked a total of 548 tax rulings that multinational companies obtained in Luxembourg in the period from 2002 to 2010.

The list of companies whose rulings were disclosed includes some of the largest multinationals not only from the U.S. and Europe but also Japan, China, Russia, Brazil, and other countries. The ICIJ alleges that these companies "have channelled hundreds of billions of dollars to Luxembourg and saved billions of dollars in taxes." Some companies are alleged to have enjoyed effective tax rates of less than one percent. The ICIJ claims that in many cases, "Luxembourg subsidiaries handling hundreds of billions of dollars in business maintain little presence and conduct little economic activity in Luxembourg."

The ICIJ does not state how it obtained copies of the rulings; however, the documents disclosed on the website all originate from PricewaterhouseCoopers in Luxembourg, which apparently acted as tax advisor to the companies affected.

Potential Legal Risk for Companies Affected by Leaks

The ICIJ itself stresses that the companies that obtained the rulings did not act illegally. Many countries around the globe issue tax rulings to companies seeking advance confirmation of the tax consequences of transactions. Unless tax rulings are obtained through misrepresentations or other illegal means, they are legal and fully enforceable.

Both the OECD and the European Union have developed general frameworks to limit "harmful tax practices" or "base erosion and profit shifting." In particular, the Code of Conduct for Business Taxation agreed upon by the Council of Economic and Finance ministers of the European Union ("ECOFIN") of December 1, 1997, and the OECD Action Plan on Base Erosion and Profit Shifting, as well as the OECD's Transfer Pricing Guidelines, contain rules that seek to prevent Member States from engaging in what are regarded as unfair taxation practices. One of the criteria of the EU Code of Conduct that supports a finding of a harmful tax practice is a Member State's beneficial treatment of a

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company in the absence of any real economic activity in the territory of that Member State. Another criterion is a departure from internationally accepted rules of transfer pricing, in particular, the arm's-length standard. Some of the Luxembourg rulings leaked to the ICIJ might be looked on as violating one or more of these principles.

Both the Code of Conduct and the OECD rules, however, are "soft" law that is neither binding on the Member State nor on individual companies applying for a tax ruling. In particular, these rules cannot be used to invalidate tax rulings that have been legally obtained.

The direct legal risk for companies whose tax rulings have been made public is that the European Commission might review individual rulings under the so-called "State aid" rules.

Over the past few months, the Directorate General Competition of the European Commission has commenced "State aid" proceedings concerning individual tax rulings that four multinationals, three U.S. and one European, had obtained in Ireland, Luxembourg, and The Netherlands. The Commission has recently published details of its preliminary judgments, which led to the commencement of proceedings involving Ireland and Luxembourg.

Independent of the State aid proceedings, companies with what are now publicly disclosed Luxembourg tax rulings may be at increased risk of audit in other jurisdictions, as local tax authorities review such rulings. Further, such companies may consider whether the release of the Luxembourg tax rulings implicates possible changes in accounting treatment or additional disclosures of uncertain tax risks under GAAP or IFRS.

EU State Aid Rules as Applied to Tax Benefits

The State aid rules prevent Member States of the EU from conferring selective economic benefits on individual companies or groups of companies without obtaining prior approval from the European Commission. The rules are applicable to all companies with activities in the EU.

In the tax sector, the Commission can attack selective tax advantages that are conferred on individual companies or distinct groups of companies if those advantages exempt such companies from taxes that would normally be imposed on them under the tax rules of the Member State in question. Once a Member State has established the level of corporate taxation it deems appropriate, it must apply those taxes to all companies that are within its jurisdiction on a consistent basis. Thus, the State aid rules allow the Commission to sanction the nonapplication or unequal application by a Member State of its own rules while otherwise leaving differences in taxation between Member States unaffected.

The current Commission investigations are different from prior cases as the Commission is now questioning the legality of individual tax rulings as opposed to general tax schemes.[1] This strategy is potentially risky for the Commission, as it will have to explain how each company in question received a special advantage when these sorts of tax rulings were open to many other firms to obtain, and many did. Further, the very nature of a tax ruling in the transfer pricing field, in particular, is to apply the law to the specific facts of each taxpayer's inevitably specific circumstances.

