Taxsutra Global TP Battleground : European Court's Landmark Ruling in Fiat Case - Adding Shadow of Uncertainty to APAs

Oct 22,2019


Taxsutra extends sincere thanks to Mr. **Partho Dasgupta (Partner)** and **Mr. Abhay Kumar (Director)** from **BDO India LLP** for lending their valuable time and expertise in contributing to this series.

European Union (EU), union of twenty-eight countries, has developed as an internal single market through a system of laws that apply to all member states. Treaty on Functioning of European Union (TFEU) is one such umbrella laws which sets the foundation of EU. The European Commission (hereinafter referred to as "Commission" or, in short, "EC") is the executive body of the EU, responsible for proposing legislation, implementing decisions, upholding the EU treaties. EC also ensures that its member states do not provide economic advantage/benefit selectively ("State aid") in a manner which restrict free flow of goods and restrict competition within EU. Article 107(1) of the TFEU provides following conditions to be met in order for an economic benefit to be classified as state aid:

• There must be an "aid" (benefit or advantage);

• Aid must be granted by State or through State resources affecting trade between member states;

• Exercise of "selectivity" in providing aid and

• The aid distorts or threatens to distort competition.

Benefit or advantage, by its very nature, is a relative term. Therefore, in order to establish that an advantage has been conferred, it needs to be demonstrated that recipient of advantage/benefit or aid has improved its commercial position as compared to other normal economic operators in the system (under "normal tax system" or "reference system").

It would be worth understanding the connotation of "advantage" in the context of state aid in greater detail as this is the fulcrum and touchstone against which facts of the case is tested to evaluate the existence or otherwise of state aid under Article 107(1) of TFEU. In respect of condition of providing economic advantage and its nature of selectivity, jurisprudence in the cases of State aid in EU provides three steps analysis in order to establish whether a selective economic advantage has been accorded or not to an entity by the State. First step would be to identify the "reference system", ie, tax system against which tax ruling is to be tested. As a second step, tax measure (FFT APA in the case under consideration) implemented is tested against the normal tax system to find out if the tax ruling is in accordance with normal tax system or derogated from it. Finally, in the third step, the State is required to prove that derogation of implemented scheme from the reference system, if any, is justified by the nature or general scheme of the reference system.

EC have been investigating measures, including tax measures, granted by the member states to entities within the state to identify cases which falls within the mischief of Article 107(1) of TFEU.

In the mid of June 2014, EU launched an investigation in the case of an advance pricing agreement (APA) granted by Luxembourg to Fiat Finance & Trade Ltd. (hereinafter referred as "FFT" which is now known as Fiat Chrysler Europe) established in Luxembourg, for five tax years 2012 through 2016. The investigation was launched to find out whether the advance pricing agreement ("tax ruling" or "FFT APA") agreed between FFT and Luxembourg constitutes State Aid or not. After a detailed hearing, arguments and counter arguments, Commission decided in October 2015 that Fiat APA was State aid and ordered recovery of the state aid from FFT. Luxembourg and FFT filed an appeal before the European General Court against the order of the Commission which affirmed the order of the Commission.

Ensuing paras discusses facts of the case and the ruling of the Commission and the European Union General Court (EGC) in so far it relates to merits of the case and the transfer pricing issues.

FACTS OF THE CASE

FFT is a Fiat group entity established in Luxembourg which is ultimately held by Fiat S.p.A, Italy (ultimate group holding company which after merger with Chrysler, known as Fiat Chrysler Automobiles N.V.). Fiat group designs, manufactures, distributes mass-market vehicles and components. Fiat group centralised its financial and treasury functions in "treasury companies". FFT provides treasury services and financing to the Fiat group companies based in Europe (excluding Italy) and also manages several cash pool structures for the Fiat group companies. Fiat Finance S.p.A (FF) is Italian treasury company which caters to group companies in Italy. Fiat Finance North America (FFNA) and Fiat Finance Canada (FFC) are subsidiaries of FFT which provides treasury and finance functions for Fiat group companies in USA and Canada respectively. Nature of international transactions covered under APA between Luxembourg and FFT (FFT APA) are:

• Provision of loan to FF (FFT procures funds from market by issuing bonds with parental guarantee and deposits from group companies);

• Receipt of loan from FFNA (FFNA procures funds from market by issuing bonds with parental guarantee);

• Provision of short terms and long terms loans to group operating companies and

• Deposits from group operating companies

FFT APA determined a method to remunerate FFT for its treasury and finance functions and risks. Briefly stated, TNMM was selected as most appropriate method with return on capital employed as profit level indicator. Under this method, FFT's total capital was segmented into three buckets, viz, "capital at risk", "functions capital" and "holding capital" deployed in FFNA and FFC. Capital at risk was determined through BASEL II framework's analogy and functional capital was deduced by deducting capital at risk and capital deployed in FFNA and FFC (holding capital) from total accounting capital of FFT. While Capital asset pricing model (CAPM) was applied to determine the rate of return for capital at risk, return required for functional capital was determined by relying market rate for short terms deposit. Further return on capital deployed in FFNA and FFC was determined as non-remunerating. Please refer **Annexure** (attached below) for the step wise approach of determining remuneration as agreed in the Fiat APA.

