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A Two-Sided Affair : The EU Commission Favours Profit Split For The Wrong Reason

Mario Tenore (Maisto e Associati) · Friday, June 30th, 2017

An analysis from a State Aid perspective.

This contribution focuses on the profit split methodology in light of current EU Commission's investigations in the area of tax rulings and transfer pricing[1]. Prior to my points, I shall make some brief preliminary comments to set the scene.

1. According to the EU Commission a tax ruling confers on the beneficiary a selective advantage under Art. 107(1) of the Treaty on the Functioning of the European Union (hereinafter "TFEU"). This happens insofar as the ruling leads to a lowering of the tax burden by deviating from the tax that the beneficiary would otherwise be obliged to pay under the general corporate tax system.
2. In its State Aid assessment, the EU Commission does not accept the arm's length principle as a "general principle of equal treatment in taxation" which "necessarily forms part" of Art. 107 TFEU. The EU Commission's analysis relies neither on international nor on domestic transfer pricing rules (if any).

According to EU Commission equal treatment derived from Art. 107 TFEU requires that integrated entities are treated in the same manner as standalone entities. Since the latter entities are taxed on a "market based outcome", illegal aid is allegedly found anytime the APA endorses a transfer pricing methodology which does not lead to a "reliable approximation of the market based outcome".

3. In performing its analysis, the EU Commission acknowledges that OECD Guidelines capture international consensus on how to achieve such objective (ensuring that a certain methodology achieves such a "reliable approximation of the market based outcome"). The OECD TP Guidelines are therefore at the heart of the EU Commission's legal analysis.

The EU Commission regards the OECD guidelines as "an existing manual in the area of transfer pricing that is the result of expert discussions in the context of the OECD(?) and elaborate on techniques aimed to address common challenges of the application of the arm's length principle to concrete situations" (Starbucks, § 66).

Consistency with the OECD Guidelines is viewed as a sort of "safe harbor" from illegal State Aid. Compliance with OECD Guidelines is an indication that the APA beneficiary is not treated more favorably compared to a standalone entity whose taxable profit is determined by the market.

4. Although the EU Commission's primary focus is whether the methodology endorsed in the APA approximates a "market based outcome", its analysis seems "biased against" or "worried about" possible BEPS effects.
   1. In the Fiat Finance and Trade decision[2], the EU Commission seems to reject so called spontaneous "compensating adjustments", being worried of possible misalignments between taxable profits and commercial profits which could be a source of double non-taxation. In the view of the EU Commission, downward compensating adjustments should be undertaken only if they match with an actual upward adjustment in the other jurisdiction.

- 310 of FFT decision illustrates this principle: "an arm's length remuneration must not be lower than the difference between the income and the charges of the company […] the entire recorded profit must be taxed, because a third party would not accept to reduce its remuneration if none of its counterparties would make justified claims to receive a higher remuneration […]".

1. In a similar vein, the EU Commission seems worried of similar BEPS effects in the Starbucks decision. In the latter case, the concern focuses on stateless income which would arise due to the deduction of royalties in one jurisdiction not being matched by a corresponding taxation in another jurisdiction.

- 112 of Starbucks decision illustrates this principle Starbucks: "In no event does the remuneration reduction and the corresponding taxable profit reduction in the Netherlands […] create an additional remuneration in Switzerland or accordingly increase the taxable profit in Switzerland"

Against this general background, I will now steer the analysis on some technical points of the Commission's analysis to converge then on profit split.

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Choice of the most appropriate method

The start of the analysis is the "Choice of the most appropriate method".

In its Working Paper on tax rulings of 3 June 2016 (hereafter "WP") the EU Commission acknowledged that "compliance with the OECD Guidelines is of fundamental importance, **including the guidance on the choice of the most appropriate method** […]. (WP, §18).

However, the EU Commission has also pointed out that choosing the most appropriate method may not be sufficient to exclude State Aid. The most appropriate method may still lead to State Aid if

- The most appropriate method "is used in combination with overly favorable parameters",
- in which case "the remuneration arrived at using that method might nevertheless underestimate the tax liability of the taxpayer and thus give rise to State Aid" (FFT, § 244)

Based on the above, one may infer that in the assessment of a transfer pricing methodology from a State Aid point of view, the Commission's analysis identifies two phases (as any other national tax authorities do when assessing transfer prices) i.e.

1) the choice of the most appropriate methodology and

2) the concrete application (choice parameters such as PLI, comparable etc).

With regard to phase 1, the EU Commission seems to have a preference for the CUP since "*Compared to the other four methods described in the OECD TP Guidelines, the* ***CUP is more direct and would, if applicable, provide for a more reliable approximation of a market-based outcome***" (FTT, § 245). Whether this statement is consistent with OECD TP Guidelines is at least questionable given that OCED TP Guidelines do not indicate the existence of a hierarchy although OECD TP Guidelines state that traditional transaction methods are regarded as the most direct means of establishing arm's length prices.