Luxembourg Cases Opened to Date

Two of the cases opened by the Commission concern Luxembourg. Luxembourg first resisted the European Commission's request for access to its tax rulings. On March 24, 2014, the Commission issued a formal decision requiring Luxembourg to provide all the information requested. Luxembourg has challenged this decision before the European Court of Justice, alleging a violation of the rights of defense and the principle of proportionality as well as the allocation of competences in tax matters between the Commission and the Member States. Luxembourg's judicial appeal is still pending but will have no impact on the cases regarding individual rulings that have already begun. As a matter of fact, in August of 2014, Luxembourg has provided further information on a number of cases requested by the Commission.

1 The Commission has also announced that it is gathering information with respect to intellectual property tax regimes, such as patent boxes, in the various EU Member States.

The first of the announced Luxembourg cases concerns Fiat Finance, a subsidiary of the Fiat Group. In this case, the Commission criticizes the Luxembourg tax authorities for accepting that a subsidiary of the Fiat Group based in Luxembourg, which provided financing and banking services to other subsidiaries, received too little a remuneration for those services, thereby deflating its taxable profits. The Commission analyzes the transfer pricing methodology applied to Fiat and accepted by the Luxembourg authorities in great detail and questions a number of judgments made by the Luxembourg authorities during the process of negotiating and issuing the ruling.

Little is known so far about the second Luxembourg investigation that the Commission recently opened concerning Amazon. According to the Commission press release, the relevant tax ruling dates back to 2003 and ratifies a practice by which the Luxembourg entity that reports much of the taxpayer's European profits pays a "tax deductible royalty to a limited liability partnership established in Luxembourg but which is not subject to corporate taxation in Luxembourg."

Specific State Aid Risk for Companies with Leaked Rulings

Following the disclosure of the tax rulings by ICIJ, the Commission will have a large number of additional Luxembourg tax rulings that it can review under the State aid rules. It might elect to conduct further reviews and proceedings concerning those rulings.

Typically the Commission will start its review with a request for information addressed to the Member State. The Member State consults with the company concerned (this is the first time the company learns that its ruling is the subject of a Commission review) and provides the requested information to the Commission. Based on its recent experience, going forward Luxembourg is likely to adopt a more cooperative approach vis-à-vis the Commission and is not likely to withhold information on individual taxpayers' files.

Once it has completed its initial review and concluded that State aid is likely to be present, the Commission opens a formal in-depth review and grants the Member States, the companies concerned, and other interested parties (including competitors) the opportunity to comment. This is normally followed by several rounds of further questions and meetings between the Commission, the Member State, and the company concerned. There is no fixed timeframe for this phase of the review. The relevant procedural regulation merely provides that the Commission will attempt to conclude any such reviews within a period of 18 months.

Normally, when the Commission, in its final decision, finds that a measure has constituted State aid, it must order the repayment of the aid going back 10 years, plus interest. There have been instances in which the Commission did not order a repayment in order to protect the aid recipient's legitimate expectations. This has particularly been the case in instances where more generally available tax schemes were found to constitute State aid; it may become a more complex (and political) issue in cases where individual rulings are being challenged.

Since the Commission has elected to conduct this initiative as a review of individual rulings, the merits of each case will very much depend on the solidity of the transfer pricing arrangements and other facts underlying the specific tax structure chosen by the individual companies. In the case of an eventual negative ruling by the Commission, consequences for the individual companies may include a retroactive payment of taxes with interest for a period of up to 10 years.

Lawyer Contacts

Jones Day has established a task force to assist clients concerned by the Commission's initiative both from an EU State aid and a tax perspective. The task force includes lawyers knowledgeable on EU State aid law and on the tax laws of key EU Member States and the U.S. For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

Howard Liebman
Brussels
+32.2.645.14.11
hliebman@jonesday.com

Raymond J. Wiacek
Washington
+1.202.879.3908
rjwiacek@jonesday.com

Thomas Jestaedt
Frankfurt / Brussels
+49.69.9726.3612 / +32.2.645.14.14
tjestaedt@jonesday.com

Scott M. Levine
Washington
+1.202.879.3437
smlevine@jonesday.com

Lodewijk Berger
Amsterdam
+31.20.305.4218
lberger@jonesday.com

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