CONTENTION/ARGUMENTS OF LUXEMBOURG & FFT:

In defence of the approach followed in the APA granted to FFT and in response to EC's view that FFT APA is state aid, Luxembourg/FFT argued that:

- Article 164(3) of Luxembourg Income Tax Code and Circular 164/2 should be considered as reference tax system on the ground that:

• FFT is an integrated company which provides services to its group companies only;

• In order to find out whether FFT has been conferred advantage/aid selectively, comparison should be made with tax rulings of other 21 integrated companies engaged in financing functions (and not with companies which are standalone companies), the details of which was already shared with EC

- The EC did not examine whether FFT APA complied with the arm's length principle, as laid down in above stated Article and Circular and the APA did not derogated from these set of Luxembourg rules.

- Capital at risk, deduced from Basel II framework, represents the capital assuming risk and entitled for remuneration. As against this, accounting equity often may be the result of historical decisions linked to the operations of a company and may not have a direct link with the level of equity necessary to sustain the risks of the company's activity. Therefore,

- Holding capital is a non-remunerative as revenue (dividend) from holdings in FFNA and FFC are tax exempt and do not entail any consideration for functions performed or risks assumed;

- Pre-tax return on "capital at risk" is derived at 6.05% (corresponding to 4.3% post tax) is based on CAPM model and beta derived from benchmarking 66 companies in similar situations and, therefore, is at arm's length

CONTENTION/ARGUMENTS OF EURPOEAN COMMISSION:

The EC, although agreed with TNMM, disagreed with the methodology adopted and concluded that the FFT APA meets the conditions mentioned in Article 107(1) of TFEU to be classified as State aid and therefore illegal. The Commission reached to this conclusion primarily on following grounds:

- FFT APA was responsible for depleting State resources, since the methodology adopted in FFT APA reduced

FFT's tax liability in comparison to tax liability based on remuneration at arm's length;

- FFT operates in all Member States of the EU and therefore any aid in its favour will affect intra-Union trade. Similarly, a reduction in tax liability, as a result of tax ruling in question, of FFT's financial position improved in comparison to other undertakings it competes with;

- Reference tax system should be General Luxembourg Corporate Income Tax system on the ground that objective of the General Luxembourg Corporate Tax system is to tax both integrated and non-integrated companies and therefore both types of companies, ie, integrated and stand-alone, should form part of the reference system

- The EC clarified that it is examining whether Luxembourg tax authorities conferred a selective advantage to FFT for the purpose of Article 107(1) of TFEU by agreeing to an APA that derive taxable profit of FFT different from what would have been taxed under general Corporate Income Tax if the same transaction had been entered into by independent entity under comparable circumstances ***(EC refers to this comparability as arm's length principle which formed the core of its assessment under Article 107).***

- If the advantage granted under a tax measure is related to a specific taxpayer (like FFT APA) then the same may be presumed to be "selective" also.

- Applying Basel II framework for computing capital only for tax purpose is not justified on the ground that:

• FFT is not a regulated financial institution to which Basel II framework applies;

• It is inconsistent to consider the accounting net profit of the company to remunerate regulatory capital;

- Argument that the level of accounting equity may be due to historical decisions is not tenable on the ground that:

• Suboptimal level of equity is not sustainable in a competitive market. When calculating the tax base of companies in conditions of free competition, such companies are required to remunerate the entirety of their capital;

• Financial institutions hold additional capital as a matter of business judgment and to avoid breaching the regulatory capital in situation of loss. This, however, should not mean that the entity should not be remunerated for additional capital.

- CAPM calculation, by its nature, is a return on equity calculation, rather than a return on any other capital measure, such as a hypothetical regulatory capital determined through an application of the Basel II framework;

- Return on minimum regulatory capital is not a commonly used performance indicator in the financial sector;

- In the event of FFT's insolvency, the entire equity including equity trapped in investment in subsidiaries would be used to cover FFT's debts. Therefore, holding equity in subsidiaries must be taken into consideration in the calculation of FFT's remuneration;

- To determine an appropriate return on equity, the aggregate statistics for the banking sector seem more adequate than the set of 66 financial companies. Besides several of the 66 companies are not regulated as per Basel II.

