INTERNATIONAL TAX ISSUES ARISING IN A GLOBAL ECONOMY: Can the U.S. and Europe Play Nicely in the New Digital Age?

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CLE: 1.5 credits in Areas of Professional Practice  
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This lecture will address European Union state aid rules and the status of the legal proceeding involving U.S. multinationals such as Apple, Amazon, McDonald’s, Starbucks, and Fiat Chrysler. It will also focus on recent developments in the EU and Italy concerning the effect of the so-called “web tax” on web companies. Finally, it will explore the European reaction to the new U.S. tax law.
International Tax Issues Arising in a Global Economy: Can the U.S. and Europe Play Nicely in the New Digital Age?

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I. Transfer Pricing and State Aid
EU Commission’s State Aid Investigations Timeline

- **First Commission’s State Aid Decision re TP**: No. 2004/77/EC (Belgium Tax ruling system for US foreign sales corporations); No. 2003/438/EC (Luxembourg Finance Companies); No. 2004/76/EC (France Headquarters and logistic)
- **11 June 2014** Opening of formal investigations re rulings granted by Ireland to Apple, by the Netherlands to Starbucks and by the Luxembourg to FIAT
- **7 Oct 2014** Opening of formal investigation re ruling granted by the Luxembourg to Amazon
- **3 Feb 2015** Opening of formal investigation re Belgian excess profit scheme
- **21 Oct 2015** Decision in Starbucks and FIAT: illegal State aid
- **3 Dec 2015** Opening of formal investigation re ruling of McDonald’s
- **11 Jan 2016** Decision re Belgian excess profit scheme: illegal State aid
- **11 Feb 2016** U.S. Secretary Public letter to Commission President Juncker
- **24 Aug 2016** US Treasury White Paper on EU Commission’s State Aid Investigations on TP Rules
- **30 Aug 2016** Decision re Ireland-Apple tax ruling: illegal State aid \(\Rightarrow\) undue tax benefits of up € 13 billion
- **15 Sept 2016** US Treasury Notice 2016-52 announcing future Section 909 regulations
State Aids Procedures on Tax Rulings

- Apple, IRL (SA.38373) – open since 11 June 2014 – Negative final decision with recovery 30 August 2016

- FFT, LUX (SA.38375) – open since 11 June 2014 – Negative final decision with recovery 21 October 2015 (pending cases T-755/15, Lux e T-759/15, Fiat vs Commission)

- Starbucks, NL (SA.38374) – open since 11 June 2014 – Negative final decision with recovery 21 October 2015 (pending case T-760/15, NL vs Commission)

- Amazon, LUX (SA.38994) – open since 7 October 2014

- McDonald’s, LUX (SA.38945) – open since 3 December 2015

- Excess Profit Ruling System, BE (SA.37667) – open since 3 February 2015 – Negative final decision with recovery 11 January 2016 (pending case T-287/16, BE vs Commission)
Definition of State Aid

Article 107(1) TFEU forbids «aids [1st element] granted by a Member State or through State resources [2nd element] in any form whatsoever which distorts or threatens to distort competition [3rd element] by favoring certain undertakings or the productions of certain goods [4th element]»

Selection of Relevant Case law

- ECJ, Gezamenlijke, Case C-30/59 [1961]
- ECJ, Italy v. Commission, Case 173/73 [1974]
- ECJ, Forum 187 ASBL, Cases C-182/03 & 217/03 [2006]
- ECJ, Commission v. Portugal, Case 88/03 [2006]
- ECJ, Gil Insurance, Case C-308/01 [2004]
- ECJ, Paint Graphos, C-78/08 & C-80/08 [2011]
- ECJ, France Telecom v. Commission, Case C-81/10 [2011]
- ECJ, SGI, Case C-311/08 [2010] (fundamental freedoms and arm’s length)
Constitutive Elements of State Aid

1. **An intervention by the State or through State resources:** aid is financial assistance which results in a concrete advantage

   *Granted through State resources:* Aid can be granted either in the form of a direct subsidy or of a (direct/indirect) intervention

2. **The intervention must be liable to affect trade between Member States:** the finding of a State Aid depends not on the objectives of the measure but on its end effects
Constitutive Elements of State Aid

3. **It must confer a selective advantage on an undertaking:** An Aid is selective if it favors certain undertakings or productions with respect to others that are in a comparable situation.

4. **It must distort or threaten to distort competition**

- **Note:** Notwithstanding the competence of the Member State over their systems of taxation, tax measures are not excluded from the scope of Article 107(1) TFEU.
Established EU Commission and ECJ State Aid Analysis

✓ Three-step analysis

a) Whether there is a tax advantage
b) Whether the tax advantage is selective \(\Rightarrow\) comparison
c) Whether this selective tax advantage is consistent with nature and logic of the system

a) Tax advantage lies in relief from a charge normally borne in the form of
   • Reduction in the tax base
   • Reduction in the tax due
   • Special payment modalities

b)/c) Selectivity test
   • Determine the system of reference
   • Identify a measure or rule which departs from that system
   • Check whether such derogation can be justified by the logic of the tax concerned or of the tax system as a whole
How Can an APAs Constitute State Aid?

