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European Commission Concludes that Starbucks and Fiat Tax Rulings Constitute Illegal State Aid and Orders Payment of Back Taxes

Today, October 21, 2015, the European Commission (the "Commission"), acting as the regulator of EU competition rules, announced that it had concluded that tax rulings obtained by a Dutch subsidiary of Starbucks and a Luxembourg subsidiary of Fiat conferred illegal State aid to those companies. Further, the Commission concluded that an amount equal to the alleged tax benefits plus interest must be repaid. The Commission concluded that the amount is between EUR 20 million and 30 million for each of these two taxpayers.

The formal decisions have not yet been published, and the reasoning of the Commission is therefore not yet available. However, based on its prior preliminary decisions in these two cases, dating from 2014, and today's press release, it is clear that these decisions—if sustained in the EU courts—are likely to have a significant impact on many other multinational enterprises ("Multinationals") that benefit from tax rulings issued by EU Member States.

Investigations

In 2013, in response to concerns that certain EU Member States were issuing favorable tax rulings to Multinationals in order to attract foreign direct investment in violation of EU competition rules, the Commission commenced State aid investigations. The Commission began investigating the ruling practices of seven EU Member States, including The Netherlands and Luxembourg, which it broadened to all 28 EU Member States in 2014. The decisions announced today with respect to Starbucks and Fiat represent the first of the Commission's final decisions relating to those investigations. Additional decisions relating to Irish rulings obtained by two subsidiaries of Apple and a Luxembourg ruling obtained by a subsidiary of Amazon are still pending. Furthermore, the Commission has launched formal probes into the Belgian excess profits tax regime, which may affect 47 Multinationals that obtained, in total, 54 Belgian rulings, and certain aspects of the Gibraltar territorial tax regime. The Commission has also announced that it is investigating the special tax regimes for income derived from intellectual property (so-called "Patent Box" or "IP Box" regimes) of 10 EU Member States.

Tax Rulings

Tax rulings have traditionally been a favored tool to provide certainty with regard to the tax implications of investments and transactions in advance

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of implementing such investments or transactions. An EU Member State's issuance of a tax ruling in and of itself does not constitute State aid. However, tax rulings may constitute illegal State aid if they provide favorable tax treatment to specific taxpayers that deviate from the issuing jurisdiction's normal tax rules or tax regimes, and may therefore be viewed as according favorable tax treatment to a specific taxpayer or industry. While the Commission has scrutinized tax regimes of various countries under its State aid rules in the past, the current investigations into specific tax rulings are unprecedented.

In the case of the two decisions issued today, the rulings under investigation validated certain specific intragroup transfer pricing arrangements. Both The Netherlands and Luxembourg generally adhere to the so-called arm's-length standard, which requires affiliated companies to enter into transactions among themselves at market terms, as interpreted in the Transfer Pricing Guidelines of the OECD (the "OECD Guidelines"). According to the Commission, rulings that comply with the OECD Guidelines do not constitute State aid. In both of these decisions, however, the Commission takes the position that the Dutch and Luxembourg tax authorities accepted transfer pricing arrangements that did not comply with the arm's-length standard and resulted in the payment of less tax than would otherwise have been due if the arm's-length standard had been applied "correctly."

The Starbucks Case

The Starbucks case relates to a ruling in the form of an Advance Pricing Agreement ("APA") obtained by a Dutch subsidiary that operates a coffee roasting plant in Amsterdam. The Dutch subsidiary also carries out certain related supply chain activities. The coffee beans are supplied to the plant by a Swiss affiliate, and IP is licensed to the plant by a UK affiliate. According to the Commission's preliminary decision of June 11, 2014, the APA characterizes Starbucks's Dutch subsidiary as a low-risk toll manufacturer that should be compensated based on the transactional net margin method ("TNMM") set forth in the OECD Guidelines, with operational cost as the profit indicator. Furthermore, the APA confirms that certain modifications should be made to the operational cost to determine the basis for the TNMM. It concludes that the arm's-length profits of the company should equal a margin of 9 percent to 12 percent over such modified cost. Income in excess of the taxable basis confirmed in the APA is paid by the Dutch subsidiary to the UK affiliate as a royalty.

