US OUTBOUND

KPMG in the US

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A US perspective on transfer pricing and EU state aid

Mark Martin and Thomas Bettge of KPMG in the US offer views on the role of the arm's-length principle in EU state aid enforcement.

Over the past several years, companies' transfer pricing arrangements have increasingly become the subject of intense dispute in a somewhat unexpected context: the European Commission's pursuit of state aid cases.

State aid is an area of competition law rather than tax law, and is meant to prohibit market distortions in the EU arising from one state's grant of assistance to an enterprise. Specifically, Article 107 of the Treaty on the Functioning of the European Union (TFEU) prohibits any aid granted by an EU member state that "distorts or threatens to distort competition by favouring certain undertakings" as incompatible with the EU internal market, and Article 108 of the TFEU grants the European Commission the power to enforce this rule.

Tax rulings, including unilateral advance pricing agreements (APAs) in which a state and a taxpayer agree on the taxpayer's transfer pricing on a go-forward basis, may result in improper distortions – and thus may constitute state aid – if they are improperly agreed to or applied. The EU General Court's September 2019 decisions involving Starbucks and Fiat, as well as its July 2020 decision pertaining to Apple, have confirmed the Commission's power to evaluate whether transfer pricing rulings and APAs constitute state aid by assessing their conformity with the arm's-length principle. Although the court concluded that there was no state aid in the Starbucks and Apple cases, the imprimatur it accorded to the European Commission's basic approach is significant.

Many areas of tax are mechanical, yielding answers that are clearly right or clearly wrong. Not so with transfer pricing. The arm's-length principle, which is the accepted standard for transfer pricing globally as well as within the EU, involves an inquiry as to how unrelated parties in comparable circumstances would price the transaction at issue. Not surprisingly, this is an area where significant differences can and do exist, not only between taxpayers and tax administrations, but also among the latter.

Transfer pricing matters where two or more interested countries disagree comprise a significant portion of global competent authority caseloads. Indeed, it is precisely because of the inevitability of such disagreements that effective dispute resolution for transfer pricing matters is recognised as an integral component to any OECD/Inclusive Framework solution to the tax challenges of the digital economy.

Transfer pricing matters often involve significant monetary amounts, and policing unilateral rulings to ensure that no selective advantage is being conveyed therefore makes sense. Yet it is important for the European Commission to remember that views on the application of the arm's-length principle may vary.

Application of the state aid rules in the transfer pricing space results in the unfortunate irony that taxpayers who took pains to collaboratively agree with their local tax authorities on the appropriate tax treatment of inter-company transactions are punished, undermining tax certainty in the EU and abroad.

Generally, these taxpayers are not trying to obtain (and tax authorities are not trying to grant) market-distorting advantages; rather, APAs and similar rulings represent sincere efforts to arrive at what both parties can accept as a correct result. Rather than bring state aid cases wherever its own views on arm's-length transfer pricing differ from what was applied in a ruling or APA, the European Commission should limit the scope of its activity to truly egregious cases, and should not challenge rulings where the tax authority took a reasonable view of what constituted an arm's-length result.

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