Analysis

Amazon case: towards transfer pricing harmonisation?

Speed read

The European Commission has adopted a decision on the *Amazon* case, ordering the recovery of illegal state aid granted to Amazon, supposedly fulfilling all the required criteria under EU rules. In particular, it concludes that Luxembourg provided an economic advantage to Amazon by allowing the application of a transfer pricing methodology not in line with the 'arm's length principle'. Luxembourg has already put forward its defence against the decision, mainly based on purported illegitimate 'covert fiscal harmonisation', wrong selectivity frame of reference and violation of the legal certainty principle. The matter now seems certain to go to the CJEU.

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In the context of the global economic turmoil following the last financial crisis and the OECD's base erosion and profit shifting project (BEPS), the European Commission has become increasingly concerned about the role that EU member states should play to ensure fair competition in the tax field within the European Union.

Under article 107(1) of the Treaty on the Functioning of the EU (TFEU), any aid granted by a EU 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 is considered incompatible with the internal market, as long as it affects trade between EU member states.

On 24 June 2014, the Commission sent a first request for information to Luxembourg regarding its tax ruling practice in relation to Amazon, in particular enquiring into the tax benefits granted under Luxembourg's former IP taxation regime.

On 7 October 2014, the Commission published an opening decision initiating the procedure laid down in TFEU article 108(2) (the 'opening procedure decision'). In particular, this opened a formal investigation procedure in relation to the Luxembourg tax ruling obtained by Amazon, on the ground that the Commission harboured serious doubts as to the compatibility of that measure with the internal market.

In the context of this procedure, the EU competition commissioner Margrethe Vestager declared in statement 17/3714 of 4 October 2017 (bit.ly/2pAaSau) that Amazon's tax benefits in Luxembourg were illegal under EU state aid rules, in particular based on article 107(1) of the TFEU (see the Commission decision of 4 October 2017 on state aid SA.38944 (2014/C) (ex 2014/NN) implemented by Luxembourg to Amazon). The non-confidential version of that decision was published on 26 February 2018 (the 'Commission decision').

This case is part of a wider saga of multinational companies supposed to have obtained illegal tax benefits granted through tax rulings. In this context, Belgium (35 multinationals), Netherlands (Starbucks), Luxembourg (Fiat) and Ireland (Apple), have been accused or investigated for granting selective tax advantages under EU state aid rules.

The Commission also has ongoing in-depth investigations with respect to Netherlands (IKEA), Luxembourg (McDonald's and GDF Suez (now Engie)) and the UK (CFC rules) concerning potential unfair tax incentives.

Amazon's structure and main relevant facts

See the diagram opposite for Amazon's structure.

Amazon EU S.à.r.l. ('Lux OpCo') and Amazon Europe Holding Technologies SCS (the 'Partnership') are the entities primarily involved in this case.

Lux OpCo is a Luxembourg company, the headquarters of Amazon group in Europe, the main retail services operator, and the operator for services to companies via Amazon's European websites. This company is subject to corporate income tax in Luxembourg.

The Partnership holds intangibles, i.e. technological and business innovations, consumer data and trademarks relevant for the activity of Amazon group (the 'intangibles'), and receives interest and royalties from its subsidiaries.

The Partnership entered into 'licence and assignment agreements' in relation to intangibles (the 'buy-in agreement'); and into a cost sharing agreement (CSA) with Amazon parent companies in the US ('Amazon US').

The Partnership licences intellectual property rights to Lux OpCo, allowing it to run European websites by paying royalties to the Partnership under a licence agreement (the 'licence agreement').

