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EU TAX PROBE, STATE AID & THE CASE OF AMAZON

Tomislav Krmek*

Summary: Multinational entities are shifting their profits from jurisdictions with high tax rates to low tax jurisdictions that result in sovereign governments losing millions of dollars and euros. Profits are moved away from the jurisdictions in which the economic activity occurs and sovereign governments face difficulties in exercising their right to taxation. The most common method employed for artificially (but legally) shifting profits is the transfer of intangibles (intellectual property). This article will discuss this legal tax avoidance in the European Union by multinational entities using that common technique: shifting of goods and services between affiliates (transfer pricing). Companies are getting more self-confident in doing this because of the advanced tax rulings issued by national tax authorities, especially of particular member states of the European Union, that provide legal certainty for their corporate structures. This article will introduce to the U.S. readers (potentially) "harmful" tax practice exercised in the European Union by one of the world's largest multinational companies. It will examine the rules of the European Union on state aid (Art. 107 and 108 of TFEU) and the European Commission's investigation and their effect on such practice that is allegedly breaching the internal market of the EU. The discussion will then move

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on to comparison of "harmful" tax practices in the United States. Measures that international community, especially OECD, is implementing to fight tax avoidance will also be considered followed by June 2015 European Commission's Action Plan on Fair and Efficient Corporate Tax System in the EU and its January 2016 proposal for Anti-Tax-Avoidance Directive. This article provides U.S. readers a basic overview of the EU rules; it is not aimed at European practitioners.

I. INTRODUCTION

The businesses of big multinational entities, especially those from the United States, have been attracted to particular member states of the European Union (the "European Union" or the "EU") because of their favorable legal and tax systems. The main goal of such multinationals is to concentrate their businesses in such an environment that potentiates maximization of profit while keeping their costs as low as possible.

Historically, one would imagine such an attractive place as an offshore tax haven jurisdiction, typically an island. Its characteristics commonly include low or non-existent tax rates on certain types of income, no requirement of substantial business activity, lack of transparency and information sharing, and ease of entry in terms of incorporation of companies. It is also typical for tax havens that there are bank secrecy rules in place and there are little or no enforcement rules applicable on the side of the tax authorities, which do not (or hardly) have access to tax havens.[1]

It seems that places like Cayman Islands, Isle of Man, Jersey, and the British Virgin Islands have lost their attractiveness to countries (such as Luxembourg, the Netherlands, and Ireland) where the rule of law and the predictability of the legal system is considered to be the highest constitutional principle. Additionally, many consulting firms employ hundreds of highly educated tax lawyers and accountants who specialize in providing expensive and valuable tax advice and the most cost-effective solutions for multi-jurisdictional business operations to achieve low to zero tax rate on certain types of income. A very important characteristic of such jurisdictions is a possibility of advanced tax rulings, which can be described as comfort letters by tax authorities giving specific company clarity on how its corporate tax will be calculated or on the use of special tax provisions.[2] Governments lose income tax revenue caused by the

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[1] *See generally* Jane G. Gravelle, *Tax Havens: International Tax Avoidance and Evasion*, CONG. RESEARCH SERV (2015).
[2] Press Release, European Commission, State Aid: Commission Investigates Transfer Pricing Arrangements on Corporate Taxation of Apple (Ireland) Starbucks (Netherlands)

shifting of profits into low tax countries. It is hard to estimate exact budget losses, but some have identified annual losses of around $100 billion per year caused by such shifting.[3] It is also worth noting that the term tax avoidance is considered to mean a legal reduction in taxes, as opposed to illegal tax evasion.[4] This paper deals with legal tax avoidance by multinational entities in the European Union using one of the most common techniques for that purpose: shifting of goods and services between affiliates (transfer pricing).

The big wave of investigations in the area of "harmful" tax practices within the European Union has started with the revelations of more than 28,000 pages of leaked documents by the International Consortium of Investigative Journalists.[5] The journalists have identified more than three hundred multinational companies that shifted their profits to countries such as Luxembourg in order to save on due taxes. Alleged savings have been enormous, and resulted in lowering effective tax rates to little as 1%.

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and Fiat Finance and Trade (Luxembourg) (June 14, 2014) .

[3] Gravelle, *supra* note 1.

[4] *Id.*

[5] Stephanie Bodoni, *LuxLeaks a 'Game Changer' for EU In Tax-Deal Probes, Gramegna Says*, DAILY TAX REP. (BNA), Dec. 22, 2014.

The recommendations within the EU on how to combat harmful tax practices go back to early 1990s. The Ruding Report of 1992 was one of the first documents to present that the differences between member states` corporate tax regimes cause significant distortions in the internal market as they influence choices of companies‘location and investments, and suggested that these practices be eliminated through harmonization of tax bases and approximating tax rates between member states.[6]

The efforts of the EU in this field continued by the adoption of the Code of Conduct for Business Taxation (which concerns non-introduction of new and re-examination of existing tax measures described as harmful) and the Commission notice on the application of the state aid rules to measures relating to direct business taxation, both in 1998.[7] The Communication on promoting good governance in tax matters from 2009 is a continuation of the European Commission`s work in this field.

Following media reports alleging that some multinational companies in the European Union have received significant tax reductions by way of tax rulings issued by national tax authorities, the European

[6] MARIE-ANN KRONTHALER &YINON TZUBERY, THE STATE AID PROVISIONS OF THE TFEU IN TAX MATTERS 97 (Michael Lang et al. eds., 3rd ed. 2013).
[7] *Id.*

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Commission has decided to open formal investigations under the EU state aid rules.[8] In a June 11, 2014 press release, three in-depth investigations have been opened to examine whether decisions by tax authorities in Ireland, the Netherlands, and Luxembourg, with regard to the corporate income tax to be paid by Apple, Starbucks, and Fiat Finance and Trade, respectively, comply with the EU rules on state aid.[9] The Starbucks and Fiat investigations, with respect to their tax positions in the Netherlands and Luxembourg, respectively, have been finalized by the European Commission with an unfavorable result for both companies. The Commission has ordered the Netherlands and Luxembourg to collect approximately $30,000,000 in taxes from Starbucks and Fiat. This paper deals with an additional investigation that has been opened with regard to a tax ruling issued to Amazon in Luxembourg as communicated by the European Commission in its letter of September 7, 2014. The European Commission claims that tax rulings may constitute an illegal state aid according to the Article 107(1) of the Treaty on the Functioning of the European Union ("TFEU"), which will be dealt with in detail in this paper.

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[8] European Commission, *supra* note 2.
[9] *Id.*

The paper argues that tax rulings issued to multinational entities providing them with tax certainty and predictability that are commonly called (by the press) “harmful” tax practices are not the negative phenomenon that is so often presented. First, the aim of this paper is to analyze (potentially) “harmful” tax practices exercised by multinational entities in the European Union that use tax rulings issued by national tax authorities of the member states of the European Union and their importance for multinational entities` businesses from the international tax point of view. Second, the paper will examine the EU rules on state aid and their effect on practice of tax rulings and alleged breach of the internal EU market, with a brief presentation of the Amazon case in the EU and comparison of the investigation and procedure in the United States. Third, the paper will address what measures the international community is implementing to fight tax avoidance, primarily the European Union, the United States and OECD/G20.

II. SOURCES OF EU LAW ON STATE AID

For more than fifteen years, the European Commission has been using the rules on prohibition of state aid as a method to tackle harmful tax competition.[10] Primary sources of EU law on state aid are contained in Article 107 and 108 of TFEU. The goal of the state aid rules is to ensure that member states do not provide selective advantages to certain undertakings to the detriment of others.[11]

Article 107(1) of TFEU also applies in the field of taxation notwithstanding the fact that the competence of the Union to regulate direct taxation is limited under the TFEU.[12]

Art. 107(1) of TFEU prescribes:

> Save as otherwise provided in the Treaties, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market.[13]

This provision prohibits the provision of advantages, in any form, by national public authorities to undertakings on a selective basis.[14] The

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[10] Kronthaler & Tzubery, *supra* note 6.
[11] *Id.* at 101.
[12] *State Aid SA.38944 (2014/C) – Luxembourg Alleged Aid to Amazon by Way of a Tax Ruling* (herein "Luxembourg Alleged Aid to Amazon"), at 13, COM (2014) 7156 final (Oct. 7, 2014).
[13] EUR-LEX, Consolidated versions of the Treaty on European Union and the Treaty on the Functioning of the European Union, art. 107(1), 2012 O.J. (326).
[14] Kronthaler & Tzubery, *supra* note 6, at 94.

following requirements[15] have to be satisfied in order to have an illegal and prohibited state aid:

a) Recipients are granted an advantage in a sense that the measure relieves them from a liability that they would otherwise incur from their budgets;
b) The advantage is granted by the state or through state resources;
c) Such measure affects (distorts) competition and trade between member states; and
d) The measure is selective in a sense that it favors certain undertakings or the production of certain goods.