✓ The EU Commission’s position

• Companies within a group should apply prices for their intra-group transactions which would prevail between independent companies acting in the market
• Otherwise group companies could artificially shift income to related companies in low tax jurisdictions, reduce their tax liability, this would be an advantage
• Market conditions can be achieved by the application of the arm’s length principle
• Arm’s length principle is not that of Art. 9 OECD Mod. Conv. but «a general principle of equal treatment in taxation falling within the application of Article 107(1) of the [TFEU]» [Starbucks Decision, § 264; Fiat Decision, § 228; Belgian Excess Profit Scheme Decision, § 150]
• The APAs scrutinized do not comply with the arm’s length principle
• Therefore, the APAs grant a selective advantage to their beneficiaries which is not available to other companies in a comparable situation
Main Issues in the EU Commission’s Approach

✓ State Aid rules may not prove to be the appropriate tool to tackle profit shifting phenomena ➔ Aggressive structures and BEPS activities are based on several, interacting elements of the structure, which exploit various loopholes in international tax system

✓ Profit Shifting through TP structures imply a cross-border issue while State Aid rules look at single States and cannot capture the exploitation of mismatches between national rules

✓ It is difficult to assess what is State Aid and what is justifiable approximation of an arm’s-length price
US White Paper
US White Paper Policy Concerns

✓ The Commission’s approach is new and unpredictable ➔ it should not have retroactive effect

✓ The Commission’s approach is inconsistent with international norms and undermine the international consensus on Transfer Pricing

✓ Drag of US taxes into the EU pocket

✓ APAs enhance legal certainty, reduce administrative costs for tax administrations and compliance costs for businesses - attack on them may be counterproductive

✓ Geopolitical conflicts with the US ➔ The Commission’s approach calls into question the ability of Member States to honor bilateral tax treaties and thus endangers economic relationships between EU and US
State Aid SA. 38945 (2015/C)– Luxembourg

Alleged Aid To McDonald’s
State Aid SA. 38945 (2015/C) – Luxembourg Alleged Aid To McDonald’s

✓ Procedure: 19 June 2013 - 03.12.2015

✓ Fact pattern:

- McDonald’s Group is composed of the McDonald’s Corporation, a company listed on the New York Stock Exchange, and all the companies directly and indirectly controlled by that corporation.

- McDonald’s Corporation controls five companies in Luxembourg.

- The European Commission inquiry focuses on **two tax rulings issued by the Luxembourg tax administration in 2009** in favor of McD Europe (a company resident for tax purposes in Luxembourg).
Fact Pattern

- McD Europe has two branches: in the US (“US Franchise Branch”) and Switzerland (“Swiss Service Branch”).

- McD Europe acquired beneficial ownership of a number of franchise rights intangibles.

- McD Europe allocated the franchise rights as well as the obligations to its US Franchise Branch.

- After the transfer concerned, all royalties that were once received by McDonald’s Corporation are now received by McD Europe through its US Franchise Branch.
Fact Pattern

- US Franchise Branch licensed the franchise rights intangibles to Swiss Service Branch.

- In its turn, the Swiss Service Branch licensed the franchise rights to franchisors in various European countries and provided management, support, development, and other similar or related services associated with the franchise rights.
The Royalty Payments and the Compensation Payments

McD Europe Franchising Sarl (2013)

- Payment for:
  - [...]
The European Commission Procedure

✓ The European Commission procedure concerns two tax rulings issued by the Luxembourg tax administration in 2009 in favor of McD Europe:

a) the **Initial Tax Ruling** issued by the Luxembourg tax administration on 30 March 2009 and

b) the **Revised Tax Ruling** issued by the Luxembourg tax administration on 17 September 2009
The Initial Tax Ruling

✓ The Initial Tax Ruling Request

According to McDonald’s tax advisor:

- McD Europe qualifies as tax resident in Luxembourg pursuant to Luxembourg tax law and it is thus fully liable for corporate income tax there.
- McD Europe should benefit from all of the provisions of any DTT concluded by Luxembourg.
- By virtue of Article 5 of the Luxembourg–US DTT, the activities of US Franchise Branch should be considered to be performed in the United States. Consequently, the profits generated by the US Franchise Branch should only be subject to possible taxation in the United States and exempt from corporate income tax in Luxembourg by virtue of Articles 7 and 25 of the Luxembourg–US DTT.

* Same line of reasoning as with regard to the Swiss Service Branch.
The Initial Tax Ruling

According to Luxembourg tax Administration:

- McD Europe is tax resident in Luxembourg and, as such, is entitled to DTTs benefits.

- Swiss Service Branch and the US Franchise Branch constitute permanent establishments.

- The Luxembourg tax administration maintained that the profits of McD Europe attributable to those two branches were to be subject to tax in their respective countries and tax exempt in Luxembourg.

- Nonetheless, the Initial Tax Ruling stated that “in order to benefit from these exemptions in Luxembourg, the company must submit proof on a yearly basis that those profits have been declared and are subject to tax in Switzerland and the United States respectively”.
The Revised Tax Ruling

According to McDonald’s tax advisor:

- the US Franchise Branch **does not constitute a PE for US tax purposes**.

“even though the branch (a) holds the franchise rights associated with the group’s European region, (b) assumes various economic risks associated with the development and maintenance of the franchise rights acquired, and (c) conducts certain activities associated with the franchise rights, the global McDonald’s organization view the primary business operations as performed through other members of the group and **does not consider the activities of the branch as constituting a US trade or business**” (emphasis added)
The Revised Tax Ruling

According to McDonald’s tax advisor:

- Article 5(1) of Luxembourg–US DTT defines a PE as a “fixed place of business through which the business of an enterprise is wholly or partially carried on”
  - the DTT fails to define the term “business”
  - according to Article 3(2), the term “business” in that provision should generally be given the meaning which it has under the domestic law of the contracting State that applies that DTT (i.e. Luxembourg)
  - under Luxembourg tax law the activities of the US Franchise Branch constitute a “business”
  - McD Europe should be entitled to exemption in Luxembourg pursuant to either Luxembourg–Switzerland DTT and Luxembourg–US provisions.

