State aid and tax rulings

Prepared for Bruegel

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1 February 2017

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Overview of cases

‘Ireland gave illegal tax benefits to **Apple** worth up to **€13 billion**’

‘Therefore, the Commission has ordered Luxembourg and the Netherlands to recover the unpaid tax from **Fiat and Starbucks**, respectively […].’

‘Commission investigates transfer pricing arrangements on corporate taxation of **Amazon** in Luxembourg’

‘Commission concludes Belgian “Excess Profit” tax scheme illegal; around **€700 million** to be recovered from **35 multinational companies**’

‘Commission opens formal investigation into Luxembourg’s tax treatment of **McDonald’s**’

‘Commission considers at this stage that the treatment endorsed in the tax rulings resulted in tax benefits in favour of **GDF Suez**’

Source: Various press releases on the European Commission’s website.

State aid framework

Selectivity and economic advantage: two sides of the same coin?

Step 1: what is the appropriate reference system?

What are the general corporate taxation regulations in the member state?

National corporate tax system in the member state

Step 2: does a measure represent a deviation from the reference system?

Are companies that are in a ‘comparable legal and factual situation’ treated differently?

Do tax arrangements lead to unequal treatment between group and independent companies?

Step 3: is the deviation justified by the logic of the system?

Is the selectivity of the measure justified?

Burden of proof is on the member state (similar to compatibility of aid arguments)

Source: European Commission, Commission Decision of 21.10.2015 on State aid SA.38374 (2014/C ex 2014/NN) implemented by the Netherlands to Starbucks, C(2015) 7143, para. 230; Joined Cases C-78/08 to C-80/08 Paint Graphos, ECLI:EU:C:2009:417.

State aid framework

Economic advantage: OECD guidelines on transfer pricing

Key test is compliance with arm's-length principle

Are the terms and conditions of intra-group transactions in line with comparable transactions between independent companies?

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Do tax rulings lead to a taxable base that is lower than the level that would result from the application of the arm's-length principle?

Traditional methods

- **comparable uncontrolled price (CUP) method**—comparison of prices charged in intra-group transactions with those charged in similar transactions between independent companies
- **cost plus method**—comparison based on costs incurred by suppliers in intra-group transactions, plus a profit mark-up
- **resale price method**—comparison based on prices at which products/services that have been purchased from an associated enterprise are resold to an independent enterprise, net of selling costs

Transaction profit methods

- **transactional net margin method (TNMM)**—comparison based on a specific profit indicator
- **transaction profit split method**—benchmarks the division of profits that independent enterprises would have expected from engaging in economic transactions

the preferred approach

Source: OECD (2010), 'Review of Comparability and of Profit Methods: Revision of Chapters I-III of the Transfer Pricing Guidelines', 22 July.

Apple's tax arrangements in Ireland

Overview of the Commission's Decision

- licenses for Apple's intellectual property held by ASI and AOE were allocated outside Ireland
  - ASI's and AOE's 'head offices' had no employees, were not based in any country, and were not subject to tax in any country

- ASI's and AOE's taxable profit in Ireland was further under-estimated due to the misapplication of the transactional net margin method
  - the selected profit indicator (operating expenses) does not result in a market-based outcome
  - the required level of profitability was too low
    - no contemporaneous explanations justifying the choice of the profit margins in the 1991 and 2007 tax rulings
  - ASI's and AOE's Irish branches may not perform the "least complex function" compared to their head offices

Source: European Commission, Commission Decision of 30.08.2016 on State aid SA.38373 (2014/C) (ex 2014/NN) (ex 2014/CP) implemented by Ireland to Apple, C(2016) 5605.

Conclusions

Mitigating state aid risk through economic and financial analysis

- the scope of the tax state aid investigations is increasing (e.g. McDonald's)
- state aid risk can be significantly mitigated through a transfer pricing report, prior to the start of the tax ruling, based on robust financial and economic analysis

how can economic tools help?

evidence supporting the appropriate OECD transfer pricing methodology

functional analysis and risk assessment

Identification of comparators (and controls for differences in comparator set and subsidiary in question)

definition and assessment of profitability (including the appropriate metric)

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