Exceptions to Article 107(1) are contained in Art. 107(2) and (3) of TFEU.

Article 107(2) of TFEU prescribes:

The following shall be compatible with the internal market:

a) aid having a social character, granted to individual consumers, provided that such aid is granted without discrimination related to the origin of the products concerned;
b) aid to make good the damage caused by natural disasters or exceptional occurrences;
c) aid granted to the economy of certain areas of the Federal Republic of Germany affected by the division of Germany, in so far as such aid is required in order to compensate for the economic disadvantages caused by that division. Five years after the entry into force of the Treaty of Lisbon, the

[15] *Id.*

> Council, acting on a proposal from the Commission, may adopt a decision repealing this point.[16]

Article 107(2) of TFEU prescribes exceptions, which are *ex lege* in compliance with the internal market.

Article 107(3) of TFEU prescribes:

> The following may be considered to be compatible with the internal market:
>
> a) aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment, and of the regions referred to in Article 349, in view of their structural, economic and social situation;
> b) aid to promote the execution of an important project of common European interest or to remedy a serious disturbance in the economy of a Member State;
> c) aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest;
> d) aid to promote culture and heritage conservation where such aid does not affect trading conditions and competition in the Union to an extent that is contrary to the common interest;
> e) such other categories of aid as may be specified by decision of the Council on a proposal from the Commission.

Opposed to the *ex lege* exceptions of Article 107(2) of TFEU, exceptions contained under Article 107(3) of TFEU are not *ex lege*

[16] EUR-LEX, *supra* note 13.

considered to be compliant with internal market. They will only be compatible with the internal market after the European Commission, upon notification by the member state, gives its authorization. The European Commission acts under a system of prior authorization to ensure that member states do not implement their measures of state aid before the Commission grants an approval. In this way, it ensures that member states implement only such measures that help firms produce goods and services that would otherwise not be provided in the internal market instead of measures that distort competition.[17] Article 107(1) of TFEU will further be briefly explained.

1. *What is aid and in What Forms can it Arise?*

Article 107(1) of TFEU defines state aid as "any aid … in any form whatsoever."[18] This means that aid represents an advantage or benefit granted to the recipient of the aid favoring or improving its financial situation, being it a positive aid, example of positive benefit is a direct payment by a member state to the recipient, or negative aid, example of negative benefit is an omission of the member state to collect a

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[17] Kronthaler & Tzubery, *supra* note 6, at 96.
[18] EUR-LEX, *supra* note 13.

tax at "ordinary" statutory rate.[19] The European Commission report on state aid rules states that "granting a tax concession entails a loss of resources for that state in that it forgoes revenue."[20] The European Court of Justice has described an aid as embracing "not only positive benefits, but also measures which, in various forms, mitigate the charges which are normally included in the budget of an undertaking and which, without therefore being subsidies in the strict meaning of the word, are similar in character and have the same effect."[21] Notice on business taxation issued in 1998 notes that an advantage may be provided through a reduction in the firm's tax burden in various ways, including:

- A reduction in the tax base (such as special deductions, special or accelerated depreciation arrangements or the entering of reserves on the balance sheet);
- A total or partial reduction in the amount of tax (such as exemption or a tax credit);
- deferment, cancellation or even special rescheduling of tax debt.[22]

[19] Kronthaler & Tzubery, *supra* note 6, at 103.
[20] *Commission Report on the implementation of the Commission notice on the application of the state aid rules to measures relating to direct business taxation* (herein "2004 Commission Report"), at 6, COM (2004) 434 final (Feb. 9, 2004).
[21] Case C-143/99, Adria-Wien Pipeline and Wietersdorfer & Peggauer Zementwerke, 2001 E.C.R. I-8365.
[22] *Commission Notice on the Application of the State Aid Rules to Measures Relating to Direct Business Taxation* (herein "1998 Commission Report"), at 3 COM (1998) 384 final (Oct. 12, 1998).

So, when can it be concluded that a certain tax arrangement constitutes state aid? To determine whether a tax scheme derogating from the normal system may constitute state aid, it must be established whether the resulting tax burden is lower than that which would have resulted from application of member states' normal taxation method.[23]

2. *Participation of a Member State*

Article 107(1) of TFEU and the European Commission, in its 1998 notice on business taxation (the "1998 Commission Report"), states that an "advantage must be granted by the State or through State resources."[24] The 1998 Commission Report further states:

> A loss of tax revenue is equivalent to consumption of State resources in the form of fiscal expenditure. This criterion also applies to aid granted by regional or local bodies in the Member States. Furthermore, State support may be provided through tax provisions which have legislative, regulatory or administrative form and through the practices of the tax authorities.[25]

[23] 2004 Commission Report, *supra* note 20.
[24] EUR-LEX, *supra* note 13.
[25] 1998 Commission Report, *supra* note 22, at 4.

3. *Aid's Effect on Competition and Trade Between Member States*

Another condition prescribed by the TFEU states that an aid "distorts or threatens to distort competition,"[26] so, this criteria also applies to a particular tax measure in order to classify it under Article 107(1) of TFEU. The 1998 Commission Report clarifies this by stating that measure must affect competition and trade between Member States. This criterion requires that the beneficiary of the measure exercises an economic activity involving trade between member states, regardless of the beneficiary's legal status or means of financing. The mere strengthening of the beneficiary's position compared with that of other firms that are its competitors in internal market is enough to conclude that internal market is affected. The small amount of aid, the beneficiary's size or its small share of internal market do not lead to a different conclusion.[27] Non-profit organizations and public enterprises may also be caught by Article 107(1) of TFEU under certain conditions.[28]

[26] EUR-LEX, *supra* note 13.
[27] *Id.*
[28] Kronthaler & Tzubery, *supra* note 6, at 108.

4. *A Selective Advantage to an Undertaking*

The last factor that needs to be satisfied, according to Article 107(1) of TFEU, is the selectivity of the measure in question. Article 107(1) describes the consequence of an aid as "favouring certain undertakings or the production of certain goods."[29] As noted in the 1998 Commission Report:

> The selective advantage involved here may derive from an exception to the tax provisions of a legislative, regulatory or administrative nature or from a discretionary practice on the part of the tax authorities. However, the selective nature of a measure may be justified by 'the nature or general scheme of the system'. If so, the measure is not considered to be aid within the meaning of Article 92(1) of the Treaty.[30,31]

A tax measure that is limited to certain taxpayers or to certain categories of taxpayers based on common features and that deviates from a member state`s "benchmark" tax system is considered to be selective.[32] In summary, a tax measure constitutes a state aid if it puts a taxpayer in

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[29] EU-LEX, *supra* note 13.
[30] 1998 Commission Report, *supra* note 22, at 4.
[31] Article 92(1) is today's Article 107(1) of TFEU.
[32] Kronthaler & Tzubery, *supra* note 6, at 109.

more favorable situation as compared to other taxpayers in comparable factual and legal circumstances.[33]

A performance of selectivity test[34] is helpful in determining whether a specific tax measure is selective. The test is consisted of three steps:

1. Determination of a member state`s "common" or "normal" tax system;
2. Determination whether a specific tax measure deviates from the "normal" tax system by granting an advantage to the beneficiary (taxpayer), as compared to a taxpayer in similar factual and legal circumstances;
3. Justification of the measure by the nature and general scheme of the tax system.

If the measure involved passes all three steps, i.e. if the measure can be justified and is consistent with the principle of proportionality (does not go beyond what is necessary for the fulfilment of its objective), it does not fall into the scope of Article 107(1) of TFEU and it is not considered a state aid.