- Luxembourg Tax Administration ➔ The Revised Tax Ruling upheld McDonald’s tax advisor’s interpretation
If under Luxembourg tax law the activities of the US Franchise Branch fall under the definition of a “business” or “PE”, ‘then Luxembourg would expect that the income may be taxed in the US because it may be treated as a PE from a Luxembourg tax perspective. There is however no requirement that the other contracting state (US) effectively taxes this income. Article 25(2)(a) of the DTT provides that Luxembourg will exempt from tax income that “may be taxed in the United States”. According to the tax advisor, “there is however no requirement that the other contracting state (US) effectively taxes this income” (emphasis added).
The Position of Luxembourg

• “There exists a **distinction between** the **exercise of discretion** when issuing a tax ruling and the **mere interpretation** of a legal provision.

• Tax administrations need to be allowed a **certain degree of flexibility** when applying the provisions of their tax law to cases of individual taxpayers.

• When doing so, and where the national tax administrations do **not deviate from the generally applicable tax provisions**, there cannot be any State aid. Thus, the Commission can **only intervene** when either the tax ruling deviates from the tax ruling practice of the tax administration, international fiscal conventions or OECD principles, or the tax administration has **committed a manifest error** in its analysis of legal, economic or factual elements leading to the tax ruling.” (emphasis added)
The European Commission’s Decision

1. An intervention by the State or through State resources

“The ruling reduces McD Europe’s corporate tax liability in Luxembourg and therefore gives rise to a loss of State resources”

3. The intervention must be liable to affect trade between Member States AND

4. The intervention must confer a selective advantage on an undertaking

“McD Europe is part of the McDonald’s Corporation, a globally active firm that operates in numerous Member States of the Union. Any aid in its favour distorts or threatens to distort competition and has the potential to affect intra-Union trade”
The European Commission’s Decision

2. **The intervention must distort or threaten to distort competition**

“To the extent it can be shown that the revised tax ruling results in an unjustified lowering of McD Europe’s tax liability in Luxembourg as compared to economic operators in a comparable factual and legal situation, that ruling will be considered to confer a selective advantage upon McD Europe and the McDonald’s Corporation.” (emphasis added)
Selective Advantage (conclusions):

- The Revised Tax Ruling constitutes State Aid ➔ Selective advantage due to a derogation from Luxembourg tax law and the Luxembourg–US DTT in the Revised Tax Ruling.
- As a result of the Revised Tax Ruling, McDonald's Europe Franchising did not pay any corporate tax in Luxembourg nor in the US on its profits since 2009.
- The Commission considered the Initial Tax Ruling to reflect a proper interpretation of the Luxembourg tax law and the Luxembourg–US DTT provisions.
The European Commission’s Decision

Selective Advantage (legal approach):

• Three-step analysis to determine whether a particular tax measure is selective.

1) First, the common or normal tax regime applicable in the Member State is identified: “the reference system”.

2) Second, it is determined whether the tax measure in question constitutes a derogation from that system, in so far as it differentiates between economic operators who, in light of the objectives intrinsic to the system, are in a comparable factual and legal situation.
Selective Advantage (legal approach):

3) **Third:** If the measure constitutes a derogation from the reference system, it is then established, in the third step of the analysis, whether that measure is justified by the nature or the general scheme of the reference system.

- A tax measure which constitutes a derogation to the application of the reference system may be justified if the Member State concerned can show that that measure results directly from the basic or guiding principles of that tax system.

- If that is the case, the tax measure is not selective.

- The burden of proof in that third step lies with the Member State.
The European Commission’s Decision

1st Step:

• “Reference system”: companies tax resident in Luxembourg are thus liable to corporation tax on their worldwide profits unless a tax treaty applies.

2nd Step:

• “Unjustified Derogation”: “where a tax measure results in an unjustified reduction of the tax liability of a beneficiary who would otherwise be subject to a higher level of tax under the reference system, that reduction constitutes both the advantage granted by the tax measure and the derogation from the system of reference.”

• The Unjustified Derogation related to the interpretation of the Luxembourg-US DTT put forward in the second ruling
The European Commission’s Decision

• The *Unjustified Derogation* related to the interpretation of the Luxembourg-US DTT put forward in the second ruling.

• In the first ruling, Luxembourg tax authorities agreed on the exemption from Luxembourg corporate law of the US PE’s income subject to “*proof on a yearly basis that those profits have been declared and are subject to tax in [...] the United States*”

• In the second ruling Luxembourg tax authorities agreed on the interpretation of the Luxembourg-US DTT put forward by the taxpayer and granted exemption from Luxembourg corporate law on the US PE’s income regardless of any proof of its taxation in the United States.
The European Commission’s Decision

✔ Article 25(2) of the Luxembourg–US DTT: “In Luxembourg double taxation shall be eliminated as follow” ➔ exemption from Luxembourg taxation for income “which, in accordance with the provisions of this Convention, may be taxed in the United States”

A. McDonald’s tax advisor’s interpretation:

As long as US Franchise Branch constitutes a PE under Luxembourg tax law, the profits attributed to it should be exempt from Luxembourg corporate income tax, irrespective of (i) whether it constitutes a PE under US tax law and (ii) any requirement of effective taxation.
The European Commission’s Decision

B. Commission’s Interpretation:

- The Commission does not consider that the requirement of “may be taxed” in Article 25(2) of the Luxembourg–US DTT should be read as a requirement to be effectively taxed but as a requirement of “liability to tax” in the source State.

- The **decisive** element is whether the Source State (the United States) may tax the income in question under the tax treaty because of the existence of a PE subject to tax in the United States. Consequently, if no PE exists under United States’ domestic law, the United States may not tax that income under also the DTT.