In line with the OECD Guidelines, the EU Commission seems inclined to accept profit split when the CUP or other methodologies are not available as "*each party to a transaction makes valuable, unique contributions[…] the* ***transactional profit split method is considered a more appropriate transfer pricing method***" (Belgian Excess Profit Ruling Decision, § 39 [3]).

The use of profit split is also recommended in the recent working paper on tax rulings in light of its two-sided nature which leads to an allocation of "*the overall profit to both parties of the transaction*" and therefore triggers lower risk of deviating "*from a market outcome" to the extent it is "applied consistently by all jurisdictions involved*" (WP, § 20).

In its analysis of the profit split, the EU Commission seems to lose sight on its priority, i.e. whether the methodology applied by the taxpayer leads to a "*reliable approximation of the market based outcome*". The EU Commission's main concern is achieving the allocation of the "full amount of profits". This seems to be their reassurance against possible BEPS cases (once again it confirms that EU Commission's analysis is biased by BEPS cases in its State Aid analysis). Taking this reading to the extreme, one could wonder whether also global formulary apportionment – which does not necessarily achieve an allocation of the taxable profits in line with the arm's length standard (or to use the EU Commissions' language in line with the "market based outcome") – would be a suitable approach from a State Aid point of view. The problem is that making sure that everything gets taxed, does not mean you are making sure that everything gets taxed at arm's length or that everything is taxed in line with "market based outcomes".

Turning now to profit split again, it could therefore be said that – from the point of view of State Aid – the use of such methodology could be criticized as to whether it is the most appropriate method (or whether alternatively CUP should be used where available) and whether the profit split relies on the correct parameters. With regard to last point, the criticism could, for example, be raised if the methodology relies on meaningless or inconsistent application of the allocation key for the splitting of the profits between the parties involved. Considering the BEPS bias highlighted above, a higher risk of State of state exposure could arise in those cases in which profit split leads to an artificial allocation of profits to a State which does not tax the profits so allocated (because the allocation is not at arm's length).

[1] Mario Tenore, LL.M. Senior Associate at Maisto e Associati. This paper was presented at the 7th International Tax Retreat, "Post-BEPS Strategies. OECD TP Guidance on Profit Split/BEPS Multilateral Convention and PE", organized on May 12-13, 2017 in Cernobbio (Italy).

[2] COMMISSION DECISION of 21.10.2015 ON STATE AID SA.38375 (2014/C ex 2014/NN) which Luxembourg granted to Fiat.

[3] COMMISSION Decision of 11.1.2016 ON THE EXCESS PROFIT EXEMPTION STATE

AID SCHEME SA.37667 (2015/C) (ex 2015/NN) implemented by Belgium.

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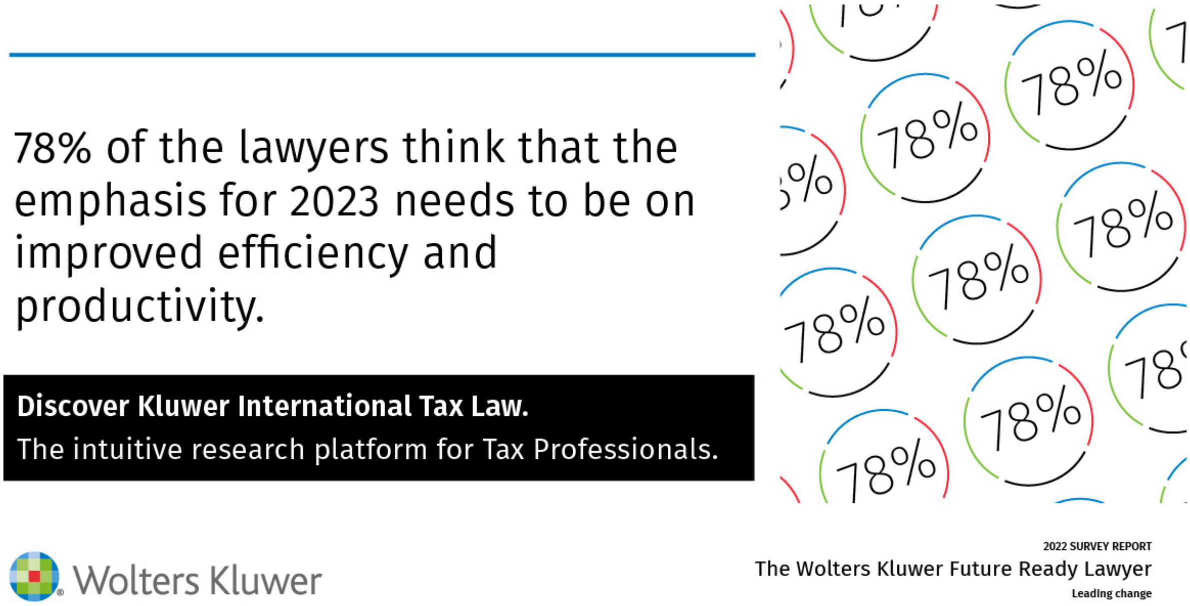

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