State aid and taxation

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Overview

- assessment of whether tax arrangements confer an economic advantage
- the market economy operator principle (MEOP) test and the role of the OECD’s arm’s-length pricing principles
- mitigating state aid risk
- looking ahead
Do tax rulings confer an economic advantage?

- the contentious questions are whether tax rulings confer a selective economic advantage\(^1\)

- in line with the General Court’s ruling in the EDF case, the MEOP test is used to assess whether rulings confer an economic advantage\(^2\)
  
  - assessment of whether intra-group transactions are at market price

  ‘tax authorities should compare the method to the prudent behaviour of a hypothetical market operator, which would require a market conform remuneration of a subsidiary or a brand, which reflect normal conditions of competition’


- the OECD’s arm’s-length pricing principles form the benchmark for the MEOP test

\(^2\) Case C–124/10 P Commission v EDF [2012], para. 92.
OECD’s arm’s-length pricing principles (I)

- relations between subsidiaries of the same corporate group should be in line with those between independent companies in comparable transactions in similar circumstances

<table>
<thead>
<tr>
<th>Traditional methods</th>
<th>Transactional profit methods</th>
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<tbody>
<tr>
<td>• compare terms and conditions of transactions between subsidiaries to those between similar stand-alone companies</td>
<td>• comparisons of the profitability of the subsidiary under investigation</td>
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<tr>
<td>• comparable uncontrolled price method</td>
<td>• benchmark against profitability of other subsidiaries of same corporate group or similar stand-alone companies</td>
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<tr>
<td>• prices charged between independent companies</td>
<td>• comparisons based on allocation of profits followed by independent companies</td>
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<td>• other methods based on resale prices or mark-up over costs</td>
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OECD’s arm’s-length pricing principles (II)

- the OECD’s guidelines leave significant room for interpretation and subjectivity in the application of the methods
  - e.g. the application of the transactional net margin method was challenged in the Opening Decision for Fiat Finance and Trade
- many practical difficulties associated with applying the OECD’s arm’s-length pricing principles
- both the traditional methods and transactional profit methods require the identification of similar transactions

‘the economically relevant characteristics’ must be sufficiently similar, and analysis should be undertaken to ‘identify and compare the economically significant activities ..., assets used and risks assumed by the parties to the transactions’

OECD’s arm’s-length pricing principles (III)

- according to the Commission, not all the OECD’s arm’s-length pricing principles approximate a market outcome correctly
  - the comparable uncontrolled price (CUP) method is preferred

<table>
<thead>
<tr>
<th>Subsidiary under investigation</th>
<th>Method applied by tax authorities</th>
<th>Method recommended by Commission</th>
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<tbody>
<tr>
<td>Luxembourg branch of Fiat Finance</td>
<td>Transactional net margin method</td>
<td>Comparable uncontrolled price and Trade¹ method</td>
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<tr>
<td>Luxembourg branches of finance companies²</td>
<td>Cost-plus Traditional methods</td>
<td></td>
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<tr>
<td>Apple’s Irish subsidiaries³</td>
<td>Transactional net margin method</td>
<td>No specific method</td>
</tr>
<tr>
<td>Starbucks’ Dutch subsidiary⁴</td>
<td>Transactional net margin method</td>
<td>Comparable uncontrolled price method</td>
</tr>
<tr>
<td>Amazon’s subsidiary in Luxembourg⁵</td>
<td>Transactional net margin method</td>
<td>Comparable uncontrolled price method</td>
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Sources:
What tax arrangements are potentially at risk?

‘tax rulings cannot use methodologies, no matter how complex, to establish transfer prices with no economic justification’


- compliance with OECD’s arm’s-length pricing guidelines (apart from the CUP method) is not sufficient
- tax arrangements that are potentially at risk include:
  - rulings covering a relatively long period (5 years or more)
  - rulings resulting in different treatments for multinationals compared with domestic companies or independent (stand-alone) companies
  - tax arrangements not based on a robust economic justification, particularly in low corporate tax jurisdictions
How to mitigate state aid risk? (I)

- Economic tools are fundamental to the arm’s-length pricing principles

>‘comparability analysis is at the heart of the application of the arm’s length principle’


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<th>Identification of comparators</th>
<th>Controls for differences in comparators</th>
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<tr>
<td>- Use of statistical techniques (e.g. cluster analysis) to <strong>identify comparators</strong> and to quantify degree of similarity</td>
<td>- OECD recommends comparability adjustments</td>
</tr>
<tr>
<td>- Insights from other state aid (MEOP and SGEI) cases</td>
<td>- Control for differences between subsidiary in question and comparators</td>
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<td>- In other areas (e.g. aviation), role for comparator analysis in MEOP assessments has been rejected</td>
<td>- Economic tools would have avoided problems in Starbucks about adjustments to profitability measures to reflect risk differences</td>
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How to mitigate state aid risk? (II)

- In addition to comparability analysis, economic tools have an important role in the application of the arm's-length pricing principles.

- How can economic tools help?
  - Appropriate definition of the cost base
  - Analysis of relative risk differentials between business segments
  - Valuation of assets (including intangibles) for the profitability assessment
  - Definition and assessment of profitability (accounting versus economic measures)
  - Valuation of royalties
Looking ahead?

- outcome of pending appeals on Starbucks, Fiat Finance and Trade, and the Belgian excess profit scheme
- broad and widening scope of tax state aid investigations
  - tax rulings spanning multiple companies under state aid investigation (e.g. excess profit scheme in Belgium)
  - widening scope from transfer pricing to double-taxation treaties (e.g. McDonalds) and tax settlements (e.g. Google and IKEA)
- growing scrutiny raises questions about robustness of economic rationale underpinning existing or future tax rulings
  - particularly for companies and tax authorities proposing any method other than the comparable uncontrolled price method

- importance of developing evidence that, prior to the start of the tax ruling, the agreement was underpinned by robust economic rationale
- companies across the EU, particularly large companies with complex and multi-jurisdictional Treasury policies, should systematically review and stress-test rulings
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