  - Since the US Franchise Branch does not constitute a permanent establishment for US tax purposes, the United States cannot tax any income attributed to that branch there is no possibility that those profits “may be taxed” by the United States within the meaning of Article 25(2) of the DTT.
The European Commission’s Decision

European Commission makes reference to Paragraph 32.6 of the OECD Commentaries:

“[t]he phrase ‘in accordance with the provisions of this Convention, may be taxed’ must also be interpreted in relation to possible cases of double non-taxation that can arise under Article 23 A. Where the Source State [US] considers that the provisions of the Convention preclude it from taxing an item of income or capital which it would otherwise have had the right to tax, the State of residence [LUX] should, for purposes of applying paragraph 1 of Article 23 A, consider that the item of income may not be taxed by the State of source [US] in accordance with the provisions of the Convention, even though the State of residence [LUX] would have applied the Convention differently so as to have the right to tax that income if it had been in the position of the State of source. Thus the State of residence [LUX] is not required by paragraph 1 to exempt the item of income, a result which is consistent with the basic function of Article 23 which is to eliminate double taxation.”


**Issues**

- If the OECD Commentary really relevant for the case at stake where it is the source State domestic law that disqualifies the existence of a PE and not the DTT that restricts the source State’s taxing rights?

- Can the European Commission’s interpretation of the DTT that diverges from the one held by a given Member State (Luxembourg, in the case at stake) suffice to support the existence of a State Aid?

- What is the weight of the OECD Commentary within this context?
✓ Art. 9(5)

“To the extent that a hybrid mismatch involves disregarded permanent establishment income which is not subject to tax in the Member State [LUX] in which the taxpayer is resident for tax purposes, that Member State [LUX] shall require the taxpayer [MD Europe] to include the income that would otherwise be attributed to the disregarded permanent establishment. […]”
Art. 9(5)

"[...] This provision applies unless the Member State [LUX] is required to exempt the income under a double taxation treaty entered into by the Member State [LUX] with a third country [US]".

Consistent with ATAD II, Preamble # 11: “Any adjustments that are required to be made under this Directive should in principle not affect the allocation of taxing rights between jurisdictions set under a double taxation treaty”.
PERMANENT ESTABLISHMENT MISMATCH – THIRD STATE - EU D/NI
(Art. 9(5))

- A Co lends money to C Co (a related company) through a branch located in US under LUX perspective but non-existent under US perspective.
- CANADA permits C Co to claim a deduction for the interest payment.
- LUX exempts or excludes the interest payment from taxation on the grounds that it is attributable to the PE located in US.
- The interest income is not taxed in US because under its domestic law there is no PE of A Co within its territory.
- The payment of interest therefore gives rise to an intra-group mismatch (a D/NI outcome).

RULE: MS I should, in principle, include the interest in its taxable income → However, if LUX-US DTT LUX requires LUX to exempt the income attributable to A Branch, then LUX must refrain from taxing the interest.
State Aid SA.38373

Ireland Alleged Aid to Apple
State Aid SA.38373 - Ireland Alleged Aid to Apple

- **Procedure**: 12 June 2013 – 30 August 2016
- **Status**: Ongoing litigation proceeding (Action brought on 9 November 2016)
- **Fact pattern:**

![Organization Chart]

* Irish tax resident company
State Aid SA.38373 - Ireland Alleged Aid to Apple

- **Apple Inc.** is a US incorporated company that directly controls AOI.

- **Apple Operations International (AOI):** is an *Irish-incorporated NON-tax resident company* with no branch in Ireland.

- **Apple Operations Europe (AOE)** is an *Irish incorporated NON-tax resident company* carrying on a trade through a branch in Ireland.
  - AOE is a 100% subsidiary of AOI.

- **Apple Sales International (ASI)** is an *Irish-incorporated NON-tax resident company* carrying on a trade through a branch in Ireland.
  - ASI is a 100% subsidiary of AOE.

According to the information provided by the Irish authorities, the territory of tax residency of AOE and ASI is not identified.
State Aid SA.38373 - Ireland Alleged Aid to Apple

**AOE:**

- AOE’s Irish branch manufactures personal computers and provides specific services to Apple companies in Europe the Middle East and Africa (such as payroll services, centralized purchasing and a customer call center).

- is party to a cost sharing agreement whereby, together with other Apple Inc. subsidiaries, it shares R&D costs and risks of developing certain Apple products.

- AOE has IP rights under that cost sharing agreement.

- **Apple Inc. holds the legal title to all Apple IP.**

- **No rights** in relation to the IP concerned are attributed to the Irish branch of AOE.
ASI:

- ASI’s branch is engaged in the procurement of Apple finished goods from third-party manufacturers, sale and logistic activities.
- ASI is a party to the R&D cost sharing agreement with other Apple Inc. subsidiaries.
- **Apple Inc. holds the legal title to all Apple IP.**
- **No rights** in relation to the Apple IP concerned are attributed to the Irish branch.
State Aid SA.38373 - Ireland Alleged Aid to Apple

State aid: Ireland gave illegal preferential tax treatment to Apple

Almost all profits allocated to head office existing only on paper and left untaxed

Almost no profits taxed in Ireland (0.005% effective tax rate in 2014)

All profits from European sales recorded in Ireland

Payments to Apple Inc. (US) to finance R&D
The European Commission’s Decision

- European Commission’s inquiry concerns the tax rulings issued by Irish tax Authorities to respectively ASI and AOI concerning the attribution of profits to the Irish branches of the two companies.

- European Commission assessment ➔ violation of arm’s length principle ➔ Artificial internal allocation of profits not grounded on factual or economic justifications

- The European Commission has concluded that two tax rulings issued by Ireland to Apple have substantially and artificially lowered the tax paid by Apple in Ireland since 1991 granting Apple a significant advantage over other business subject to Irish national tax rules ➔ State Aid
The European Commission’s Decision

- According to the European Commission:
  
a) **The head office did not have employees or own premises**
  
b) **Only** the **Irish branch of ASI** had the capacity to generate any income from **trading**, i.e. from the distribution of Apple products
  
c) **Only** the **Irish branch of AOE** had the capacity to generate any income from **trading**, i.e. from the production of certain lines of computers for the Apple group
  
- Therefore, sales **profits** of AOE/ASI **should have been recorded with the Irish branch** and taxed there.
  