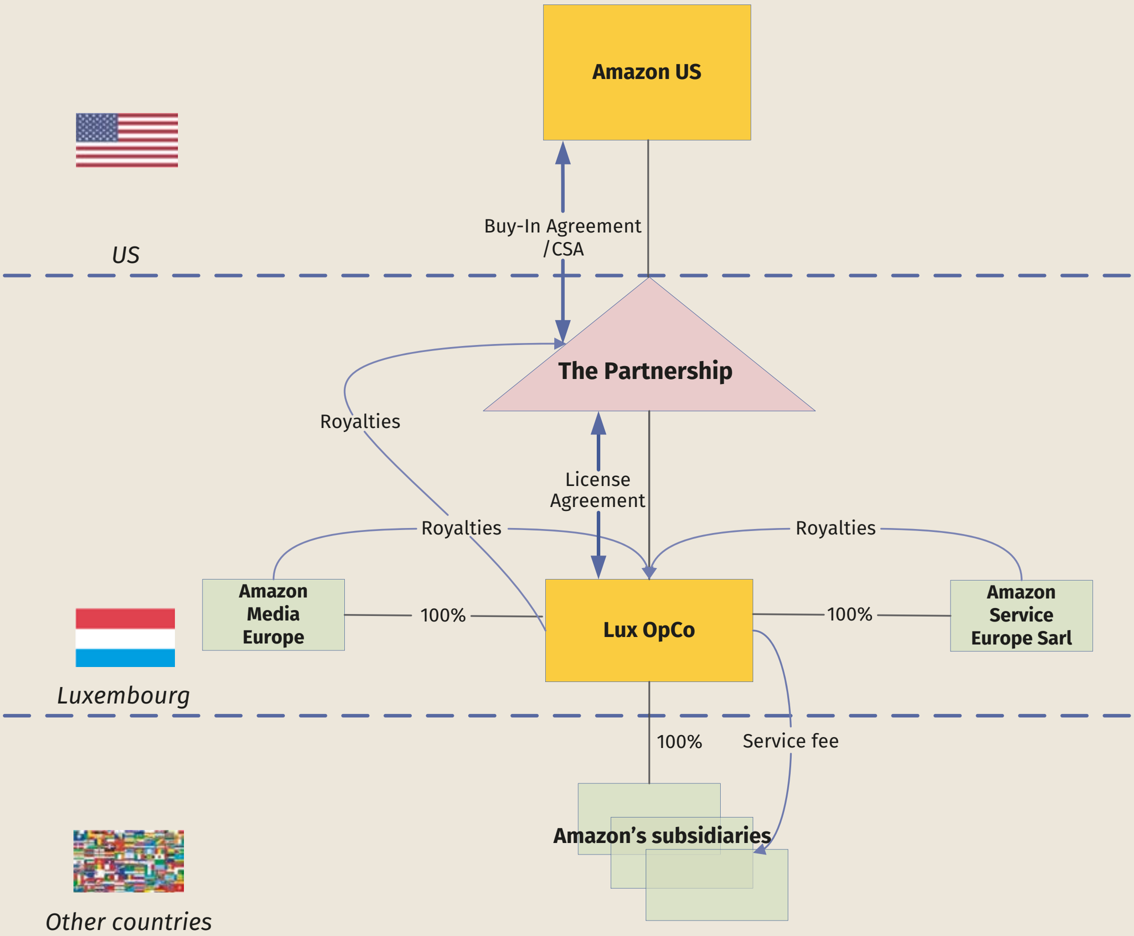
The Partnership is a tax transparent entity and, accordingly, its profits are only taxed at the level of Amazon US.

Amazon group filed a tax ruling with the Luxembourg tax administration (LTA) to confirm the right amount of taxable remuneration, based on a transfer pricing (TP) report, at the level of Lux OpCo. The tax ruling mainly requested confirmation of the application of a 4% to 6% mark up on operating expenses to remunerate Lux OpCo's so called 'routine functions' and was finally accepted by the LTA.

Existence of state aid

Based on TFEU article 107(1) and settled case law (*Commission v World Duty Free* (Case C-20/15P) para 53),

Amazon's structure



four conditions are required for a declaration of state aid:

1. an intervention by the state or through state resources;
2. such intervention must be liable to affect trade between the member states;
3. it must confer a selective advantage on the recipient; and
4. it must distort or threaten to distort competition.

With respect to the first, second and fourth conditions, the Commission considered that they were met since, respectively: there is an issue derived from a tax ruling granted by the LTA; several EU countries were involved; and the tax treatment of Amazon in Luxembourg rendered investments in other states less attractive.

