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# The Fiat & Starbucks State Aid cases:

## The arm’s length principle, a new tool to challenge (but also defend) transfer pricing rulings in illegal state aid investigations?

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## In Brief:

On 24 September 2019, the General Court of the European Union (the “**General Court**”) (the “**UE**”) ruled on two decisions of the European Commission (the “**Commission**”) regarding the potential qualification of tax rulings issued by Members States on intra-group transfer pricing aspects as unlawful state aid.

These judgments were fervently awaited by both Members States and majors economics actors as the Commission’s investigations, are becoming more and more regular in that sector, leading inevitably to a consequent UE state aid litigation.

In its judgments, the General Court:

- confirmed the decision of the Commission declaring the tax ruling granted by Luxembourg to Fiat Chrysler Finance Europe, formerly Fiat Finance Tarde (“**FFT**”), the cash pooling company of the group, qualified as an unlawful state aid (T-760/15 Netherlands v Commission);

- annulled the decision of the Commission against Starbucks, as there was no sufficient evidence to demonstrate that the tax ruling granted by the Netherlands to Starbucks Manufacturing EMEA BV («**Starbucks Manufacturing**»), in charge of the sale and distribution of roasted coffee, qualified as a unlawful state aid (T-755/15 Luxembourg v Commission).

In both cases, and for the first time, the General Court confirmed that the arm’s length principle is a valid tool to assess whether a transfer pricing ruling could qualify as an unlawful state aid.

These mixed issues seem to illustrate an unprejudiced position of the General Court regarding the current Commission’s investigations on tax rulings’ practices. Both parties were invited to justify their respective positions on equal and objective terms. The diverging outcomes seems due to the factual appreciation of the evidence of the violation of the arm’s length principle and the selective criterion.

Even if an unlawful state aid qualification has been recognised in the Fiat case, it should not be assimilated to a condemnation of the Luxembourg transfer pricing rules & practice *per se* in comparison with the EU law. They should be appreciated from a competition law perspective and mainly be read from a standard of prove perspective. The arm’s length principle could also be used as a strong and useful weapon for anyone under investigation to justify the transfer pricing policy established for its business. Starbucks succeeded whilst Fiat failed in that exercise.

These judgments should lead in practice to a global review of the rationale of the tax transfer pricing rulings currently in place to ensure they cannot be challenged regarding a potential violation of the arm’s length principle which could lead to a “selective advantage” under the state aid rules.

## Summary of the cases:

**In Fiat's case**, FFT was acting as a cash pooling company towards a large number of companies of the Fiat Chrysler group i.e. providing treasury and financial services in Europe such as intra group loans. In consideration for such financial services, FFT received a remuneration, determined in accordance with a transfer pricing report. In particular, FFT had to determine its equity at risk, as well as the remuneration of its equity, according to a transfer pricing report based on objective and economic considerations in order to ensure arm's length intra group prices for its financial services. One of the cornerstones of such report was to determine the proper amount of the FFT's remuneration based on the part of equity at risk corresponding to its financial activity.

In 2012, FFT obtained a tax ruling from the Luxembourg tax authorities (i.e. an advance pricing agreement or "APA") regarding the applicable transfer pricing methodology allowing the determination of its remuneration and allocation of its taxable profits.

However both the level of equity at risk and correlative remuneration of FTT were not considered by the Commission as consistent with the arm's length principle which created an advantage for FTT. Such advantage was analysed as selective since such transfer pricing methodology was confirmed by a tax ruling and lead to a reduced tax liability of the company, which could not be comparable to the standard tax burden generally expected from a company taxed under the classic tax system.

Both the amount of equity at risk and the remuneration was re assessed by the Commission. To do so, the activity of FFT has been validly compared both by the Commission and the General Court to banking activity. As a result, and as applicable in the banking sector, its taxable profits were to be determined based notably on the capital's return used by FFT for its financing activities (i.e. equity at risk in line with its financing activity).

The General Court confirmed that the correlative tax savings allowed by this transfer pricing methodology and as covered by the Fiat tax ruling issued by Luxembourg created a selective advantage in the meaning of the state aid rules.

