

## Tax rulings and State aid: where are we now?

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Following a period of relative quiet, the European Commission's output from its State aid investigations into tax rulings and special tax regimes seems to be ramping up again, with Luxembourg in particular under fresh scrutiny. After a three-year investigation into a tax ruling obtained by Amazon from the Luxembourg tax authorities, the Commission has finally concluded that the ruling falls foul of EU State aid rules. Luxembourg is now required to recover the aid, estimated at €250m, plus interest, from Amazon.

### Why does the Commission believe Amazon's tax ruling constitutes illegal State aid?

State aid arises, broadly, when a business operating in a competitive market receives a selective benefit out of state resources. In tax ruling cases, the focus is typically on whether the ruling grants a "selective advantage" or, in other words, an advantage that could not be obtained by taxpayers in comparable situations. We have seen the Commission repeat the argument in several recent State aid decisions, including *Fiat*, *Starbucks* and *Apple*, that any transfer pricing ruling that departs from a methodology that is a "reliable approximation of a market-based outcome" confers a selective advantage.

The Amazon ruling in question relates to royalty payments for the right to use certain Amazon IP made by Amazon EU Sarl, the Luxembourg operator of Amazon's European retail business, to Amazon Europe Holding Technologies (IPCo), a Luxembourg partnership. These royalty payments were tax deductible for Amazon EU, but tax on IPCo's income is deferred unless and until it distributes profits to its (US) partners.

In the Commission's view, the royalty was "inflated", "did not reflect economic reality" and "enabled Amazon to avoid taxation on three quarters of the profits it made from all Amazon sales in the EU".

IPCo, an "empty shell" which had no employees, held the relevant Amazon IP under a cost-sharing agreement that it had entered into with Amazon US. IPCo had made an initial buy-in payment to Amazon US in order to acquire rights to use the IP and made subsequent payments under the cost-sharing agreement in order to contribute to the costs of developing the IP. IPCo was, however, not actively involved in the management, development or use of the IP; "it did not, and could not, perform any activities to justify the level of the royalty it received", so the Commission argues. The royalty payments by Amazon EU to IPCo were 1.5 times higher than IPCo paid on to Amazon US under the cost-sharing agreement.

The Commission's focus seems to be on whether Amazon EU is paying the right (arm's length) royalty to IPCo, taking into account the cost-sharing payments by IPCo to Amazon US, but without questioning whether those cost-sharing payments are themselves arm's length. Is it sufficient that "the appropriate level of these [cost-sharing] payments has recently been determined by a US tax court"? Indeed the IRS has recently appealed the US tax court's decision.)

The structure "worked" because of the hybrid nature of IPCo. While the royalty was tax deductible for Amazon EU in Luxembourg, IPCo was not taxed on receipt as it was transparent for Luxembourg tax purposes. However, IPCo was treated as a (non-US) corporation for US tax

purposes so its partners have deferred their US tax liability until the profits are distributed to them.

### What is the US view on this?

Whilst the Commission's State aid challenges have not been directed specifically at US multinationals, these are the businesses that have been most affected by the decisions published so far, because of the current structure of the US tax regime; in particular, both the deferral of US tax on profits retained offshore and the "check the box" rules provide plenty of opportunity and incentive to reduce the effective tax rate on profits from sales outside the US.

The US government (under both Obama and Trump) has not sought to hide its criticism of the State aid challenges. Shortly before publication of the Commission's decision in the *Apple* case in 2016, the US Treasury put out its own paper condemning the previous decisions, arguing that the approach the Commission is taking imposes retroactive tax and "undermines the international tax system". The *Amazon* case now threatens to bring any conflict over taxing rights between the EU and the US to a head. At the same time as the EU investigation, the IP arrangements between IPCo and Amazon US have been the focus of a recent US tax court case, with the IRS also seeking to tax a larger share of Amazon's European profits.

In March the US Tax Court rejected the IRS's argument that the initial price paid by IPCo to Amazon US (\$255m) for the value of the IP transferred to IPCo should have been considerably higher (around \$3.5bn using the IRS's valuation). It also rejected the IRS's argument seeking to increase the level of cost-sharing payments by IPCo to Amazon US.