The Court of Justice has confirmed that if the method of taxation for intra-group transfers does not comply with the arm's length principle, and leads to a taxable base inferior to the one which would result from a

[33] *Id.* at 105.
[34] *Id.* at 110.

correct implementation of that principle, it provides a selective advantage to the company concerned.[35]

5. *De Minimis Exception*

Commission Regulation (EU) Number 1407/2013 on the application of Articles 107 and 108 of the Treaty on the Functioning of the European Union to de minimis aid prescribes a ceiling below which Article 107(1) of TFEU can be considered not to apply. According to this Regulation (which applies from January 1, 2014 to December 31, 2020)[36] the total amount of de minimis aid granted per member state to a single undertaking shall not exceed EUR 200,000 over any period of three fiscal years.[37] This rule ensures that any measure within the scope of this Regulation can be deemed not to have any effect on trade between member states and not to distort or threaten to distort competition. Such measure is exempt from the notification requirement contained in Article 108(3) of TFEU.[38]

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[35] Luxembourg Alleged Aid to Amazon, *supra* note 12, at 14.
[36] Commission Regulation 1407/2013, 2013 O.J. (L 352) 1, 8.
[37] *Id.* at 5.
[38] *Id.*

6. *Procedural Aspect: Notification of State aid to and Decision by the European Commission*

The European Commission is the competent authority that decides on compatibility of state aid with internal market, and the procedure is prescribed by Article 108 of TFEU and Council Regulation (EC) Number 659/1999.[39] Its decisions are subject to review by the Court of Justice. The state aid control system distinguishes existing aid, introduced before the establishment of the EU or a member state's accession date, and new aid, introduced after a member state's accession date.[40]

The provision of Article 108(1) of TFEU for existing aid requires "constant review all systems of aid existing" by the European Commission and its proposals to the member states "any appropriate measures required by the progressive development or by the functioning of the internal market."[41] Existing aid is considered to be lawful as long as the European Commission does not find it incompatible with the internal market.[42]

The provision of Article 108(3) of TFEU for new aid requires that "the Commission shall be informed, in sufficient time to enable it to

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[39] Commission Regulation 659/1999, 1999 O.J. (L 083) 1.
[40] Kronthaler & Tzubery, *supra* note 6, at 120.
[41] EUR-LEX, *supra* note 13.
[42] Kronthaler & Tzubery, *supra* note 6, at 121.

submit its comments, of any plans to grant or alter aid."[43] After a member state has notified the European Commission, Article 108(3) of TFEU obliges the state not to put its proposed measures into effect until this procedure has resulted in a final decision by the European Commission. This means that the European Commission has to determine a measure to be compatible with the internal market before a member state puts the measure into application. This procedure applies to all aid, including tax aid.[44]

Even if a measure is covered by one of the ex lege exceptions contained in Article 107(2) of TFEU, the member states still have an obligation to notify the European Commission before they implement the measure.

If a member state does not follow the European Commission`s proposed measures, in case of existing aid, or the Commission concludes that notified new measure represents a state aid, it will initiate a formal investigation procedure in accordance with Article 108(2) of TFEU and communicate its decision to a member state in question by letter, please

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43 EUR-LEX, *supra* note 13.
44 1998 Commission Report, *supra* note 22, at 8.

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see below for review of the letter to Amazon. This procedure ends with a final decision by which the European Commission decides on (in)compatibility of the measure with internal market or its conditional compatibility.[45]

III. EUROPEAN EFFORTS IN TACKLING HARMFUL TAX PRACTICES

The suggestions within the EU on how to combat harmful tax measures go back to the early 1990s. The Ruding Report presented to the European Commission in 1992 was the "study of ways of reforming the taxation of Community companies in an increasingly unified internal market" and it set out a "series of practical recommendations" upon which the Commission was to "draw up its own guidelines for company taxation policy."[46] This Report concluded that:

> Despite the tax convergence which has occurred over the past decade, the Committee considers it unlikely that Member States acting independently of each other can bring about any significant reduction in the distortions affecting the functioning of the internal market. Action must therefore be taken at Community level.[47]

[45] Kronthaler & Tzubery, *supra* note 6, at 124.
[46] Press Release, European Commission, (Dec. 20, 2016), http://europa.eu/rapid/press-release_IP-92-197_en.htm.
[47] *Id.*

Further work included adoption of the Code of Conduct for Business Taxation by the Council of Economics and Finance Ministers ("ECOFIN") of December 1, 1997. By adopting this Code, the member states have obliged themselves to refrain from introducing any new harmful tax measures ("standstill") and amend any laws or practices that are deemed to be harmful in respect of the principles of the Code ("rollback"). The code covers tax measures (legislative, regulatory and administrative), which have, or may have, a significant impact on the location of business in the Union.[48]

Later in 1998, the European Commission published its "Notice on Business Taxation of 1998,"[49] which deals with the prohibition of state aid in detail, and it was followed by the Report on the Commission Notice in 2004.

As noted in the introduction to this paper, the European Commission has today been using the principles on prohibition of state aid to tackle harmful tax competition and has lately initiated significant

[48] European Commission, TAX'N & CUSTOMS UNION, *Harmful Tax Competition* (Jan. 20, 2017), http://ec.europa.eu/taxation_customs/taxation/company_tax/harmful_tax_practices/index_en.htm.
[49] 1998 Commission Report, *supra* note 22.

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procedures "to examine whether decisions by tax authorities in Ireland, the Netherlands and Luxembourg with regard to the corporate income tax to be paid by Apple, Starbucks and Fiat Finance and Trade, respectively, comply with the EU rules on state aid."[50]

Specifically, the European Commission will examine if the three transfer pricing arrangements, validated in the following tax rulings, involve state aid to the benefit of the beneficiary companies:

- The individual rulings issued by the Irish tax authorities on the calculation of the taxable profit allocated to the Irish branches of Apple Sales International and of Apple Operations Europe;
- The individual ruling issued by the Dutch tax authorities on the calculation of the taxable basis in the Netherlands for manufacturing activities of Starbucks Manufacturing EMEA BV;
- The individual ruling issued by the Luxembourg tax authorities on the calculation of the taxable basis in Luxembourg for the financing activities of Fiat Finance and Trade.[51]

Additionally, an investigation has been opened with regard to corporate taxation of Amazon in Luxembourg, and this will be further presented in this paper.

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[50] European Commission, *supra* note 2.
[51] *Id.*

The details of these cases can be found under case numbers: SA.38373 (Alleged aid to Apple), SA.38374 (Alleged aid to Starbucks), SA.38375 (Alleged aid to FFT), and SA.38944 (Alleged aid to Amazon) at the website of the State aid register.[52] The register contains, among other things, information on a member state concerned, aid instrument in question, case type, press release, and a letter from the European Commission to the member state. The Commission has stated that Fiat and Starbucks have received selective tax advantages from Luxembourg and the Netherlands, respectively, which are considered illegal under EU state aid provisions and has ordered those member states to recover due taxes from both multinationals.

The proposal by the European Commission from March 2015 concerns amendment of the Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation. This proposal has so far been identified as one of the strongest towards tax transparency because its goal is to ensure "comprehensive and effective administrative co-operation between tax administrations by providing for the mandatory

[52] European Commission, *State aid Register*, http://ec.europa.eu/competition/state_aid/register/ (last visited June 19, 2017).

automatic exchange of information regarding advance cross border rulings and advance pricing arrangements."[53] The core of the proposal is the new provision of Article 8(a) which sets conditions for automatic exchange of information on tax rulings issued or amended by competent authority of a member state with other member states' competent authorities. The obligation also "catches" valid rulings issued in the ten-year period before the date on which the proposed Directive will take effect.[54] According to the proposal, the exchanged information should be stored in the central depository.

IV. Is the Practice of Multinationals Compatible With Internal Market – Alleged Aid to Amazon

In its press release published on October 7, 2014, the European Commission announced that it "opened an in-depth investigation to examine whether the decision by Luxembourg's tax authorities with regard to the corporate income tax to be paid by Amazon in Luxembourg comply

[53] European Commission, *supra* note 2, at 3.

[54] *Proposal for a Council Directive Amending Directive 2011/16/EU as Regards Mandatory Automatic Exchange of Information in the Field of Taxation*, 12 COM (2016) 25 final (Jan. 28, 2016).

with the EU rules on state aid."[55] This procedure was performed according to Article 108(2) of TFEU.

As stated in the letter communicated by the European Commission to Luxembourg (the "Letter"), "the Commission requested Luxembourg to provide a complete description of the structure of Amazon in Luxembourg, to provide for each of its activities in Luxembourg the amount of tax due for the years 2011, 2012 and 2013, and to provide an explanation on how those amounts were determined."[56] The Commission also requested all tax rulings addressed to the Amazon Group in Luxembourg since 2004 together with transfer pricing report, if any, provided by Amazon to the Luxembourg authorities.

In its reply to the Commission`s request, the Luxembourg authorities provided a tax ruling addressed to Amazon dated November 6, 2003.[57] The exact matter of concern of the European Commission is described in paragraph 7 of the Letter as:

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[55] Press Release, European Commission, State Aid: Commission Investigates Transfer Pricing Arrangements on Corporate Taxation of Amazon in Luxembourg (Oct. 7, 2014).
[56] Luxembourg Alleged Aid to Amazon, *supra* note 12, at 1-2.
[57] *Id.* at 2.