**In Starbucks' case**, Starbucks Manufacturing was the single EU entity in charge of the sale and distribution of roasted coffee and related goodies among Europe, Africa and Middle East. In particular, Starbucks Manufacturing determined in a transfer pricing report (i) the arm's length amount of royalties to be paid to another company of the group in consideration for its know-how on roasting the coffee and (ii) the price paid for the purchase of green coffee beans to a Swiss company of the group.

In 2008, Starbucks Manufacturing obtained a tax ruling from the Netherland tax authorities regarding the transfer pricing methodology allowing the determination of its taxable results.

Both the amount of royalties and the price of green coffee beans paid by Starbucks Manufacturing were considered as excessive regarding the arm's length principle. Since the transfer methodology determining such excessive remuneration was covered by a tax ruling, a selective advantage in the meaning of the state aid rules was granted.

The General Court confirmed the reasoning could be based on the arm's length principle. However, it found that in the case at hand the Commission failed to demonstrate the violation of the arm's length principle and the existence of a selective advantage and annulled its decision. It should be noted that the Starbucks position was quite complex and it had been complex to determine whether the particularity of the case was more pleading in favour of a state aid qualification of in favour of an evidence of the unicity of the economic business strategy.

**In both cases,** the General Court recognized, for the first time, that the arms' length principle is a valid tool to appreciate if a selective advantage, within the meaning of state aid rules, is granted in the transfer pricing ruling area. The mixed issues were precisely based on the appreciation by the General Court of the standard of proof provided to establish whether the selectivity criterion was met (i.e. whether a distortion of competition was created by a transfer pricing ruling in light of the arm's length principle). These are very useful and welcome guidelines regarding the rationale of the transfer pricing methodology and its effective application to avoid/face any future challenge from the Commission. It is however still required to understand more clearly how the General Court intend to position itself regarding the exacts standards to be used and in particular the reliability of the OECD transfer pricing guidelines.

## Analysis and comments:

### Commission's investigations on tax ruling practices

In June 2013, the Commission started investigating Members States' practices on tax ruling to assess whether they could qualify as unlawful state aids.

As already mentioned by the Commission and confirmed by the EU case law, tax rulings cannot however be seen *per se* as unlawful state aids. Tax rulings allow a taxpayer to obtain the confirmation to a taxpayer of the correct application of the Luxembourg tax law in a specific transaction. However, if providing a "selective advantage" which is not authorised by the Commission, it could be seen as an unlawful state aid. Tax rulings have then been more scrutinised and are also subject, since 1 January 2017, to an automatic exchange of information.

"*The Commission will continue to look at aggressive tax planning measures under EU state aid rules to assess if they result in illegal state aid*" mentioned Margrethe Vestager, the Europe's competition commissioner, the week after the General Court Fiat and Starbucks judgments were published. This investigation's angle from the Commission is certainly reinforced in a post-BEPS world, further that some significant changes occurred under Luxembourg Law and international tax law to ensure harmful tax competition between Members States by implementing higher tax transparency and anti-avoidance standards.

The Commission is therefore clearly taking good note of the amplitude of these cases to give itself the means to collect sufficient evidence in its pending investigations. All the attention is also now focused on the potential impact these Fiat and Starbucks cases could have on the ongoing Apple and Amazon cases.

### Focus of the Commission on transfer pricing area

The Commission has, these last years, more particularly focused its investigations on transfer pricing rulings (i.e. advance pricing agreements or "APA") such as the ones granted in the Fiat and Starbucks cases but also to Ikea, Nike and Huhtamaki which are currently under investigations. An APA allows a taxpayer and the tax authorities, to avoid future transfer pricing disputes, to enter into a prospective agreement, generally covering at least five tax years, regarding the taxpayer's transfer prices.