- required post tax return on equity for European banks is around 10 %, a level which has been maintained even during the financial crisis and therefore return on capital applied in the FFT APA is below the market return

<u>PLEAS BEFORE EUROPEAN GENERAL COURT</u>

Aggrieved by the order of the EC, Luxembourg and FFT filed an appeal before the EGC. The principle pleas of Luxembourg and FFT, in so far as they relate to selective advantage to FFT through the tax ruling in question, before the EGC were that EC erred in concluding that the tax ruling granted to FFT conferred advantage to FFT and the advantage was selective in nature which in turn questioned the scope of ALP applied by EC and also the findings of the EC regarding determination of remuneration for FFT in the APA. In order to adjudicate the plea(s), EC analysed, inter alia, following major points:

A. <u>Scope/content and legality of Arm's length principle (ALP) applied by EC: In respect of ALP applied by EC, EGC observed that:</u>

- ALP which EC applied in respect of APA in question was that intra-group transactions should be remunerated as if they had been agreed to by independent companies. The purpose of that principle was to ensure that intra-group transactions were treated for tax purposes by reference to the amount of profit that would have arisen if the same transactions had been executed by independent companies;

- ALP, as applied by EC, formed part of its principal analysis of "selective advantage" and therefore ALP applied by the EC was legal;

- EC was well within its power to apply the arm's length principle which was consistent with Article 107 of TFEU irrespective of the fact whether the arm's length principle is incorporated in the domestic tax laws or not.

Based on the above, the EGC rejected the arguments that the EC substituted an extraneous rule for Luxembourg rules of tax law and also rejected the questions raised by Luxembourg/FFT on the scope and legality of the arm's length principle applied by EC.

B . <u>Approach of determining the remuneration: In respect of pleas regarding approach of determining remuneration, EGC observed as under:</u>

- Neither OECD TP Guidelines nor Circular no 164/2 specifically permits segmentation of capital for the purpose of determining the arm's length result;

- The segmentation of capital, accepted in the FFT APA, does not reflect the various functions or activities of FFT

- By segmenting the capital, Luxembourg ignored the fact that the full capital is necessary for the provision of the financing functions and to absorb any losses linked to the financing activities;

- Since functional capital is derived as residual capital, this segment does not correspond to any particular function or activity of FFT;

- Regulatory capital, as per Basel II framework, is minimum capital which a financial institution has to maintain. It is not a parameter to measure the performance of the financial institutions which is performed based on accounting capital, ie, total capital deployed;

- Equity is fungible and in situation of insolvency of FFT entire capital will considered for paying the creditors and shareholder therefore bear risks in respect of entire capital

In respect of computation of rate of return on capital employed, the EGC held that it is not relevant to go into the computation of rate of return as the when the capital base itself is inadequate, the remuneration of FFT, as followed in APA agreed, is bound to be inadequate and establishes the granting of advantage.

Without going into the technical discussion on selection or appropriateness of reference system to be applied in the case under consideration EGC concurred with the EC that FFT APA also derogated from ALP mentioned in Article 164(3) of Luxembourg Income Tax Code and Circular no. 164/2.

Taking into considerations all the arguments of all the parties and in the backdrop of the above observations, EGC affirmed the order of the EC ruling FFT APA as state aid.

CONCLUSION

Although the ruling of the EGC affirms the primacy of arm's length principle in EU, it leaves a shade of uncertainty due to the fact EC had concluded that FFT was conferred advantage through the APA based on its primary arguments itself wherein, EC specifically mentioned that it had not analysed arm's length principle as laid down under Luxembourg laws. Therefore, EC may seem to be framing a hypothetical arm's length principle beyond local domestic laws which may create confusion and uncertainty for taxpayers in EU member states in regard to arm's length principle under local laws. EGC could have clarified this issue but instead of taking this issue head on it merely concurred with EC's subsidiary arguments that FFT APA derogated from Luxembourg laws, Article 164(3) and Circular 164/2, as well. APAs are entered into for bringing certainty to tax liability of taxpayer but state aid laws in Europe adds volatility to this certainty, to say the least. Companies operating in EU, including Indian outbound companies having operations in EU region, have their task cut out to strike a balance between EU level umbrella treaty, domestic tax laws of the member state including circular/notifications while entering into APA with EU member states.

It would be interesting to see if Luxembourg/FFT appeal this ruling before Court of Justice of the European Union.