Hence, the focus of the Commission's case is on demonstrating the existence of a selective advantage, as per the third condition.

Existence of an advantage

In the context of TFEU article 107(1), an advantage exists whenever 'a measure adopted by the state improves the net financial position of an undertaking'. As explained above, the advantage may be granted through the reduction of a tax liability.

Essentially, according to the Commission, Amazon's tax treatment in Luxembourg is mostly driven by the acceptance of a TP methodology which is distant from 'a reliable approximation of a market-based outcome', which then generates a lower taxable base (for Lux OpCo) and confers an economic advantage (the 'economic advantage').

Transfer pricing methodology

The Commission expressed from the outset, in its opening procedure decision, doubts with regard to the TP methodology applied to determine the remuneration of Lux OpCo. In effect, this argument is further developed in the Commission decision, where the Commission states that the TP method used by Amazon and approved by the LTA does not comply with the TP guidelines contained in OECD principles (the 'OECD Guidelines').

Regarding the functional analysis

The Commission considers that the assets used, functions performed and risks assumed ('TP criteria') by the Partnership and Lux OpCo were not accurately analysed from a TP perspective in the tax ruling and TP report.

Partnership's functions: Although the Partnership was the legal owner of the intangibles, it licensed them to Lux OpCo. In turn, Lux OpCo sub-licensed them and ensured legal compliance. Therefore, according to the Commission, the Partnership was no longer exploiting such assets, and could not perform certain functions related with their development, enhancement, management and exploitation ('TP use').

In particular, the Commission maintains that the Partnership did not in practice carry out its functions under the CSA (e.g. outsourcing, selection, hiring and supervision of contractors and subcontractors); and, in any event, lacked the capacity to supervise these functions. Indeed, the only functions undertaken by the Partnership, under Lux OpCo's control, were those related to the maintenance of the legal ownership of the intangibles.

Partnership's assets: From a TP perspective, remuneration from an asset depends on the effective control over the use of such an asset and the associated risks. The significance does not lie with the assets that someone owns in a passive way, but with the TP use of such assets. In the Amazon situation, the Partnership 'uses' the intangible assets by simply licensing them to Lux OpCo. However, according to the Commission, in the light of the licence agreement, an irrevocable licence of the economic exploitation was granted to Lux OpCo, including such assets' TP use, without any ability for the Partnership to use such assets, or to manage or control their use.

Partnership's risks: Based on the OECD Guidelines, for a party to assume a risk it is necessary not only that such party legally assumes it, but also that it is both capable of controlling it ('operational capacity') and has the financial means to undertake it ('financial capacity'). Where there are inconsistencies between the contractual arrangements and the reality, the actual conduct and capabilities of the parties should take precedence.

In respect of the 'operational capacity', for Amazon, the risks associated with the TP use of the intangibles were assumed by the Partnership, which bore the risk in relation to the European retail operations, as they largely depend on the intangibles. The Commission does not share such view and argues that, based on the licence agreement, the Partnership did not assume the risks associated with the use of the intangibles.

Regarding the 'financial capacity', Amazon argues that under the CSA it had to incur certain costs in relation to the intangibles, and hence the Partnership bore the associated financial risks. According to the Commission, this was not true since, in particular, the Partnership had no financial means to pay those costs except from the income received from Lux OpCo.

Lux OpCo's functions: For Amazon, Lux OpCo 'did not contribute to the creation, acquisition, management, deployment or strategic direction' of the intangibles. The Commission disagrees, as the functions undertaken by Lux OpCo were not limited to the TP use of the intangibles. Furthermore, Lux OpCo took important decisions in relation to the key drivers of Amazon's group retail business (i.e. selection, price and convenience) in Europe. Essentially, Lux OpCo ensured that the largest selection would be available, with the most adapted price, and made sure that consumers found the use of the website convenient.

Lux OpCo's assets: The Commission argues that Lux OpCo owned the whole inventory in Europe, as well as EU subsidiaries' shareholdings and other intangibles in relation to its video streaming line.