- **Nonetheless**, according to the European Commission “As a result of the tax rulings, most sales profits of Apple Sales International were allocated to its "head office" when this "head office" had no operating capacity to handle and manage the distribution business, or any other substantive business for that matter”.
State aid SA.38374 (2014/C)
Netherlands Alleged Aid To Starbucks
State aid SA.38374 (2014/C) – Netherlands Alleged Aid To Starbucks

- **Procedure:** 30 July 2013 – 21 October 2015
- **Status:** Ongoing litigation proceeding (Action brought on 23 December 2015)
- **Fact pattern:**
  - Starbucks Manufacturing EMEA BV (“EMEA”) is a company resident of the Netherlands.
  - EMEA is the only coffee roasting company in the Starbucks group in Europe. The company is engaged in the **sale and distribution** of roasted coffee and coffee-related products (e.g. cups, packaged food, pastries) to **Starbucks outlets in Europe, the Middle East and Africa**.
  - EMEA pays royalties to a **Alki** (a UK-based company belonging to Starbucks group) as a consideration for specific coffee-roasting know-how.
  - EMEA purchases green coffee beans from a **Starbucks Coffee Trading SARL** (a Switzerland-based company belonging to Starbucks group).
State aid SA.38374 (2014/C) – Netherlands Alleged Aid To Starbucks
The European Commission’s Decision

- The European Commission's investigation concerns APAs concluded by the Netherlands and EMEA in 2008.

- According to the European Commission, the APA artificially lowered taxes paid by EMEA in two ways:
  a) Starbucks Manufacturing pays a **very substantial royalty to Alki** for coffee-roasting know-how;
  b) Starbucks Manufacturing pays an **inflated price for green coffee beans** to Starbucks Coffee Trading SARL.

- The European Commission argues that the pricing of the intercompany transactions involved in the APA **does not reflect the arm’s length principle**.
The European Commission’s Decision

- The royalty paid by EMEA to Alki does not adequately reflect market value.
  - In fact, only EMEA is required to pay for using this know-how while no other Starbucks group company nor independent roasters to which roasting is outsourced are required to pay a royalty for using the same know-how in essentially the same situation.
- The purchase price of green coffee beans paid by EMEA to Starbucks Coffee Trading SARL does not adequately reflect market value.
- The European Commission highlights that taking into consideration the high cost of the green coffee beans, EMEA's coffee roasting activities alone would not actually generate sufficient profits to pay the royalty for coffee-roasting know-how to Alki. The European Commission thus infers that the royalty mainly shifts to Alki profits generated from sales of other products sold to the Starbucks outlets, such as tea, pastries and cups, which represent most of the turnover of EMEA.
State aid SA.38944 (2014/C)

Luxembourg Alleged Aid to Amazon
State aid SA.38944 (2014/C) – Luxembourg Alleged Aid to Amazon

✓ **Procedure:** 7 October 2014 – 4 October 2017

✓ **Status:** Ongoing litigation proceeding (Action brought on 14 December 2017)

✓ **Fact pattern:**

- The Commission decision concerns Luxembourg's tax treatment of two companies in the Amazon group – Amazon EU and Amazon Europe Holding Technologies ("Amazon Holding").

- Amazon EU and Amazon Holding belong to Amazon group and are ultimately controlled by Amazon US.
State aid SA.38944 (2014/C) – Luxembourg Alleged Aid to Amazon
Fact pattern:

- **Amazon EU** operates Amazon's retail business throughout Europe. The company has more than 500 employees who select the goods for sale on Amazon's websites in Europe. It purchases the products from manufacturers, and manages the online sale and the delivery to the customers in the European market.

  Amazon EU records all European sales, and the profits stemming from these sales, in Luxembourg.

- Under **Luxembourg tax law**, the company **is subject to corporate taxation in Luxembourg**.
Fact pattern:

- **Amazon Holding** is a limited partnership with no employees, no offices and no business activities.

- The Amazon Holding company acts as an intermediary between the operating company and Amazon in the US.

- The company **holds certain intellectual property rights** for Europe under a so-called "cost-sharing agreement" with Amazon in the US.

- Under the **cost-sharing agreement** the Amazon Holding company makes annual payments to Amazon in the US to contribute to the costs of developing the intellectual property.

- Amazon Holding **makes no active use of the said intellectual property**. It merely grants an exclusive license to this intellectual property to Amazon EU, which uses it to run Amazon's European retail business.
State aid SA.38944 (2014/C) – Luxembourg Alleged Aid to Amazon

✓ Fact pattern:

- From a **tax** perspective, **Amazon Holding** qualifies as a **reverse hybrid entity**:
  - Under **Luxembourg tax law**, Amazon Holding, being a limited partnership, is **not subject to** corporate taxation in Luxembourg.

    Profits recorded by the holding company are only taxed at the level of the partners and not at the level of the holding company itself.

  - Under **US tax law**, **Amazon Holding** is treated as an **opaque entity**.

    **Amazon Holding** 's partners are located in the US.
The scope of the Commission investigation:

- The Commission’s State aid investigation concerned a tax ruling issued by Luxembourg to Amazon in 2003 and prolonged in 2011.
- The ruling endorsed a method to calculate the taxable base of Amazon EU. Indirectly, it also endorsed a method to calculate annual payments from Amazon EU to Amazon Holding for the use of intellectual property, which were used only by Amazon EU.
- Royalty payments exceeded, on average, 90% of Amazon EU's operating profits.
- The Commission investigation did not question Amazon Holding ownership of the intellectual property, nor the regular payments Amazon Holding made to Amazon in the US to develop this intellectual property.