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> A tax ruling which validates a transfer pricing arrangement[58], also referred to as advance pricing arrangement ("APA"). APA means an arrangement that determines, in advance of intra-group transactions, an appropriate set of criteria (e.g. method, comparables, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time.[59]

Describing a multinational company doing business in many different jurisdictions where different tax rates apply, the European Commission made the following observation:

> The after tax profit recorded at the corporate group level is the sum of the after-tax profits in each country in which it is subject to taxation. Therefore, rather than maximise [sic] the profit declared in each country, multinational corporations have a financial incentive when allocating profit to the different companies of the corporate group to allocate as much profit as possible to low tax jurisdictions and as little profit as possible to high tax jurisdictions.[60]

> The European Commission gives an example that:

> This could be achieved by exaggerating the price of goods sold by a subsidiary established in a low tax jurisdiction to a subsidiary established in a high tax jurisdiction. In this manner, the higher taxed subsidiary would declare higher costs and therefore lower profits when compared to market

[58] *Id.* at 2-3. As defined in par. 8 of the Letter, transfer pricing refers to the prices charged for commercial transactions between various parts of the same corporate group, in particular, prices set for goods sold or services provided by one subsidiary of a corporate group to another subsidiary of that same group. *Id.*

[59] *Id.* at 2.

[60] *Id.* at 3.

> conditions. This excess profit would be recorded in the lower tax jurisdiction and taxed at a lower rate than if the transaction had been priced at market conditions.[61]

The question arises why is this observation so important? The European Commission clarifies the tax consequences of such an "artificial" price by stating:

> If the (manipulated) price of the transaction between companies of the same corporate group were taken into account for the assessment of the taxable profits in each jurisdiction, it would entail an advantage for the firms which can artificially allocate profits between associate companies in different jurisdictions compared to other undertakings. So as to avoid this type of advantage, it is necessary to ensure that taxable income is determined in line with market conditions.[62]

What standards or methods are to be applied to associate entities so that they abide by market conditions and do not artificially allocate profits? Arm's length principle is an international standard for setting commercial conditions between companies of the same corporate group or a branch and its parent company and for the allocation of profit. Arm's length standard requires that commercial and financial relations between

[61] *Id.*
[62] *Id.*

associated enterprises should not differ from relations, which would be made between independent companies.[63]

The Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations issued by OECD "provide guidance on the application of the "arm's length principle" for the valuation, for tax purposes, of cross-border transactions between associated enterprises. They stress that it is very important to prevent multinationals in artificially shifting their income, and to tax them where they exercise their economic activities."[64]

A "normal" calculation of taxable profit in the case of an independent enterprise is based on the difference of its income and expenses. Methods have been developed for determining taxable income of associated enterprises for the purpose of preventing them in tax avoidance and to achieve a comparable level of taxation, which could have been arrived at if they were independent market players.[65]

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[63] *Id.*
[64] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (herein "OECD Transfer Pricing Guidelines"), Abstract (2010), http://www.oecd.org/ctp/transfer-pricing/transfer-pricing-guidelines.htm.
[65] Luxembourg Alleged Aid to Amazon, *supra* note 12, at 3.

OECD Transfer Pricing Guidelines provide five methods for determining that prices in transactions between affiliates are in compliance with an arm's length principle:

1. The comparable uncontrolled price method;
2. The cost plus method;
3. The resale minus method;
4. The transactional net margin method; and
5. The transactional profit split method.[66]

1. *The Amazon Group as Beneficiary of the tax Ruling*

As stated in paragraph 16 of the Letter, the European Commission focused its investigation on a tax ruling concluded on November 6, 2003 between the Luxembourg tax authorities and the Amazon group, consisting of Amazon.com Inc. and its subsidiaries.[67] Amazon is an online retailer and its business also consists of the manufacture and sale of Kindle devices. It offers programs that "enable sellers to sell their products on Amazon websites and their own branded websites, and to fulfill orders through Amazon. Besides that, Amazon generates revenue through other marketing and promotional services, such as online advertising and co-

[66] *Id.*
[67] *Id.* at 5.

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branded credit card agreements. Amazon's worldwide net sales in 2013 amount to $74,452,000 and a post-tax net profit was $274,000,000."[68]

2. *Amazon's Structure in Luxembourg*

Paragraphs 18 – 23 of the Letter describe the structure of Amazon group in Luxembourg. It is comprised of several entities:

1. Amazon EU Société à responsabilité limitée ("Amazon EU Sarl"), having a function of the "head office of Amazon for Europe and is the principal operator of the retail and business services offered through Amazon's European websites. It holds other European subsidiaries, owns the inventory, earns the profits associated with the selling of products to end customers, and bears the risk of any loss."[69]
2. Amazon Europe Technologies Holding SCS ("Lux SCS"), being "a Luxembourg limited liability partnership that holds all the shares in Amazon EU Sarl, licenses the Amazon group's intellectual property rights to Amazon EU Sarl to operate the European websites in return for a tax deductible royalty payment."[70]
3. Amazon Services Europe Sarl, being a "third party seller (i.e. marketplace) business."[71]
4. Amazon Media EU Sarl, being a "Amazon's EU digital business (in which MP3s and eBooks are sold)."[72]

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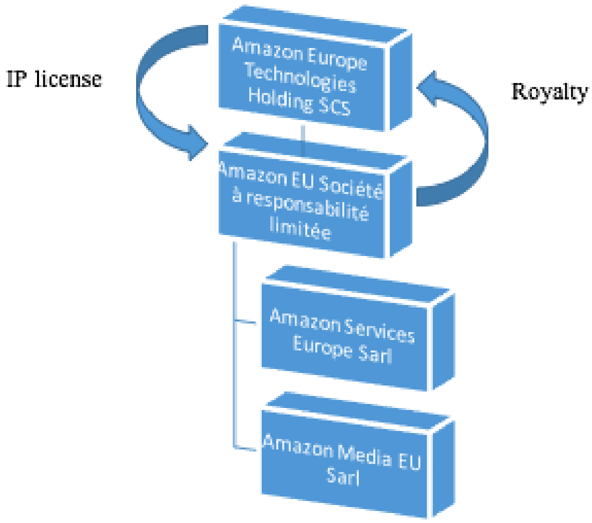
[68] *Id.*
[69] *Id.*
[70] *Id.* at 5-6.
[71] *Id.* at 6.
[72] *Id.*



The first, third, and fourth companies listed above form a fiscal unity in Luxembourg together with entities Amazon Luxembourg Sarl, FinLux Sarl and Amazon Payments SCA, with the first listed company being the parent of the unity. These entities are liable for corporate income tax in Luxembourg.[73] There are other entities existing in Luxembourg, which are subsidiaries of the second company listed above.

3. *Letters by Amazon of October 23 and 31, 2003 and Response by Luxembourg of November 6, 2003*

In letters from October 23 and 31, 2003, Amazon requested the acceptance of the transfer pricing arrangement between Amazon EU Sarl

[73] *Id.*

and Lux SCS and the approval of the legal structure of Amazon for Luxembourg corporate income tax purposes by the Luxembourg tax authorities. Amazon`s requests were approved by the Luxembourg tax authorities on November 6, 2003, just several days after the initial request.[74] The letters sent by Amazon described the restructuring plan for its European business. Only a part of the plan is important for the purpose of this paper, which, among others, describes that:

- The headquarters is based in Luxembourg,
- Amazon EU Sarl is the operator of the retail and business services offered through Amazon's European websites (operator of European websites and owner of servers through which transactions are processed),
- Lux SCS (a limited liability partnership which holds all shares in Amazon EU Sarl) is a transparent entity for tax purposes in Luxembourg and its purpose is to be an intangibles holding company which licenses IP to Amazon EU Sarl in return for a tax deductible royalty payment.[75]

The confirmation by the Luxembourg tax authorities in their letter of November 6, 2003 in which they accepted the transfer pricing arrangement of Amazon is subject of review by the European Commission in the context of alleged state aid.

[74] *Id.* at 6-7.
[75] *Id.* at 5, 7.

4. *Transfer Pricing Agreement Between Amazon EU Sarl and Lux SCS*

According to the Letter, the IP was developed in the United States and Lux SCS obtained a right to exploit it. Lux SCS licensed that IP to Amazon EU Sarl in return for a tax-deductible royalty payment that was approved by the Luxembourg tax authorities. It was agreed that the amount of royalty is computed each year and it would be equal to a percentage of Amazon EU Sarl`s revenue with regard to its operation of the European web sites.[76]

Due to the fact that Lux SCS is a transparent entity[77] for tax purposes in Luxembourg, the royalties it receives from Amazon EU Sarl are not taxed at the entity level in Luxembourg. Instead, this income is, or should be, taxed at the level of participants in the entity, that is, at the level of the partners in Lux SCS, in their country of residence in the United States, to whom the profits of Lux SCS are allocated.[78]

[76] *Id.* at 10-11.
[77] Transparent means that an entity does not have a separate tax personality and does not get taxed at the level of the entity. Instead, the income should pass through the entity and be taxed at the level of participants in the entity. The participants in this case are the partners.
[78] Luxembourg Alleged Aid to Amazon, *supra* note 12, at 12.

