Global Counsel

# Corporate tax troubles in Europe

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## Summary

*Tax revenue leakage has become a hot button issue in Europe, the US and the G20. The European Commission is seeking to strike down advance tax agreements concluded years ago between member states and some of the world's largest corporations, because they confer a selective advantage and fall foul of state aid rules. The test cases currently in progress could have far-reaching implications for multinationals operating in Europe. The real target is not unfair competition, but aggressive tax avoidance. The actions of the Commission open a new front against tax avoidance, but the practices they have exposed will also add political impetus to wider international efforts to improve tax transparency and clamp down on profit shifting. The job of tax planners is becoming more difficult and the reputational and political risks of the corporations that employ them are increasing.*


Preliminary judgements published by the European Commission last week into corporate tax practices in Ireland and Luxembourg could result in huge retrospective bills for Apple and Fiat Finance and Trade (FFT). More significantly, the judgements illustrate how the landscape for corporate taxation is changing rapidly in Europe. The Commission says it is concerned that aggressive tax planning is eroding the tax base of countries that are already fiscally constrained, underlining how this is about more than a narrow interpretation of competition law. Any multinational operating in Europe could potentially be impacted, but particularly those with substantial intangible assets, such as technology or digital businesses. So too could the smaller European countries that have benefitted from what the Commission, in effect, alleges is tacit collusion to cut tax bills.

## The case made by the Commission

The Commission investigations concern advance tax agreements, which are supposed to give individual companies clarity on how their corporate tax will be calculated. The Commission alleges that in the Apple and FFT cases the agreements entered into have instead allowed improper transfer pricing, distorting the value of transactions between subsidiaries of the same group, and enabling profits to be diverted to countries with lower tax rates. In each case the preliminary conclusion of the Commission is that the authorities have conspired with the companies to reduce their tax bills and that this amounts to state aid. As such it is a violation of

Article 107(1) of the Treaty on the Functioning of the European Union on the grounds that it ‘distorts competition’ and is ‘incompatible with the EU Single Market’.

The charge against Luxembourg is that in 2012 the authorities manipulated a transfer pricing report to provide an artificially low tax base for FFT, which provides cash management and treasury services for the Fiat Group. The Commission challenged whether the methodology used took full account of the capital tied up in FFT and the extent to which it was being put at risk, both because of a failure to correctly interpret minimum capital requirements and as unsuitable benchmarks were used when determining an appropriate return on equity for a company with FFT’s risk profile. The Commission has also been engaged in a struggle with the Luxembourg authorities over access to information, which is the subject of a separate legal process.

The Irish case has a longer history and is perhaps more serious. It concerns the transfer pricing arrangements at two Apple subsidiaries, which were the subject of tax agreements in 1991 and 2007. Both subsidiaries are incorporated in Ireland, have branches that trade in Ireland, but are not tax resident. The Commission alleges the 1991 agreement was reverse engineered to produce a particular tax liability without any ‘scientific basis’ and with the aim of keeping jobs in Ireland. Unlike the Luxembourg case, no transfer pricing report was prepared. The agreement is also unusual in its duration, applying through to 2007, despite the typical practice in other European countries of such agreements lasting only three to five years.

In the 2007 agreement a formula for identifying taxable profits was provided, but without adequate explanation of the method and the figures used. There is insufficient evidence to show that the transactions are priced in a way that is similar to what one might expect under an arm’s length agreement between unrelated firms. The Commission is also critical of the apparent inconsistency in the evolution of costs and revenues following the 2007 agreement, which it says cannot be explained.

Both cases will now proceed to full investigations, which could take up to a year. If the findings are confirmed then the Commission could require the authorities in each country to retrieve under-paid taxes going back ten years. For both companies this would be embarrassing and expensive, although it would not ultimately threaten their financial position.