It also did not question Luxembourg's general tax system as such.
State aid SA.38944 (2014/C) – Luxembourg Alleged Aid to Amazon

✓ Commission assessment:

- The Commission's State aid investigation concluded that the Luxembourg tax ruling endorsed an unjustified method to calculate Amazon EU's taxable profits in Luxembourg.

- In particular, according to the Commission’s view:
  - the level of the royalty payment from Amazon EU to the holding company was inflated and did not reflect economic reality.
  - Amazon EU was the only entity actively taking decisions and carrying out activities related to Amazon's European retail business.
  - Amazon Holding was an empty shell that simply passed on the intellectual property rights to Amazon EU for its exclusive use.
  - Amazon Holding was not itself in any way actively involved in the management, development or use of this intellectual property. It did not, and could not, perform any activities, to justify the level of royalty it received.
"Where one or more associated non-resident entities holding in aggregate a direct or indirect interest in 50% or more of the voting rights, capital interests or rights to a share of profit in a hybrid entity that is incorporated or established in a Member State, are located in a jurisdiction or jurisdictions that regard the hybrid entity as a taxable person, the hybrid entity shall be regarded as a resident of that Member State and taxed on its income to the extent that this income is not otherwise taxed under the laws of the Member State or any other jurisdiction”.

RULE: The Member State where the Reverse Hybrid entity is located must treat that entity as opaque
A, B and C are Associated Enterprises.

- Hybrid entity B is transparent in LUX (Member State) but non-transparent in US (Third country) (Reverse Hybrid Entity).

- Interest payment from C Co to B Co is deducted by C Co, but neither included by reverse hybrid entity B nor by A Co.

**RULE:** LUX should tax the interest income in the hands of B.
State aid SA. 38375 (2014/NN) (ex 2014/CP) – Luxembourg
Alleged Aid to FFT
State aid SA. 38375 (2014/NN) (ex 2014/CP) – Luxembourg
Alleged aid to FFT

✓ **Procedure:** 11 July 2014 – 21 October 2015

✓ **Status:** Ongoing litigation proceeding (Action brought on 29 December 2015)

✓ **Fact pattern:**

- Amazon EU is a company incorporated under the laws of Luxembourg and resident thereof.

- Amazon Holding Technologies ("Holidng") is a company incorporated under the laws of Luxembourg and resident thereof.

- Amazon.com is a company incorporated under the laws of United States and resident thereof ("Amazon USA")
State aid SA. 38375 (2014/NN) (ex 2014/CP) – Luxembourg
Alleged aid to FFT
State aid SA. 38375 (2014/NN) (ex 2014/CP) – Luxembourg Alleged aid to FFT

✓ Fact pattern:

- Amazon EU is a company incorporated under the laws of Luxembourg and resident thereof.
- Amazon Holding Technologies ("Holding") is a company incorporated under the laws of Luxembourg and resident thereof.
- Amazon.com is a company incorporated under the laws of United States and resident thereof ("Amazon USA")
Advanced Pricing Agreement

- APAs are arrangements that determine, in advance of intra-group transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time.

- An APA is formally initiated by a taxpayer and requires negotiations between the taxpayer, one or more associated enterprises, and one or more tax administrations.

- APAs are intended to supplement the traditional administrative, judicial, and treaty mechanisms for resolving transfer pricing issues.
On 3 September 2012 Luxembourg tax authorities confirmed that the transfer pricing analysis based on the transfer pricing report prepared by the tax advisor on behalf of FFT respects the arm’s length principle (FFT APA).

According to that letter, the decision by the tax authorities is binding for 5 years (i.e. from tax year 2012 to tax year 2016).
The arm’s length remuneration of FFT, as established in the transfer pricing report and accepted by the FFT APA, is as follows:

“The transfer pricing study determines an appropriate remuneration on the capital at risk and the capital aimed at remunerating the functions performed by the company of EUR 2.542 million on which a range of +/- 10% is envisaged.”.
TNMM APPLIED IN FFT APA

- TNMM relies on a net profit indicator which refers, in principle, to the ratio of profit weighted to an item of the profit and loss account or of the balance sheet, such as turnover, costs or equity. To this selected item, a margin is applied which is considered “arm’s length” to approximate the amount of taxable profit.

- In the case at stake, the profit allocation is determined by using the Capital Asset Pricing Model.
The European Commission’s Decision

- The Commission’s investigation concerns the FFT APA.

- In the view of the Commission, the FFT APA granted a selective advantage to FFT.

- In particular, according to the Commission’s line of reasoning, FFT APA artificially lowers taxes paid by FFT since:
  a) it refers to a number of economically unjustifiable assumptions and downward adjustments;
  b) the capital base approximated by the tax ruling is much lower than the company's actual capital;
  c) the estimated remuneration applied to the capital for tax purposes is lower compared to market rates.
The Commission maintains that:

a) the FFT APA enabled FFT to pay taxes in Luxembourg on a small portion of its actual accounting capital at a very low remuneration.

b) if the estimations of FFT’s capital and remuneration applied by the FFT APA had corresponded to market conditions, the taxable profits declared in Luxembourg would have been 20 times higher.
IV. EU REACTIONS TO THE US TAX REFORM
A) Letter of the five Ministers of Finance (December 2017)

A) **Letter of the five Ministers of Finance (December 2017)**

1) **BEAT (Code Sec. 59(A))**

- Issue of compatibility with the non-discrimination principle enshrined in Art. 24 of the US Model Convention which reads as follows “Except where the provisions of paragraph 1 of Article 9 (Associated Enterprises), paragraph 8 of Article 11 (Interest), or paragraph 7 of Article 12 (Royalties) apply, interest, royalties, and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned Contracting State. Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of the first-mentioned resident, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned Contracting State” (Emphasis Added).
WEB TAX (OECD – EU)
The Digital Economy and the Purpose of BEPS Action 1

- The digital economy ("DE") is the result of a transformative process in continuous state of evolution brought by information and communications technology ("ICT").