Although this income should be taxed at the partners` level in the United States, it gets an indefinite deferral until its repatriation to the United States. The reason for this lies in different classification of Lux SCS between Luxembourg and the United States, transparent in the first and non-transparent in the latter country, due to the U.S. check-the-box rules.[79]

According to the European Commission statement contained in paragraph 40 of the Letter, Amazon also requested a confirmation from the Luxembourg tax authorities that the level of activities carried out in Luxembourg by Lux SCS and its partners cannot be interpreted as constituting a fixed place of business, i.e. a permanent establishment that could trigger taxation.[80]

5. *Did Amazon Receive a Selective Advantage*

As stated earlier in this article, one of the prerequisites that needs to be fulfilled for determination of state aid according to Article 107(1) of TFEU is the selectivity of the measure in question. Only such tax measure that puts a taxpayer in a more favorable situation compared to other

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[79] *Id.* at 8.
[80] *Id.* at 12.

taxpayers in comparable factual and legal circumstances constitutes a state aid. This concern is expressed in paragraph 48 of the Letter and it is manifested in possible lowering of Amazon's tax liability in Luxembourg.[81] The European Commission elaborates in paragraph 48 to 52 why all other conditions for determination of state aid, as presented earlier in this paper, are fulfilled.

The European Commission expressly stated, "it can also be concluded that the ruling gives rise to a loss of State resources. That is because any reduction of tax for Amazon results in a loss of tax revenue that otherwise would have been available to Luxembourg."[82] For determination of the selectivity criterion, the European Commission proposed comparison of methods of assessment of the taxable income of Amazon: the method approved in the tax ruling with the "ordinary" tax method, "based on the difference between profits and losses of an undertaking carrying out its activities under normal market conditions."[83]

If Amazon`s calculation is in line with the market conditions, the European Commission expects that an arrangement applied to Amazon

[81] *Id.* at 13.
[82] *Id.*
[83] *Id.* at 14.

would not differ from the arrangement "that a prudent independent operator acting under normal market conditions would have accepted."[84]

On the other side, if the reality shows that Amazon`s taxable base is lower because the arm`s length principle was not correctly applied, it results in a selective advantage for an entity, i.e. it is the case of prohibited state aid.[85] The European Commission has not had its final word on the subject matter and the decision is still expected.

6. *The Response of the Luxembourg Government*

In its response to the letter communicated by the European Commission to Luxembourg with regard to the alleged aid provided to Amazon by way of a tax ruling, Luxembourg denied that the tax ruling in question constitutes state aid.[86]

The explanation provided by the Luxembourg Government in support of its claim was that its tax code of 1967 does not give any discretion to tax authorities and "consequently not able to give rise to State aid unless the law was misapplied, which could, however, be judged solely

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[84] *Id.*
[85] *Id.*
[86] *Id.* at 12.

by an assessment of the national law."[87] The Government added that this particular ruling is "in line with the general tax ruling practice of multinationals in Luxembourg and with the OECD principles."[88]

Further, in paragraphs 43 and 44 of the Letter, the Government stated that an arm's length royalty was determined based on performed analysis of agreements between Amazon and non-related third parties which concern substantially the same IP, and the explanation is given why the profit split method was applied to analyze the functions and risks of Amazon EU Sarl and Lux SCS.[89]

7. *Provisions of Luxembourg tax law that Were the Basis for the Amazon Ruling*

Apparently, there was no official legislation in Luxembourg based on which Amazon and tax rulings that concern other companies were issued. Rather, it was a mere administrative practice to issue such rulings. In December 2014, the Luxembourg parliament introduced amendments to its national tax law, among which was a new provision that concerns the

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[87] *Id.*
[88] *Id.*
[89] *Id.* at 12-13.

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tax ruling practice, with its date of coming into force on January 1, 2015.[90] This means that the current advanced ruling practice, which was based on internal instruction issued in 1989 by the head of Luxembourg tax authorities, gets modernized with its official basis in the national law.[91] The new law also prescribed a time period of five years for the validity of the decision.[92]

8. *Amendments to the Luxembourg law with Regard to tax Rulings*

This subchapter presents the French wording of the newly introduced Paragraph 29a of the General Tax Act of Luxembourg, which concerns issuance of tax rulings. This provision codifies the existing practice of issuance of advance tax rulings. A provisional English translation can be found parallel to the original French text.[93]

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[90] *Luxembourg Introduces Legal Framework for Tax Rulings and Updates Transfer Pricing Rules*, ERNST & YOUNG (Dec. 29, 2014), http://www.ey.com/gl/en/services/tax/international-tax/alert--luxembourg-introduces-legal-framework-for-tax-rulings-and-updates-transfer-pricing-rules.

[91] *Id.*

[92] *Id.*

[93] *Newsletter Du 27 Octobre 2014*, LE GOUVERNEMENT DU GRAND-DUCHÉ DE LUXEMBOURG (Oct. 27, 2014), http://www.impotsdirects.public.lu/fr/archive/newsletter/2014/nl_27102014.html; *Id.*

Chapitre 4 - Modification de la loi générale des impôts modifiée du 22 mai 1931 («Abgabenordnung»)	***Chapter 4 - Amendment to the general tax law modified on May 22, 1931 ("Abgabenordnung")***
Art. 8. *La loi générale des impôts modifiée du 22 mai 1931 («Abgabenordnung») est modifiée et complétée comme suit:*	***Art. 8*** *The general tax law modified on May 22, 1931 ("Abgabenordnung") is amended and completed as follows:*
1° Il est inséré un paragraphe 29a, libellé comme suit:	*1. A paragraph 29a is inserted, to read as follows:*
«(1) Sur demande écrite et motivée, le préposé du bureau d'imposition émet une décision anticipée relative à l'application de la loi fiscale à une ou plusieurs opérations précises envisagées par le contribuable ayant pour effet de lier le bureau d'imposition à l'occasion de l'imposition à effectuer ultérieurement.	*"(1) Upon written and motivated request, the tax inspector of the tax office in charge issues a binding advanced tax agreement related to the application of the tax law in one or more specific transactions contemplated by the taxpayer.*
(2) La décision anticipée permet d'offrir au contribuable par l'interprétation uniforme et égalitaire de la loi fiscale une sécurité juridique par rapport au traitement fiscal d'une ou de plusieurs opérations projetées.	*(2) Through a uniform and fair interpretation of tax law, the advance tax agreement offers legal certainty to the taxpayer with respect to the taxable treatment of one or more contemplated transactions.*
(3) Un règlement grand-ducal détermine la procédure applicable aux décisions anticipées."	*(3) A Grand-Ducal Regulation sets forth the procedure for advanced tax agreement."*
2° Le paragraphe 171 est complété par un alinéa 3, libellé comme suit:	*2. Paragraph 171 is completed by a paragraph 3, to read as follows:*
«(3) Les dispositions des alinéas 1 et 2 s'appliquent de manière correspondante aux transactions entre entreprises associées.»	*"(3) The provisions of paragraphs 1 and 2 shall apply correspondingly to transactions between associated enterprises."*

V. IS IT REALLY A SELECTIVE TAX TREATMENT?

The European Commission is currently investigating whether the tax ruling provided to Amazon by Luxembourg tax authorities is in compliance with the arm`s length principle. Its concerns are with regard to the following:

1. Failure of Luxembourg to submit a transfer pricing report (analysis) prepared by Amazon in support of the transfer pricing arrangement in the ruling request, although it seems that such document might exist;[94]
2. Assessment of the Amazon`s ruling request within (only) eleven working days from the receipt of the first letter (which is a very short period of time had a transfer pricing report been submitted and assessed);[95]
3. Appropriateness of transfer pricing method proposed by Amazon which does not seem to correspond to any of the OECD methods;[96]
4. Presentation of royalty payments by Amazon EU Sarl to Lux SCS in the form of a royalty rate over revenue and not really calculated in that way, but instead it is calculated as a residual profit. Rather than being expressed as a percentage of revenues, the royalty should be calculated based on revenues;[97]
5. Deviation from the OECD transfer pricing and no justification for the use of indirect method for an arm's

[94] Luxemourg Alleged Aid to Amazon, *supra* note 12, at 16.
[95] *Id*.
[96] *Id*.
[97] *Id*. at 17.

length remuneration due to Amazon EU Sarl, while there was a possibility to use a direct method, which is also preferred by the European Commission. In addition, the level of remuneration seems low;[98] and

6. The tax ruling is more than 10 years old, and has been applied to Amazon without amendment, which would take into account economic changes that occur over time.[99]

After taking all these concerns into account, the Commission believed that the Amazon ruling is contrary to the arm's length principle and that the Luxembourg tax authorities provide an on-going selective advantage to Amazon by agreeing on its tax liability.[100] The Commission believed that all conditions for determination of state aid are fulfilled which is considered contrary to the EU law and might be found incompatible with the internal market.