In the Fiat and Starbucks cases, the novelty came from the fact that the Commission relied for the first time on the violation of the arm's length principle to characterise an advantage. Since Fiat and Luxembourg tried to question the ability for the Commission to rely on the arm's length principle, the latter justified its reference as it is a general and independent anti-discrimination principle preventing that a company receive a more favourable tax treatment than another. It also stated that the arm's length principle is inherent to article 107 of the Treaty on the Functioning of the European Union ("**TFUE**"). The General Court confirmed the Commission's analysis and refused all the arguments relating the alleged indirect tax harmonisation tendency of the Commission.

The Commission further clarified that its appreciation of the selectivity criterion was made by reference to domestic tax system while the existence of the "advantage" is assessed regarding the arm's length principle. The said "advantage" was recognised as "selective" in the Fiat case as soon as the transfer pricing methodology in cause has been confirmed by the Luxembourg tax authorities via the issuance of a tax ruling derogating from the general tax regime regarding the final and effective tax burden of FFT.

It is now clear that an unlawful state aid can be recognised if a transfer pricing methodology covered by a tax ruling granted by a Member State results in an allocation of profits in violation with the arm's length principle creating a distortion in competition. Indeed, an incorrect allocation of profits results automatically on an incorrect tax liability (either via an inadequate level of margin, an excessive amount of remuneration or deductible costs). Allowing methodologies leading to a reduced tax liability for certain companies as compared to the liability under the generally applicable tax regime is a selective advantage creating a distortion in competition.

An important question is whether such selective advantage could also be recognised independently of the issuance of a tax ruling e.g. in case where a transfer pricing methodology would lead to a distortion in competition based on some specific tax schemes provided by the law itself. The Commission has announced that its investigations will also focus on these specific tax schemes cases. The arm's length principle recognition will with no doubt help the Commission to assess whether such tax schemes, when leading to an incorrect application of the arm's length principle, are creating a unfair tax discrimination by comparison with taxpayers subject to the standard tax regime. However, the question is whether the Commission will also manage for each cases to evidence the selectivity of the advantage. Nothing is less certain as in the Starbucks case, even with a tax ruling derogating from the general tax system in cause, the advantage was not considered as "selective" by the General Court.

### Arm's length determination of the equity at risk

In principle, any Luxembourg company engaged in a financing activity such as FFT must receive an arm's length remuneration in consideration for its intra-group services. The arm's length character is determined in a transfer pricing report depicting and justifying the transfer pricing methodology used to determine, based on objective criteria and relevant comparable, the final allocation of profits (resulting in a corresponding taxable basis).

Today, the appropriate profit margin and the amount of equity at risk at the level of each financing entities must be determined by a transfer pricing study to be performed in accordance today with articles 56/56 bis of the Luxembourg income tax law as well as the new circular LIR n°56/56bis of 27 December 2016 issued by the Luxembourg tax authorities on intra-group financing activities (the "**New Circular**").

The New Circular replaced in 2016 the former circular 164/2 dated 28 January 2011 largely because of the Fiat case. Precisely, the New Circular had a material impact regarding the determination of the equity at risk in relation with the intra-group financing activities. Under the former circular (in force during the Fiat case), the same requirement was deemed to be satisfied with an amount of equity corresponding either to 1% of the nominal value of the loans or EUR 2 million. The former criteria appeared as too artificial and simplistic to ensure that the equity at the level of FFT was appropriate regarding its financing activity. Today, the "risks" bear by a financing company cannot be anymore "limited".

Luxembourg argued during the case that the transfer pricing methodology in cause in the Fiat tax ruling had been determined in line with the former circular. The Commission found however that the transfer pricing methodology exposed in the tax ruling was too complex and artificial to reflect properly the market conditions and, absent of proper consistent domestic rules, made its own assessment in relying autonomously on the arm's length principle. As mentioned, it will be fundamental to have a clear overview on how such assessment will be realised and on the reliability of the OECD transfer pricing guidelines.

As the activity performed by FFT was comparable to that of a bank, a correct application of the arm's length principle would have led to consider the proper level of equity at risk per activity and type of rule according the prudential rules subject to solvability criteria defined by, among others, Bâle II; but not according to an artificial and complex methodology. The investigation of the Commission showed that an arm's length profit allocation would have lead for FFT to estimate it taxable profits in Luxembourg 20 times higher than the ones officially reported to the Luxembourg tax authorities.