Based on the cost structure of Lux OpCo, an important part of its assets are used to meet the costs related with the TP use of the intangibles and Lux OpCo's functions, including:

- marketing costs related to trademarks;
- transportation costs (where only a minimal part is recovered from consumers); and
- the cost of dispatching orders.

These elements all help to develop Amazon's brand in Europe.

Amazon argues that the Partnership reimburses such costs to Lux OpCo directly or indirectly. However, the Commission could not identify any such reimbursement. Indeed, it considers that the costs related to certain intangibles were absorbed by Lux OpCo, which is the company generating revenue and able to meet them as part of the ongoing business.

Based on this costs structure, the better analysis was that the Partnership rendered services to Lux OpCo, holding the intangibles on its behalf. Hence, Lux OpCo effectively bore the costs and the corresponding risks related to TP use of the intangibles.

Lux OpCo's risks: Amazon contends that the group relied significantly 'on technology to manage or assume business risks'. The Commission considers this is not proved. On the contrary, Lux OpCo (from both legal and practical perspectives) assumed and controlled the risk associated with the TP use of the intangibles, as well as the business and entrepreneurial risks in relation to Amazon's retail line of business. This is evidenced by Lux OpCo operating as European headquarters and operator of the retail and service lines of business. Hence, Lux OpCo ultimately assumed and controlled all the risks inherent in the intangibles, as well as the business and entrepreneurial risks arising as a result of Amazon's retail and services lines of business.

Which TP method and mark-up should have been applied?

First, it is argued that the transactional net margin method (TNMM) allowed Amazon to attribute a 4% to 6% mark-up on operating expenses to determine Lux OpCo's remuneration for its allegedly 'routine functions' (not so routine and basic as the Commission argues – see 'Partnership's functions' and 'Lux OpCo's functions' above). Second, Amazon allocated 100% of the remaining profit to the Partnership, whereas under normal use of the 'residual profit split' method the split and allocation of the residual profit should have been done taking into account the TP criteria.

In the Commission's opinion, since only Lux OpCo undertook complex functions, the TNMM was the most suitable method to determine the arm's length remuneration under the licence agreement.

Under the TNMM, a taxpayer should: select a 'tested party' to the controlled transaction; and test or examine such party based on a 'profit level indicator' (PLI) in accordance with the functional analysis performed. Such a 'tested party' should be the one undertaking less complex functions so the broadest scope of comparables is found, which is more difficult if the functions are complex. Therefore, the 'tested party' should have been the Partnership instead of Lux OpCo.

What PLI and mark-up should have been applied?

The Commission considers that a mark-up should only be applied to the limited costs that the Partnership incurred to maintain legal ownership over the intangibles, assuming that they represented the functions undertaken by the Partnership.

Ideally, a mark-up based on the relevant PLI considerations and comparability analysis should be identified. Based on the EU Joint Transfer Pricing Forum Report of February 2010 (the 'EU TP rules'), the Commission considers that a 3% to 10% (with a 5% median) mark-up on the operating costs incurred by the Partnership would seem more appropriate, as long as it reflects the real functions undertaken.

Existence of an economic advantage

The Commission considers that the level of remuneration was lower than the one agreed with the LTA, which granted all the residual profits generated by Lux OpCo to the Partnership. Hence, the tax ruling granted an economic advantage.

As a subsidiary argument, the Commission argues that the tax ruling was based on 'inappropriate choices', which resulted in an economic advantage. These wrong choices included:

- considering that Lux OpCo performed only 'routine' functions, allowing the allocation of the whole residual profit to the Partnership;
- choosing operating expenses instead of costs as the PLI; and
- no economic justification to set a ceiling for TP purposes.

Based on certain of the above TNMM considerations, the attribution to the Partnership of the residual profit generated by Lux OpCo in excess of the 4% to 6% mark-up on its operating expenses was incorrect. Had the TNMM been applied correctly, it would have resulted in Lux OpCo being remunerated based on the above functional analysis (see 'Existence of an advantage' above), with a higher remuneration than the one resulting from the tax ruling. Therefore, for the Commission, this confirms the existence of an economic advantage.