## The wider drive against corporate tax avoidance

The Commission is not acting in isolation. Even though the nominal target is unfair competition, the real target is aggressive tax avoidance. Multiple fronts are opening up against such practices and not only in Brussels. These include actions by individual countries. Last week the UK Chancellor George Osborne told his party conference that he will put an end to abuse of the tax system by those companies that go to ‘extraordinary lengths’ to pay little or no taxes. He singled out technology companies as a particular concern and the press has dubbed his initiative as the ‘Google tax’.

There is, of course, a limit to what individual countries acting in isolation can do, which is why finance ministers are also collaborating though the G20. In February this year the G20 endorsed a new OECD standard on the automatic exchange of information between tax authorities in an attempt to ensure that taxpayers with offshore investments comply with their domestic tax obligations. This is based on the Foreign Account Tax Compliance Act (2010) in the United States, which was itself an important turning point in international efforts against tax avoidance and subsequently prompted the larger EU states to support the development of an international standard. 44 countries have now committed to adopt this standard by 2017, with Austria and Luxembourg the only EU member states yet to do so.

The OECD is also leading an initiative on behalf of its membership and the G20 to clamp down on profit shifting of the sort allegedly undertaken by Apple and FFT. The initiative involves 15 areas for reform including closing loopholes from inconsistencies in national tax regimes, preventing tax treaty shopping, and ensuring proper transfer pricing arrangements and documentation. One strand specifically addresses the challenges posed by the digital economy. The OECD is also considering the feasibility of developing a multilateral instrument to implement some of its proposals. The profit shifting initiative is being talked up as potentially the most radical change in international tax policy since the 1920s.

In Europe, the Commission’s investigations – and the light they shed on tax practices – might also provide political impetus for tax harmonisation. The Commission is coming under pressure from the European Parliament and NGOs to open a wider front against tax avoidance in part to counter-balance its support for austerity. However, member states are more divided on this issue. The UK

opposes tax harmonisation and itself engages in tax competition through low corporation tax rates and initiatives like the patent box. For many there is a thin line between legitimate tax competition and unfair practices and last year the Commission singled out the UK's patent box scheme as 'harmful'.

### Implications for multinationals in Europe

The Commission's investigations into FFT and Apple takes the EU state aid policy into new territory, giving the Commission a locus on tax that it has not enjoyed before. Other investigations are in the pipeline. These include an investigation into the tax treatment of Starbucks by the Netherlands, which is already underway, and investigations into practices in Gibraltar and Luxembourg's treatment of Amazon, which have only just been announced. *Margrethe Vestager*, who has been nominated as the next European Competition Commissioner, signalled last week at her confirmation hearing that she will take up the issue and may seek to codify EU practice in this area.

The increased scrutiny of tax agreements means that both tax authorities and multinationals have an interest in ensuring that these agreements stand up to close examination, which will require high standards in terms of policies, process and documentation. Without this it may be hard to demonstrate credibly, after the fact, that tax agreements are based on an appropriate transfer pricing regime. As such they may remain a lingering source of risk for businesses.

Apple's reputation has suffered as a result of this case, as has that of other technology companies by association. The Commission's ruling has exposed the extent to which Apple has succeeded in driving down its tax bill. It also looks odd that the Irish authorities are unable to say where the Apple subsidiaries are resident for tax purposes. The case will increase pressure on Ireland to close down the 'double Irish' loophole in its tax code, which allows profits to be shifted to tax havens, and add political fuel to wider initiatives to reduce tax avoidance, such as those being led by the G20.

The procedures followed by the Luxembourg authorities appear to be more formal than those applied by Ireland. However, the degree of secrecy adopted by Luxembourg will add to the suspicion in other countries that abuse there is widespread. This is, embarrassing for the President-Elect of the European Commission Jean-Claude Juncker, who until recently as Prime Minister presided over a rapid expansion of inward investment in Luxembourg. That embarrassment may constrain his options for resisting change, should he want to. Closing down on corporate tax leakage has every prospect of becoming one of the salient issues for the European Commission that he will lead, when it enters office next month.

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