Since 2017, according to the New Circular, the equity at risk must be determined on a case by case basis to ensure a real correlation with the arm's length principle. The new article 56 bis also provides more guidelines on the effective application of the arm's length principle in the Luxembourg tax law. This is a major change and allows the transfer pricing methodologies to proper reflect the economic reality and associated risks.

### Evidence of the "selective advantage"

If the tax ruling granted to Fiat a "selective advantage" by allowing a reduction of its tax burden in comparison with the normal rules of taxation in Luxembourg law between independent (non-group) companies, the Commission failed in evidencing the selective criterion in the Starbucks' case.

More specifically, the Commission erred in the demonstration that the Starbucks' tax ruling derogated from the general tax system and provided a selective advantage. The General Court stated that a simple error in transfer pricing methodology was not sufficient to prove the selectivity criterion but that a reduction in the taxable profit, by comparison with the tax burden of the normal tax regime.

It is finally interesting to note that for the two cases under review (i) the Commission used for the first time systems of request of information in order to obtain additional elements regarding the market under review and market practices prices; and (ii) the General Court analysed and discussed the technical arguments and transfer pricing concepts with in details.

This clearly means that the outcome of an investigations will largely depend on the seriousness of the transfer pricing documentation in place. Evidence of the arm's length character of the selected allocation of profits will be key to avoid a transfer pricing ruling to be qualified as a "selective advantage".

**Points of attention:**

- The first point of attention to be investigated further is whether the Commission in determining the equity at risk of FFT has actually applied the same rules and principles than the ones applied in the bank sector.

- Another question is whether the selectivity criterion has been validly applied by the Commission regarding the effective impact of transfer pricing ruling in cause. Indeed, recognising a higher allocation of profits at the level of FFT leads to increase the Luxembourg taxable basis but only in reducing the Italian one accordingly. Therefore, it could be questioned whether a simple switch of allocation of taxes between Members States can be seen as a selective advantage. In practice, the global amount of taxes paid by the Fiat group remains unchanged, only the amount of taxes allocated to Luxembourg is increased by reducing the Italian taxes.

- This question also largely depends whether the selectivity criterion is appreciated at the level of FFT only, or more globally at the effective level of taxation of the group. If the Commission is willing to embrace the problematic of the harmful tax practices/anti-avoidance regulations, it will be difficult to achieve correctly and fairly if it reduces its analysis to an entity's taxation level. It should rather consider the global situation of a group to appreciate (i) whether the transfer pricing methodology is in line with the arm's length principle and (ii) if it leads to a discriminatory tax savings.

- Finally, we now also await to see how the Commission will in practice rely on the OECD guidelines to assess of the violation of the arm's length principle. It is important, now that the Commission can use the arm's length principle, to ensure its proper application under recognised standards.

## Further developments:

With these two judgments the General Court upheld the Commission in its reasoning by confirming that the analysis of whether a transfer pricing ruling could be seen as a "selective advantage" in light of the arm's length principle. However, the way the Commission is evidencing the violation of the arm's length principle and the selective criterion remains key as reflected by the mixed issues in the Fiat and Starbucks' cases.

The parties have two months and ten days to appeal against these judgments.

The Starbucks judgment provides useful hallmarks to economics actors facing current Commission's investigations and reinforces the required standard of proof of a "selective advantage". It will be interesting to see whether the Commission will simply reopen its investigation into Starbucks and/or appeal the General Court's judgment as it recently did on the aid scheme nature of the Belgian excess profit rulings.

It is not yet known whether Fiat or Luxembourg are willing to challenge the judgment. It will largely depend on whether the legality of the judgment can be challenged before the Court. Indeed factual elements (and therefore the evidence they support) cannot be discussed in front of the Court. This means that, if it is decided to appeal on points of law in the Fiat case, and only in case the Court annuls the judgment, the case will be send back to the General Court which will re-examine the case.

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