The IRS has, however, recently filed a notice of appeal against that decision. If the IRS wins on appeal, and the buy-in payment by IPCo to Amazon US is increased from \$255m to \$3.5bn, will the EU revisit its own view of whether the royalty from Amazon EU to IPCo reflects "economic reality"?

Not only does this appeal suggest that the tension between the US and the EU over taxing rights in State aid cases will not be resolved any time soon, it brings into stark focus the possibility that the legality, under EU State aid rules, of a ruling granted by an EU Member State could be influenced by a tax case outside the EU brought many years after the initial ruling. This makes certainty for both tax administrations and taxpayers appear challenging.

### Why is Ireland back in the State aid spotlight?

In August 2016, the Commission announced that rulings granted to two Apple group companies amounted to illegal State aid, with Ireland being ordered to recover this aid (worth up to €13bn) from Apple. Although Ireland appealed the Commission's decision, it is still required, within four months, to comply with the obligation to recover the aid, but it can place the recovered aid into an escrow account until the appeals are resolved.

More than one year has passed since the initial decision, and Ireland has not yet recovered any of the aid from Apple. Given the sums involved and the fact that it is up to Ireland to calculate the exact amount of the illegal aid granted to Apple, this is perhaps not surprising. It seems that the Commission is, however, not happy with the progress being made (in particular, Ireland's proposal to conclude its work on calculating the exact amount of the aid by March 2018 at the earliest) and has therefore taken the decision to refer Ireland to the European Court of Justice.

### Are there still unanswered State aid questions?

We have learnt a lot about the Commission's approach to using the State aid rules to challenge tax rulings granted by Member States since the Commission first launched investigations into high profile rulings provided by Luxembourg (to Amazon), the Netherlands (to Starbucks) and Ireland (to Apple) back in 2014.

We know, for instance, that State aid challenges will not be restricted to the transfer pricing sphere; EU groups with tax rulings for financing or IP holding structures should review their position in case the Commission gets in touch. The *Apple* decision demonstrates just how serious the financial consequences of a successful State aid challenge, with its 10 year plus look-back, can be. Given the significant developments we have seen in the way in which the Commission's thinking in relation to tax State aid has developed over the past few years, it is unlikely that this risk was contemplated when the ruling was sought.

There is still, however, a lot that remains unclear. Is, for instance, the arm's length principle that the EU is seeking to apply different from the well-established OECD arm's length principle, or is it just pushing for a higher price in the "arm's length" range?

The big unanswered question is: how far can (and will) the Commission extend its new-found tax State aid powers? It is difficult to look at a ruling (during due diligence on a corporate acquisition, for example) and classify it as definitively safe from any State aid challenge. This is because the EU itself does not yet seem to have decided what features it finds offensive; it seems simply to be collecting as many rulings as it can and then challenging the rulings that are at the more extreme end. So far, we have seen challenges to rulings granted by only a select few EU countries, but we do not yet know where the Commission plans to stop. If it targets only cases it considers

to be egregious, how will the EU ensure its approach is consistent? It is, however, near impossible to imagine that the Commission has sufficient resources to enable it to apply its approach consistently in a way which ensures that all EU taxpayers are treated fairly.

Putting the question of resources aside, it is also hard to ignore the risk that the Commission could extend its State aid challenges beyond tax rulings to the discretion of a tax authority to settle a dispute. The Commission has already suggested in *Engie* that a failure to invoke a global anti-abuse rule (GAAR) could amount to State aid and seems to be laying groundwork for a challenge along these lines.

#### What next for the Commission?

The Commission has open State aid investigations into rulings given by Luxembourg to McDonald's and Engie and we can expect decisions in these cases to be published in the not too distant future. We also know that the Commission has been reviewing, and raising queries on, many other tax rulings; it remains to be seen how many formal investigations will be triggered as a result. And, of course, the Commission's decisions in *Apple*, *Amazon* and the other tax State aid cases will all be appealed to the European Court of Justice, so it will be several years (at least) before the scope of the Commission's tax state aid powers is definitively settled.

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