- The DE has been implemented through several business models (e-commerce, app stores, online advertising, etc.) which present some key features (e.g. mobility of intangibles and business functions) potentially relevant from a tax perspective.

- DE is increasingly becoming an economy itself → from a tax perspective it is extremely difficult to ring-fence from the rest of the economy.

- OECD Response → BEPS Action 1 - Addressing the Tax Challenges of the Digital Economy
OECD BEPS Action 1

The OECD does not provide for *ad hoc* regulations, but rather suggests specific options:

- A new *nexus* based on the concept of "*significant economic presence*", which creates a taxable presence in a country on the basis of *factors* that evidence a purposeful and sustained interaction with the economy of that country via technology and other automated tools. To determine such a presence, *revenues* (which exceeds a set threshold of the transactions covered) should be combined with:
  
  i. *digital factors* (local domain name, local digital platform, local payment options); *and/or*
  
  ii. *user factors* (monthly active users, online contract conclusion, data collection).

- A "*withholding tax*", which apply on the gross value of the goods and services *ordered online* by residents (and local PEs) of a country (*i.e.* digital sales transactions), or to all sales operations *concluded remotely* with non-resident providers.

- An "*equalization levy*", which applies to all transactions *concluded remotely* with in-country customers, only where the business maintains a *significant economic presence*. However, imposing an equalization levy raises the risk that the same income would be subject to both corporate income tax and the levy. For this reason, a tax credit should be introduced.
The European Union Position


A Fair and Efficient Tax System in the European Union for the Digital Single Market

 ✓ In his 2017 State of the Union Address, the President of the Commission called for fair taxes for the digital industry.

 ✓ All businesses operating in the EU should pay their taxes where profits and value are generated.

 ✓ Businesses are now more digitalized than ever before

 ✓ We are acting in a borderless and globalized world. Increased consumption is accompanied by intensified trade and increasing trade volumes

 ✓ Digitalization has acted as a facilitator and accelerator of cross-border trade.
Digitalization changes the nature of exchange by blurring the lines between goods and services, transforming products to their digital representation, such as e-books, or using the least material possible, for example 3D printing.

The digitalization of the global economy is happening at a fast pace and large scale, permeating almost all areas of society.

![Revenue growth (%)](chart.png)

- ENTIRE EU RETAIL SECTOR
- 5 TOP E-COMMERCE RETAILERS
In 2006 only one technology company was among the top 20, accounting for only 7% of the market capitalization. In 2017, 9 out of the top 20 companies by market capitalization were technology companies, accounting for 54% of the total top 20 market capitalisation.
The EU needs a modern tax framework to seize digital opportunities, while also ensuring *fair taxation*

**Critical challenges**

- The main challenge is to *reform the international tax framework*, which was first designed at the start of the twentieth century and is no longer fit for purpose.

- The underlying principle for corporation tax is that profits should be taxed *where the value is created*. However, in a *digitalized world*, it is not always very clear *what that value is*, *how to measure it*, or *where it is created*.
The **two main policy challenges** that need to be addressed can be summarized as follows:

- **Where to tax? (nexus)** – how to establish and protect taxing rights in a country where businesses can provide services digitally with little or no physical presence despite having a commercial presence; and

- **What to tax? (value creation)** – how to attribute profit in new digitalized business models driven by intangible assets, data and knowledge.

**Objectives:**

- Fairness
- Competitiveness
- Integrity of the Single Market
- Sustainability
 POSSIBLE SOLUTIONS

1) To embed the taxation of the digital economy in the general international corporate tax framework.

   a) reform of international tax rules on permanent establishment: Alternative indicators for significant economic presence are therefore required in order to establish and protect taxing rights in relation to the new digitalized business models;

   b) Transfer pricing and profit attribution applicable to digital technologies: the challenge of identifying and valuing intangible assets as well as determining their contribution to value creation requires alternative methods for attributing profit that better capture value creation in the new business models.
POSSIBLE SOLUTIONS

2) Equalization tax on turnover of digitalized companies: tax on all untaxed or insufficiently taxed income generated from all internet-based business activities, including business-to-business and business-to-consumer, creditable against the corporate income tax or as a separate tax.

3) Withholding tax on digital transactions - A standalone gross-basis final withholding tax on certain payments made to non-resident providers of goods and services ordered online.

4) Levy on revenues generated from the provision of digital services or advertising activity - A separate levy could be applied to all transactions concluded remotely with in-country customers where a non-resident entity has a significant economic presence.
The ideal approach would be to find multilateral, international solutions to taxing the digital economy given the global nature of this challenge.

EU Member States should have a coordinated position to have a greater impact on the work at global level.

An Important milestone will come early in 2018 when the OECD will present an interim report on the taxation of the digital economy to the G20.
The Italian Web Tax

✓ The 2018 Italian Budget Law introduced a tax on digital transactions (so-called “Web Tax”). The rule will enter into force as of 1 January 2019.

➢ The Web Tax in a nutshell ➔ Withholding tax to be levied on certain B2B digital transactions involving Italian customers
The Italian Web Tax

- Web Tax applies to the supply of services electronically provided to resident enterprises and domestic PE of non-resident enterprises located in Italy (B2B).
  - **Threshold**: Web Tax applies only with respect to Qualifying Transactions provided for by either resident or non-resident suppliers that carry out more than 3,000 Qualifying Transactions in a given calendar year.

- **Qualifying Services** are services supplied through the Internet or another electronic network whose nature makes the supply essentially automated, with a minimum human intervention, and impossible to be carried out without ITCs. A forthcoming Ministerial Decree, to be issued by 30 April 2018, will provide a definition of Qualified Transactions (that are a subset of Qualifying Services).