Instead, a mark-up on total costs would have been in line with the arm's length principle. Therefore, to the extent that the tax ruling applied the mark-up on the operating expenses, it granted an economic advantage.

Furthermore, the fact that a remuneration ceiling of 0.55% of annual sales was included in the TP analysis was not in accordance with the arm's length principle and generated an economic advantage.

Existence of selectivity

Based on settled case law (*Commission v MOL* (Case C-15/14 P) para 60; *Commission v World Duty Free Group* (Joined Cases C-20/15 P and C-21/15 P) para 55; *Orange v Commission* (Case C-211/15 P) paras 53 and 54; and *Belgium v Commission* Case (C-270/15 P) para 49, selectivity may be presumed in a case involving individual economic advantage granted by a member state (which need only be identified). Nevertheless, the EU Commission goes on and argues that the tax ruling at the centre of the discussion is a measure targeting specific Amazon entities (i.e. the Partnership and Lux OpCo), which fundamentally grants a selective economic advantage.

Amazon and Luxembourg argue that the correct comparison to determine if there is selectivity in this context is a 'multinational corporate group', and in that context there was no selectivity. However, the Commission argues that all corporate taxpayers should individually be considered as being in a similar situation, since they are taxed based on the same rules (e.g. tax base, rate and adjustments, including TP rules etc.). Hence, such a standard corporate taxpayer should be used as the comparator.

Finally, the Commission points out that the burden of proof for justifying the economic advantage falls on Luxembourg, and the Commission argues that Luxembourg has failed to show any justification.

Recovery

The Commission has ordered the recovery of the tax amounts saved by Amazon (plus compound interest calculated as from the day the amounts were made available) and proposed a methodology to calculate such an amount, which should be recovered from any entity within Amazon's group should Lux OpCo not be in position to assume it.

Luxembourg's position

In an action brought on 14 December 2017, Luxembourg has reinstated its defence against the Commission decision. More precisely, Luxembourg requests an annulment of the Commission decision based on the following arguments.

Firstly, Luxembourg argues that it did not grant any advantage to Amazon group, since the royalties paid by Lux OpCo to the Partnership were at arm's length. Luxembourg considers that the Commission has wrongly applied the TNMM and mistakenly chosen the Partnership as 'tested party'. Indeed, the Commission's calculations are not in line with the arm's length principle, according to Luxembourg.

Secondly, Luxembourg contests the selectivity of the tax ruling, saying that the EU Commission chose the wrong 'frame of reference'.

Thirdly, Luxembourg accuses the Commission of violating TFEU articles 4 and 5, and aiming to undertake 'covert fiscal harmonisation' by imposing what it considers is the 'right' TP methodology, in breach of its limited competences with respect to direct taxes.

Fourthly, Luxembourg argues there has been a violation of its right of defence (in particular of the EU Council Regulation (EU) 2015/1589 of 13 July 2015 laying down detailed rules for the application of TFEU article 108, since Luxembourg was not able to comment on the 'tested party' aspect of the Commission's argument.

The final argument targets the recovery of the aid itself as purportedly contrary to the principle of legal certainty, on the basis that Luxembourg applied the TP rules in good faith and the approach adopted by the Commission was impossible to foresee.

What is at stake and comes next?

Taxpayers and advisers around the world will impatiently await the final decision of the CJEU in this case. The final decision will not only have an impact on Amazon and Luxembourg but should also determine how TP is applied and approached by EU tax administrations generally. Indeed, it is not only Luxembourg, Ireland and the Netherlands which applied TP rules in a way that might be considered as illegal state aid by the Commission.

The fact that the Commission aims to apply TP rules on a retroactive basis is a serious issue. It goes to the heart of taxpayers' rights and how the principle of good faith, legal certainty and security are to be understood. One might ask if the Commission considers that the EU TP rules provide a safe harbour for tax practitioners and EU tax administrations to apply in a European context.

In the context of tax competition intensified by the US tax reform, the CJEU should consider not only the limitations imposed by the separation of competences between member states and the EU, but also what makes most sense to preserve legal certainty and clear rules for taxpayers. ■

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