VI. CONSEQUENCES OF ILLEGAL AID

The European Commission has broad powers in preserving the European internal market. Its actions in dealing with illegal aid depend on whether the aid already exists or represents a newly granted aid. If the European Commission finds an existing aid to be incompatible with

[98] *Id.* at 18-19.
[99] *Id.* at 20.
[100] *Id.*

internal market, it can propose appropriate measures to the member state concerned with a view to removing the distortion of competition caused by the aid. However, it may not require such aid to be recovered from the participants.[101]

The recovery of the new aid can be requested if measure that constitutes it is implemented before receiving prior authorization from the European Commission. Such aid is unlawful aid and it will have to be recovered if it is determined to be incompatible with internal market.[102] Article 14 of Council Regulation (EC) No 659/1999 provides that all unlawful aid may be recovered from the recipient of such aid.

The Notice on business taxation of 1998 explains the calculation of the amount to be recovered in case of state aid in form of tax measures: comparison is made between the tax actually paid and the amount which should have been paid if the generally applicable rule had been applied, and that amount is increased for the interest.[103]

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[101] 1998 Commission Report, *supra* note 22, at 3-9.
[102] *Id.* at 8.
[103] *Id.*

VII. Investigations in the U.S. and How Should the U.S. attack Abusive tax Practices

The European Union is not the only jurisdiction where the relevant authorities "fight" multinational entities that shift their profits to those member states where tax rates are lower, such as Luxembourg or Ireland, with the goal of cutting their tax bills. Amazon's transfer pricing dispute[104] (to name just one example) with the tax authorities in the United States (Internal Revenue Service) before the U.S. Tax Court shows that tax avoidance is a global phenomenon, which goes beyond the borders of the European Union.

Joint Committee on Taxation, a body of the United States Congress, prepared a publication, "Present Law And Background Related To Possible Income Shifting And Transfer Pricing," which it submitted to the House Committee On Ways And Means on July 22, 2010. In this document, the Joint Committee on Taxation presented six cases (described on an anonymous basis) of U.S. based multinational corporations that had an effective (i.e. average) tax rate on worldwide income of less than 25%

[104] Amazon.Com, Inc. & Subsidiaries V. Comm'r Of Internal Revenue, Docket No. 031197-12 (T.C. 2014), https://www.ustaxcourt.gov/USTCDockInq/DocketDisplay.aspx?DocketNo=12031197.

during at least one multi-year period since 1999.[105] The goal of the case study was to "identify business structures that facilitate possible income shifting or deficiencies in the application of transfer-pricing rules."[106] This publication states, in the overview of the U.S. tax system, that:

> The United States employs a worldwide tax system under which U.S. resident individuals and domestic corporations generally are taxed on all income, whether derived in the United States or abroad; the foreign tax credit provides relief from double taxation. Income earned in the United States directly or through a pass-through entity (such as a branch) is taxed on a current basis. By contrast, active foreign business earnings that a U.S. person derives indirectly through a foreign corporation generally are not subject to U.S. tax until such earnings are repatriated to the United States through a distribution of those earnings to the U.S. person.[107]

The publication further notes that the principal tax policy concern is that "profits may be artificially inflated in low-tax countries and depressed in high-tax countries through aggressive transfer pricing that does not reflect an arm's length result from a related-party transaction and

[105] *Testimony of Staff of the J. Comm. on Tax'n Before the H. Comm. on Ways and Means Hearing on Transfer Pricing Issues* 1 (2010).
[106] J. Comm.on Tax'n, PRESENT LAW AND BACKGROUND RELATED TO POSSIBLE INCOME SHIFTING AND TRANSFER PRICING 1 (Comm. Print 2010).
[107] *Id.* at 5.

that there is "empirical evidence that U.S. multinational corporations shift income to low-tax foreign jurisdictions."[108]

Examples of corporations such as Amazon and others that are "rich" with intellectual property ("IP") show that a reduction in the U.S. tax base is accomplished by moving the IP rights into a low tax jurisdiction. The above quoted publication describes two possibilities for accomplishing this goal: either by having a "foreign affiliate enter into an agreement with the U.S. group to buy in to the pre-existing foreign or worldwide territorial rights to exploit the intellectual property rights attributable to certain product lines and share the cost of future development of those intellectual property rights" or by having the "foreign affiliate enter into a license agreement with the U.S. group to make and sell certain product lines either solely in non-U.S. territories or worldwide."[109]

The publication concludes that all companies presented in the case study have the following common characteristics:

- Concentration of more profitable functions in foreign jurisdictions where the average tax rate is lower and a

[108] *Id.* at 4, 5.
[109] *Id.* at 10.

concentration of their less profitable functions in jurisdictions where the average tax rate is higher;

- Exploitation of intangible property rights effectively as part of foreign operations (as stated above, either through buy-in and cost-sharing arrangements, or through licensing agreements);
- Deferral of a substantial percentage of foreign earnings by effectively managing exposure to the subpart F rules (check-the-box rules[110] in conjunction with the manufacturing exception[111]).[112]

According to the case study, these companies are successful in concentrating their income in jurisdictions with low tax rates, statutorily prescribed or negotiated with local authorities, in lowering their worldwide tax rates and increasing their after-tax earnings.[113]

Various solutions have been suggested in the United States to better tax worldwide income of its multinationals. For example, the U.S. President in the Fiscal Year 2016 and 2017 Budgets of the U.S.

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[110] CHARLES H. GUSTAFSON ET AL., TAXATION OF INTERNATIONAL TRANSACTIONS MATERIALS, TEXT AND PROBLEMS 1082 (4th ed. 2011). "Check-the-box regulations permit the organization to elect to be treated for U.S. tax purposes either as a corporation or as a conduit, flow-through or fiscally transparent entity (i.e. in effect, as a partnership or if it has only one member, as a disregarded entity or branch). The election is available to any business entity organized under foreign law except the foreign law counterpart of a U.S. corporation, which is required, even under the check-the-box regulations, to be treated as a corporation for U.S. tax purposes." *Id.*
[111] *Id.* at 911."If a controlled foreign corporation manufactures goods in its country of incorporation, the income it generates by their sale cannot be foreign base company sales income." *Id.*
[112] J. Comm. on Tax'n, *supra* note 106, at 103-04.
[113] *Id.* at 105.

Government proposed a reform of the U.S. international tax system, which would include the following:

1. Introducing a 19% minimum tax on foreign earnings that would require U.S. companies to pay tax on all of their foreign earnings when earned (without opportunities for deferral), after which earnings could be reinvested in the United States without additional tax;
2. Preventing U.S. companies from avoiding tax through "inversions" (transactions in which U.S. companies buy smaller foreign companies, then reorganize the combined firm to reduce U.S. tax liability);
3. Preventing foreign companies operating in the U.S. from using excessive interest deductions to "strip" earnings out of the U.S. and avoid U.S. tax;[114]
4. Limiting shifting of income through intangible property transfers;
5. Restricting the use of hybrid arrangements that create stateless income; and
6. Limiting the ability of domestic entities to expatriate.[115]

Proposals from prior budgets included:

1. Taxing excess returns on intangibles: treating excess returns in a low tax country on intangibles transferred to it from the United States as Subpart F income (current taxation) and in a separate foreign tax credit basket (to prevent other foreign taxes to offset U.S. taxes due on the excess returns);

[114] OFFICE OF MGMT. & BUDGET, FISCAL YEAR 2016 BUDGET OF THE U.S. GOVERNMENT, 57 (2015).
[115] *Id.* at 125-26.

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2. Clarifying rules that concern transfer pricing of intangibles: intangibles would include workforce in place, goodwill, and going concern value. IRS would be able to aggregate intangibles if that leads to a more appropriate value. The best value of intangibles would be by a willing buyer and seller with reasonable knowledge of the relevant facts.[116]

VIII. OECD: BEPS PROJECT AND THE STATELESS INCOME PROBLEM

The European Union and the United States participate in an internationally coordinated and worldwide approach to tackle double non-taxation and the artificial shifting of profits, known as the BEPS Project. The BEPS Project is developed under the leadership of OECD, the Organization for Economic Cooperation and Development.

BEPS stands for "Base Erosion and Profit Shifting" and refers to "tax planning strategies that exploit gaps and mismatches in tax rules to make profits 'disappear' for tax purposes or to shift profits to locations where there is little or no real activity but the taxes are low, resulting in little or no overall corporate tax being paid."[117]

OECD explains that BEPS is caused when "activities cross border, the interaction of domestic tax systems means that an item of income can

[116] Gravelle, *supra* note 1, at 46.
[117] OECD, *BEPS – Frequently Asked Questions*, OECD.ORG, http://www.oecd.org/ctp/beps-frequentlyaskedquestions.htm (last visited June 19, 2017).

be taxed by more than one jurisdiction, thus resulting in double taxation. The interaction can also leave gaps, which result in income not being taxed anywhere. BEPS strategies take advantage of these gaps between tax systems in order to achieve double non-taxation."[118] Therefore, BEPS does not necessarily deal with illegal tax avoidance strategies, but with strategies that are legal within tax regimes implemented by governments of different countries among which there are discrepancies in tax rules. Those who use BEPS strategies use these differences to cut their tax bills.