- Web Tax applies at a rate of 3% on the value of each transaction, calculated on a net VAT basis, regardless of the place where the transaction is concluded.

- Web Tax is to be levied by the resident enterprise or PE located in Italy paying for the service. The recipient of the service must, thus, act as withholding agent.
The Italian Web Tax

 Practical issues regarding the application of Web Tax may arise with respect to:

- the monitoring and tracking of the qualifying transactions.
- the potential clash between Web Tax and DTTs’ provisions.
- double taxation – in case the service provider is not granted with tax credit/exemption, for Web Tax suffered in Italy, in its country of residence.
The End

(for the time being......)
SPEAKER BIOGRAPHY
PROF. DR STEFANO GRILLI

HIGHER EDUCATION

Ph.D. (2012) at the University of Bergamo on International and European Tax Law.


B.B.A. (1994) at University Bocconi of Milan

CURRENT JOB

Tax partner at GIANNI, ORIGONI, GRIPPO, CAPPELLI & PARTNERS

ACADEMIC ACTIVITIES

Professor of Domestic and International Tax Law at the University of Milan – Bicocca

Visiting Professor at the University of International Business and Economics (UIBE) of Beijing on international tax treaties matters (summer 2017)

Lecturer on Double Tax Treaty and EC Tax Law matters at the Master of Advanced Studies in International Tax Law (Adv. LL.M.) - International Tax Centre - University of Leiden (The Netherlands).

Lecturer on selected EU tax matters at the New York Law School (Oct. 2016)

Lecturer on Double Tax Treaty matters at 2015 ITC Leiden South-East Asia Executive Program in International Tax Law organizes by the Malaysia Tax Authorities (LHDN) and the International Tax Centre - University of Leiden (October 2015).

Lecturer at the Master program in domestic and international tax law organized by the Italian Tax Authorities.

Lecturer at the Chartered Institute of Taxation UK – European Branch

Lecturer at IFA (i.e. International Fiscal Association – Italian Branch) symposiums on International and European topics.

Lecturer at the C.E.R.T.I. (Centro Ricerche Diritto Tributario dell’Impresa – Research Committee on Company Tax Law - of the “Luigi Bocconi” University of Milan) LL.M. Program in (domestic and international) Tax Law.
Lecturer on International tax issues at the I.F.A.F - Italian School of Finance.

Lecturer at the International Tax Academy of the International Bureau of Fiscal documentation (IBFD) – Amsterdam (The Netherlands)

**Main Areas of Practice**

International Tax Controversies

Transfer Pricing Planning and Disputes

Advance Pricing Agreements

Mutual Agreement Procedure (Competent Authority)

Tax Treaties

EU Tax Law

Financial Products and Financial Institutions ("Debt and Equity Capital Market")

International Aspects of Individual Tax Planning (Estates and Trusts)

Permanent Establishments

Expert Testimony in Italian and U.S. Court (Independent expert for the U.S. Department of Justice – NY Court)

Issues Relating to Offshore Financial Accounts

Domestic and International Tax aspects of trading and collecting of Art and Collectables

Domestic and International Tax aspects related to the operations of Football Club

Tax litigation.

**Main Publications**

“Ancora sviluppi su libertà di stabilimento, imposizione dei gruppi societari e riporto delle perdite” [Translation: “Again on Freedom of Establishment, Group Taxation and Losses, Comment on the UK Special Commissioners Ruling on Marks&Spencer”], in Diritto e Pratica Tributaria Internazionale, 2004, pp. 755-792;


Banca popolare di Cremona Soc. coop Arl v Agenzia Entrate Ufficio Cremona: when a tax is not a turnover tax, in British Tax Review, 1, 2007, pp. 11-16.


“Applicazione delle convenzioni per evitare le doppie imposizioni ai dividendi incassati da una partnership e ruolo del commentario Oseo nell’ambito degli strumenti interpretativi delle convenzioni alla luce di una recente sentenza della Cassazione” [translation: “the application of double tax treaties to Italian sourced dividends cashed by a foreign (US) fiscal transparent partnership under the line of reasoning of a recent Supreme Court ruling”) in Diritto e Pratica Tributaria Internazionale, Vol. VI – N. 2, (2009), pp. 93 – 1011.

Le operazioni di fusione e scissione under common control [translation: Merger and Division Between Companies that are Under Common Control]. It is a chapter of a major publication edited by Prof. Giuseppe Zizzo [La fiscalità delle società IAS/IFRS], published by IPSOA-KLUWER, 2011. The book deals with the interaction of the Italian corporate income tax law and the international accounting principles endorsed by the European Union.

“Hybrid Entities and the EU Direct Tax Directives”. It is the Italian chapter of a pan-European book edited by Prof. Dr. G.K. Fibbe, and Prof. Dr. A.J.A. Stevens (Fiscal Institute Tilburg / Center for Company Law, Tilburg University - NL) and published by Wolters Kluwer - Eurotax Series 2015 - dealing with the discipline of tax transparent entities and double tax treaties in the most important European Member States.


“Italian Tax Reform Aims for certainty and Foreign Investment”, in Tax Notes International, Volume 80, Number 7, 16 November 2015

“Italy’s Branch Exemption: A competitive Boost for Italian Business Abroad” (co-autor with Marco Busia), in Tax Notes International, Volume 81, Number 8, 22 February 2015


"Per i big esteri si profilano imposte iper-scontate", [English translation: “For the big foreign players special tax breaks are arriving”] in Il Sole 24 Ore, 5 agosto 2017.

“Lo status delle Holding ai fini del Common Reporting Standard” [English translation: “The status of the holding company for the purposes of the Common Reporting Standard”] to be published in “Strumenti Finanziari e Fiscalità”, Egea – University Bocconi