In its preliminary decision, the Commission asserted, *inter alia*, that (i) the functions carried out and the actual risks incurred by the Dutch subsidiary go beyond the functions and risks of a toll manufacturer, (ii) the contractual allocation of risks and functions does not meet the arm's-length standard because it deviates from allocations that would be agreed upon by "a hypothetical prudent market operator," (iii) the Dutch authorities should not have accepted the modifications to the cost base for purposes of computing the taxable profits on the basis of the TNMM, and (iv) the Dutch tax authorities should not have accepted that any residual income in excess of the agreed taxable basis may be paid as a royalty for the use of IP without assessing if such payments indeed represent an arm's-length price for its use. It now follows from today's press release announcing the Commission's final decision that the Commission believes that Starbucks's Dutch subsidiary paid inflated prices for coffee beans to its Swiss sourcing affiliate and for royalties to its UK affiliate. Interestingly, at today's press conference, it was mentioned that the Commission could not identify any other coffee manufacturers that treat their formulae for roasting coffee as valuable intellectual property rights, but it is unclear in our view if that is an argument against or in favor of the APA.

The exact reasoning of the Commission will become available once a redacted version of the final decision is published, but it appears that the dispute fundamentally boils down to the question of whether it matters if each of the individual transactions (such as the purchase of beans and payment of royalties) meets the arm's-length standard when the resulting compensation itself is an arm's-length remuneration in accordance with OECD Guidelines for the functions performed, assets used, and risks incurred. It is accepted by many OECD Member States that there is no need to test every individual transaction if the TNMM is selected as the preferred transfer pricing method, and the views of the Commission, if sustained before the EU Courts, may therefore have a significant impact on many rulings and transfer pricing positions, including the rulings issued to Apple and Amazon that are also being investigated.

The Fiat Case

The Fiat case relates to a ruling obtained from the Luxembourg tax authorities by a Luxembourg subsidiary of Fiat that carries out treasury and intragroup financing activities. According to the preliminary decision of the Commission of June 11, 2014, the ruling confirms that the arm's-length taxable profits of the Fiat subsidiary may be determined on the basis of the TNMM with the amount of equity at risk as the profit indicator. The Commission, although apparently endorsing TNMM as the right method, asserts that (i) the equity that was made available for the relevant activities was too low compared to the level of capitalization that is required in the financial industry, (ii) certain downward adjustments to the equity that have been used for purposes of computing taxable profits are unjustified, and (iii) the return on the capital was too low.

The Fiat case is very fact-specific and, in our view, will be less likely to affect many other tax rulings and tax positions.

EU Courts

These two Commission decisions can be challenged in the EU courts by either the Member States that issued the original tax rulings (i.e., Luxembourg and The Netherlands) or by the taxpayers that benefitted from the rulings (i.e., Starbucks and Fiat). An EU court action would be appealed to the EU General Court in Luxembourg. Proceedings before that court normally take between 30 and 35 months. A further appeal to the European Court of Justice in Luxembourg, taking an additional 10 to 15 months, is available.

Consequences

A court action against a Commission decision does not suspend the Member States' obligation to immediately implement the Commission's decision. Thus, Luxembourg and The Netherlands are under an immediate obligation to compute the amount of the "illegal State aid" from which the two companies benefitted and to reclaim that amount (i.e., approximately EUR 20 million to EUR 30 million for each company). They also must bring the taxation of the two companies in line with the Commission's decisions. Further, competitors of the supposed beneficiaries of this illegal State aid also have the right to claim damages based on losses suffered from such illegal aid. To be successful with such a claim, however, they would have to substantiate that the aid has caused them harm in competing with the aid beneficiaries.

These decisions may also have significant financial consequences for other Multinationals that benefit from tax rulings issued by EU Member States, as such rulings currently may be or become the subject of a formal State aid investigation on similar grounds. As the decisions of the Commission are inherently fact-specific and the Commission continues to reach unprecedented conclusions that may or may not be sustained by the EU courts, the current environment may cause many Multinationals to face materially uncertain tax positions for past rulings and concern about whether or not to seek future rulings within the EU.

What Should Multinationals Do?

The State aid investigations with respect to tax positions are at the crossroads of the legal and tax functions of many Multinationals and require that a joint approach be taken. Multinationals that benefit from rulings issued by EU Member States should, in our view:

- Assess the possible impact of the decisions by analogy to their own tax rulings and tax positions in each relevant EU Member State;
- Prepare for questions from public auditors and audit committees regarding potentially uncertain tax positions;
- Give due regard to professional privilege issues;
- Carefully avoid statements in filings, such as entity-level financial statements in one or more EU Member States, that could erroneously be misinterpreted as suggesting the presence of State aid;
- Determine structural implications for the ability to credit any back taxes owed as a result of a State aid procedure under applicable foreign tax credit regimes; and
- Consider terminating or amending existing rulings, particularly in light of (i) each EU Member State's agreement to exchange tax rulings with the Commission and (ii) the new transfer pricing reporting requirements adopted or to be adopted by many EU Member States in accordance with the recommendations of the OECD under BEPS Action 13.

Lawyer Contacts

For a discussion as to how the Commission's continuing investigation may affect you and your company, 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/contactus/.

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