The wider international community has been concerned about BEPS because it provides certain taxpayers a "competitive advantage over enterprises that operate at the domestic level"[119] with the result of distortion of competition. BEPS Project is a worldwide approach, including not only the most developed countries in the world, but also non-G20/non-OECD members that are also concerned about this issue and are actively participating in the project. BEPS consists of 15 action

[118] *Id.*
[119] *Id.*

plans[120] that aim to bring profound amendments to the international tax rules. These action plans are the following:

- Action 1 - The digital economy
- Action 2 – Hybrid mismatch arrangements
- Action 3 – Controlled Foreign Company (CFC) regimes
- Action 4 – Financial payments
- Action 5 – Harmful tax practices
- Action 6 – Treaty abuse
- Action 7 – Permanent establishment (PE) status
- Action 8 – Transfer pricing and intangibles
- Action 9 – Transfer pricing and risks/capital
- Action 10 – Transfer pricing and other high-risk transactions
- Action 11 – Data and methodologies
- Action 12 – Disclosure of aggressive tax planning
- Action 13 – Transfer pricing documentation
- Action 14 – Dispute resolution mechanisms
- Action 15 – A multilateral instrument

The ultimate goal of this project is to enable countries to impose taxation on income in those jurisdictions where multinationals exercise economic activity and to prevent possibilities for allocating income to places with no nexus to such activity, through harmonization of international taxation rules. If this project achieves its desired goals, it may mean an end to the artificial shifting of income and double non-

[120] *Id.*

taxation. In the end, it will result in restoring and strengthening taxing rights of sovereign countries around the world.[121]

As these measures, which are mere recommendations by OECD, will not become directly applicable for all participants in the BEPS Project, OECD stated that they will have to be introduced through domestic laws, bilateral tax treaties, or a multilateral convention that would amend the network of existing bilateral tax treaties at one time.[122]

IX. COMMISSION'S JUNE 2015 ACTION PLAN FOR FAIR AND EFFICIENT CORPORATE TAX SYSTEM – REINTRODUCING CCCTB

The European Commission presented its "Action Plan for Fair and Efficient Corporate Tax System in the European Union" on June 17, 2015 (the "Action Plan").[123] The Action Plan represents a proposal for fundamental reform of corporate taxation system within the EU that currently provides opportunities for multinational companies to engage in complex tax strategies with a goal of avoiding taxes. The Commission believes that if the member states were to cooperate more closely and together through the Action Plan they would develop "fair, efficient and

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[121] *Id.*
[122] *Id.*
[123] *Communication from the Commission to The European Parliament and the Council* (herein "Action Plan"), COM (2015) 302 final (June 17, 2015).

more growth-friendly"[124] corporate tax environment. The Commission proposes five elements[125] for the major upgrade of corporate tax structure, as follows:

> 1. Re-launching the Common Consolidated Corporate Tax Base ("CCCTB"), by introduction of one set of rules for calculation of companies' profits for all their activities in the EU, in lieu of various national rules that currently apply. The biggest advantage of this system would be a consolidation that would allow "offsetting losses in one member state against profits in another."[126] The CCCTB would be mandatory for all member states. It is expected that it would be "highly effective in tackling profit shifting and corporate tax abuse"[127] and result in (administratively) simpler and cheaper environment for companies doing business in the EU.
> 2. Ensuring effective taxation where profits are generated, by introduction of various measures that will secure effective taxation in the EU of companies doing business in the EU and measures for improving the transfer pricing system. The Commission has plans for adjusting the definition of permanent establishment, amending the controlled foreign corporation ("CFC") rules, and updating the Code of Conduct for Business Taxation, Interest and Royalties Directive and Parent Subsidiary Directive.
> 3. Creating a better business environment, by removing tax obstacles for EU businesses and simplifying and attracting businesses to operate in the EU. The Commission has in mind introduction of the CCCTB and

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[124] Press Release, European Commission, Questions and Answers on the Action Plan for Fair and Efficient Corporate Taxation in the EU (June 17, 2015), http://europa.eu/rapid/press-release_MEMO-15-5175_en.htm.
[125] *Id.*
[126] Action Plan, *supra* note 123.
[127] *Id.*

new mechanisms for resolving double tax disputes and allowing cross-border loss offsetting. This would result in a level playing field for all companies, from small start-ups to multinationals.

4. Increasing transparency, by publishing first pan-EU list[128] of tax havens ("third-country non-cooperative jurisdictions") and opening an online public consultation[129] on tax transparency and public disclosure of corporate tax information by companies, which is a continuation of Tax Transparency Package[130] introduced in March 2015 that proposed an automatic exchange of information on cross-border tax rulings.

5. Improving EU coordination on corporate tax matters, by introduction of joint audits that would allow tax authorities of different member states to jointly audit a multinational company.

A major difference between OECD's BEPS project, which is actively supported by the EU, and the Action Plan is the latter's mandatory nature. As stated earlier, BEPS represents a set of legally non-binding recommendations, which needs to be implemented through bilateral or multilateral tax treaties. On the other side, the European

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[128] *Tax Good Governance in the World as Seen by EU Countries*, EUROPEAN COMM'N (2016), http://ec.europa.eu/taxation_customs/business/company-tax/tax-good-governance/tax-good-governance-world-seen-eu-countries_en (last visited June 19, 2017).

[129] *Public Consultation on Further Corporate tax Transparency*, EUROPEAN COMM'N (2015), http://ec.europa.eu/finance/consultations/2015/further-corporate-tax-transparency/index_en.htm (last visited June 19, 2017).

[130] *Communication from the Commission to the European Parliament and the Council on tax Transparency to Fight tax Evasion and Avoidance,* EUROPEAN COMM'N (2015), http://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX%3A52015DC0136 (last visited June 19, 2017).

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Commission proposes mandatory, legally binding solutions for EU-28 through the Action Plan. The Commission expressly confirmed that it has "no intention" to harmonize corporate tax rates because it is "Member States' sovereign right to decide their statutory tax rates."[131] Adoption of these measures could deliver the necessary framework for fair and efficient corporate taxation system in the EU, with clear and transparent rules that would make it difficult or impossible for multinational companies to engage in aggressive tax planning to artificially reduce their tax debts and result in fair distribution of tax revenues among the member states.

X. EUROPEAN COMMISSION'S PROPOSAL FOR ANTI-TAX AVOIDANCE DIRECTIVE

In early 2016, the European Commission announced its anti-tax-avoidance package that, among others, includes a draft anti-tax-avoidance directive. The Commission explained the policy behind the package as "competitive disadvantage suffered by businesses that do not engage in aggressive tax planning" compared to those that do and "significant

[131] EUROPEAN COMM'N, *supra* note 124.

revenue loss" by the member states.[132] The draft directive suggests implementation of some BEPS-presented measures as minimum standards to the EU member states to provide better protection to the corporate tax bases. Some of the key suggestions[133] of the draft directive are:

- Introduction of the General Anti-Abuse Rule ("GAAR") – The tax authorities' tool to disallow transactions with the main purpose of obtaining a tax advantage that defeats the purpose of the provision or rule.
- Hybrid entities mismatch rules – These encompass rules that deal with mismatches between EU member states as a result of hybrid entities or instruments. Hybrid entities or instruments provide tax advantages for multinational groups resulting from differences in the tax treatment of an entity or instrument between different jurisdictions.
- Introduction of the controlled foreign corporation ("CFC") rules for entities subject to a low level of taxation and where a certain percentage of the entities income is passive (usually more than 50%).

Taking into account the complex enactment procedure, before the European Parliament and the Council, it is predicted that the directive might take effect in 2017.

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[132] PricewaterhouseCoopers, *European Commission proposes anti-tax-avoidance package*, TAX INSIGHTS FROM INTERNATIONAL TAX SERVICES 3 (Feb. 3, 2016), https://www.pwc.com/us/en/tax-services/publications/insights/assets/pwc-european-commission-proposes-anti-tax-avoidance-package.pdf.
[133] *Id.* at 2.

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XI. CONCLUSION

The international community has become aware that sovereign governments are losing millions of dollars and euros because of multinational entities that shift their profits from jurisdictions with high tax rates to low tax jurisdictions. There is no exact number on the total loss that governments suffer each year, but some estimates suggest that it amounts to more than $100 billion per year. The main reason for loss of revenues are not illegal activities of multinationals known as tax evasion, but tax avoidance which represent activities of multinational entities using "loopholes" and discrepancies between tax regimes implemented by different governments around the world. The right to taxation is the prerogative of sovereign governments that do not succeed in exercising that right in full because profits are moved away from jurisdictions in which the economic activity occurs. It needs to be stressed that multinational entities are led by their legitimate business reasons when trying to lower their taxes. In doing so, they are using channels (i.e. bilateral tax treaties) set up in legitimate procedures by sovereign governments around the world.

The procedures that undergo several phases of bilateral negotiations between the governments, local parliamentary procedures that include, usually, majority votes in parliaments and ratification processes. Once bilateral treaties enter into force, they are to be used by businesses that operate in cross-border environments. For people outside of the business world it might be hard to understand that multinationals, while wisely yet cautiously using legal gaps, are still fully complying with bilateral tax treaties that have been negotiated and put into force by their respective governments.

In addition, many countries have contributed to the problem by their reluctance to the implementation of principles of transparency, reporting of income and exchange of information, for the purpose of keeping their bank secrecy and similar non-transparent rules in application. In such an environment, the most common methods used by multinationals for shifting their income from high to low tax jurisdictions are transfers of intangibles (intellectual property), allocation of debt, and using hybrid entities, to name just a few. One of the reports issued by the U.S. Congress identified some major jurisdictions as tax havens, among which are the Netherlands, Ireland, Luxembourg, the UK, and three states

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in the United States, Delaware, Nevada, and Wyoming. Many other less developed countries around the world have room to tighten their tax anti-abuse rules as well.

In order to prevent further erosion of tax bases, OECD has invited governments to act collectively, rather than on an individual basis. The theoretical and political idea is that the tax laws need to be changed in a way to achieve complete harmonization between tax regimes of different countries. Various individual suggestions have been made from introducing anti-abuse legislation or restricting foreign tax credits from offsetting taxes owed to own country, but no proposal yet has been so broad and thorough to amend international tax rules as the OECD's project on Base Erosion and Profit Shifting ("BEPS").

Although this project involves the most developed nations in the world, as well as many developing countries not members of OECD, the real question is whether such a complex international alliance can truly combat harmful tax practices. In theory, the outcome of the BEPS project should be a broad and harmonized implementation of standards that prevent double taxation together with standards designed to avoid double non-taxation. However, whether the current 96 members of the BEPS project can unanimously adopt its recommendations without any reservations will eventually be an indicator of success.

Taking into consideration that there are a few thousand bilateral tax treaties currently in effect which took years to negotiate and become enforceable, and that BEPS Action 15 suggests a multilateral instrument to implement tax-treaty BEPS related measures in all those treaties, the author of this article does not believe in the broad success of the BEPS project. It is not only the size of the project that is troubling, but also the fact that some countries may only adopt those measures that fit them best. For example, the European Commission is a long-standing supporter of the Common Consolidated Corporate Tax Base ("CCCTB") project. This project involves only EU member states and should enable companies that operate in more than one EU member state to file a single tax return through one tax administration for all their EU activities. In addition, it would enable them to offset losses they have in one member state against profits in another member state. Its positive effects would manifest in greater transparency, simplification, reduction of compliance costs and closing loopholes between member states' tax systems. Although this project has been developing for over a decade and it involves only 28 countries (i.e. EU member states), unfortunately it has not achieved any significant results yet.

The tax investigations performed by the European Commission have shown that some multinational entities have paid too low corporate income tax in particular EU member states. Specifically, the Commission has stated that Fiat and Starbucks have received selective tax advantages from Luxembourg and the Netherlands, respectively, which are considered illegal under EU state aid provisions and has ordered those member states to recover due taxes from both multinationals. The Commission suspects that those companies have received illegal state aid by respective governments implemented through issuance of advance tax rulings providing legal certainty by "blessing" their corporate structures and planned intra-group transactions. The Court of Justice will make the final decision in both cases several years from now. In case the Court of Justice confirms the Commission's findings that the governments have not taken into account regular market conditions and the arm's length principle when issuing advanced rulings, the consequences should include: the repayment of aid received, increased for the amount of interests and penalties, and public disclosure of financial information (as far as bank and tax secrecy rules allow). On the other side, if the Court of Justice does not agree with Commission's conclusions and rules in favor of multinationals, there will already be some irreversible accompanying consequences for such multinationals in terms of negative publicity and damaged public image, potential loss of customers, and profit.

Amazon is still waiting for the outcome of the Commission's investigation. The European Commission preliminarily believes that the tax ruling granted by Luxembourg resulted in a reduction of charges that should have been borne by Amazon and, therefore, constitutes state aid. It has not yet been decided whether that ruling is compatible with the EU internal market or not. Although Luxembourg and the Netherlands have been ordered to collect due taxes from Fiat and Starbucks respectively, the decisions in those cases should not prejudice the outcome of the Amazon investigation in the EU. Amazon has also been confronted with serious and expensive procedure against the Internal Revenue Service before the U.S. Tax Court, the outcome of which is still unpredicted; most part of the trial has been closed to the public. Due to the fact that Amazon has been involved in two major tax procedures (in the U.S. and in the EU), the possible negative outcome of those procedures might be very burdensome

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for the company. It might result in reduced volume of business activity, dismissal of employees, and company's withdrawal from certain markets. The case before the U.S. Tax Court might end in settlement with the IRS. The European Commission's decision will not be final for Amazon, since it is subject to review by the Court of Justice that can either confirm the Commission's findings or rule in favor of Amazon.

The United States has put political pressure on the European Commission stating that the EU is disproportionately targeting U.S. companies and that "EU state aid probe violates the rule of law" by its retroactive effect that is "improper and plainly undermines legal certainty."[134] The United States has made it clear that it would "ensure that the U.S. is using all of the tools at its disposal to protect U.S. interests."[135] One of the tools at the U.S.' disposal is enforcing the Internal Revenue Code Section 891 "Doubling of rates of tax on citizens and corporations of certain foreign countries."[136] If Section 891 were invoked against the EU,

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134 Kevin A. Bell & Alex M. Parker, *Hatch, Wyden: EU State Aid Probe Violates Rule of Law* DAILY TAX REP. (May 23, 2016).
135 *Id.*
136 Internal Revenue Code Section 891 reads: "Whenever the President finds that, under the laws of any foreign country, citizens or corporations of the United States are being subjected to discriminatory or extraterritorial taxes, the President shall so proclaim and the rates of tax imposed by sections 1, 3, 11, 801, 831, 852, 871, and 881 shall, for the

it would “double the tax rate on income earned at U.S. subsidiaries of European companies.”[137] Specifically, enforcement of this section would mean that a U.S. domestic 30% tax rate would apply on certain types of income of EU corporations doubled by the application of Section 891. For U.S. source could become taxable by 60% tax rate, where Croatia does not have a double tax treaty with the United States that could provide a relief. Such an economic warfare between the United States and the EU might put pressure on the European Commission to end tax investigations against U.S. multinationals.

Differences between corporate tax regimes influence choices of multinational entities’ location and investments. Multinational businesses that operate in cross-border environments have legitimate business reasons

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taxable year during which such proclamation is made and for each taxable year thereafter, be doubled in the case of each citizen and corporation of such foreign country; but the tax at such doubled rate shall be considered as imposed by such sections as the case may be. In no case shall this section operate to increase the taxes imposed by such sections (computed without regard to this section) to an amount in excess of 80[%] of the taxable income of the taxpayer (computed without regard to the deductions allowable under section 151 and under part VIII of subchapter B). Whenever the President finds that the laws of any foreign country with respect to which the President has made a proclamation under the preceding provisions of this section have been modified so that discriminatory and extraterritorial taxes applicable to citizens and corporations of the United States have been removed, he shall so proclaim, and the provisions of this section providing for doubled rates of tax shall not apply to any citizen or corporation of such foreign country with respect to any taxable year beginning after such proclamation is made.” I.R.C. § 891 (2015).

[137] Bell & Parker, *supra* note 134.

to concentrate their activities where the cost of doing business is the lowest. In doing so they are using bilateral tax treaties entered into between their sovereign governments. Their activities can result in erosion of tax bases and a loss of tax revenue for tax authorities. However, these "harmful" tax practices, as they are commonly called in the press, have been enabled by the governments, and not by the multinationals. Multinationals should not be in the spotlight for using the means (i.e. tax treaties) that were provided to them by their sovereign governments. Governments have become aware of this phenomenon and are trying to prevent further erosion of tax bases by harmonizing their tax regimes and tightening anti-abuse rules through projects such as BEPS and CCCTB. It is uncertain whether these projects will succeed because countries can selectively adopt only those measures that suit them best which would inevitably contribute to even more complexity in an already complex world of international tax.