The Element of Selectivity in State Aid Cases concerning multinational Companies and their Tax Rulings

A Critical Analysis of the Selectivity Assessment in the Cases concerning Apple, Fiat Finance & Trade and the Belgian Excess Profit Exemption.

Mag. Philipp Konzett

Thesis submitted for assessment with a view to obtaining the degree of Master in Comparative, European and International Laws (LL.M.) of the European University Institute

Florence, 24 July 2018

European University Institute
Department of Law

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THESIS SUMMARY - ABSTRACT

In the recent years, many companies face legal proceedings of the European Commission against their tax arrangements (tax rulings). The fact that the Commission investigates in State aid issues is not a novelty, but the tools it uses have changed. Since 2013 the Commission has repeatedly challenged tax rulings that lack compliance with the so-called arm's length principle and has changed the way of assessing individual elements of Art. 107 para. 1 TFEU. Naturally, this has provoked wide criticism from scholars, the affected parties and foreign governments that fear for their own tax revenue.

This criticism is the starting point for this thesis. In a doctrinal study, they will be tested against the written law and the case-law of the European Court of Justice. In particular, the power-to-tax cases bear valuable insight in how the European Court of Justice perceives the arm's length principle and how it must be applied.

Eventually, I will find that the Commission's approach does not infringe this case-law but needs more thoroughness and conscientious reasoning. The Commission takes some mental leaps in its logic that – even though leading in the right direction – must be filled with sound and consistent argumentation. This concerns mainly the reasons on whether integrated group companies and independent stand-alone companies are in a similar legal and factual situation, which the Commission seems to simply assume without giving an extensive explanation why, and on why the Commission conflates the element of selectivity with the element of advantage.

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III. LIST OF ABBREVIATIONS

Abbreviation	Meaning
ADI	*Apple Distribution International*
AEUV	*Vertrag über die Arbeitsweise der Europäischen Union [TFEU]*
AG	*Aktiengesellschaft*
AOE	*Apple Operations Europe*
AOI	*Apple Operations International*
APA	*Advanced Pricing Agreement / Tax Ruling*
arg	*argumento*
Art.	*Article*
ASI	*Apple Sales International*
ATAD	*Anti-Tax-Avoidance Directive*
ATR	*Advanced Tax Ruling*
BBC	*British Broadcasting Corporation*
BETR	*Business, Entrepreneurship & Tax Law Review*
BIT	*Bulletin for International Taxation*
CAPM	*Capital Asset Pricing Model*
cf.	*confer/compare*
COM	*European Commission*
CSA	*Cost Sharing Agreement*
CUP	*Comparable Uncontrolled Price (method)*
CYBELS	*Cambridge Year Book of European Legal Studies*
DG Competition	*Directorate General Competition*
Dr.	*Doctor*
E.L. Rev.	*European Law Review*
EBITDA	*Earnings Before Interest, Taxes, Depreciation and Amortisation*
EC	*Treaty establishing the European Community*
ECOFIN	*Council of Economics and Finance Ministers*
ed.	*edition*
Edit.	*Editor*
EStAL	*European State Aid Law Quarterly*
et seq	*and what follows*
etc.	*et cetera*
EUR	*Euro (currency)*
EWHC	*High Court for England and Wales*
FA99	*Finance Act 1999*
FFT	*Fiat Finance and Trade*
Fn.	*Footnote*
Fordham Int'l L.J.	*Fordham International Law Journal*
GC	*Court of 1st Instance of the EU (General Court)*
HQ	*Headquarter*
ibid.	*ibidem [in the same place]*
Inc.	*Incorporation*
IP	*Intellectual Property*
ITC	*(Luxembourg) Income Tax Code*
JECL	*Journal for European Competition Law & Practice*
JO	*Journal Officiel [Official Journal]*
LIR	*Loi concernant l'impôt sur le revenu (Luxembourg Income Tax Code)*
lit.	*litera [letter]*

n.b. .... *nota bene*
N.V. ....*Naamloze Vennootschap [public company]*
OECD ....*Organisation for the Economic Co-operation and Development*
para. ....*paragraph*
R&D ....*Research and Development*
RdW ....*Österreichisches Recht der Wirtschaft (Journal)*
rec. ....*recital*
TCA97 ....*Taxes Consolidation Act 1997*
TEU ....*Treaty on the European Union*
TFEU ....*Treaty on the Functioning of the European Union*
TP ....*Transferpricing*
UK .... *United Kingdom of Great Britain and Northern Ireland*
US .... *United States (of America)*
v ....*versus*
WACC ....*weighted average cost of capital*
WIB 92 ....*Wetboek van de Inkomstenbelastingen 1992*

INTRODUCTION AND METHOD

In the last two decades of 'Fiscal State Aid' one can detect how the COM's focus shifted from concentrating on selective aid schemes, which are more or less easily identified in the national tax regime, to investigating into the individual treatment of multinational companies and the (alleged) support of their tax strategies.[1] Starting in June 2013, the COM requested information from six Member States on their tax ruling practice and an overview of the tax rulings issued to multinational companies, information from Belgium on its tax system, and information from ten Member States on their taxation of Intellectual Property (IP).[2] Thereupon, the COM opened further investigations against *Apple*, *Starbucks*, and *Fiat Finance and Trade (FFT)* on 14.06.2014,[3] against *Amazon* on 07.10.2014, and against Belgium and its Excess Profit Exemption Scheme on 03.02.2015.[4]

This development received wide media coverage over several years as the procedures went on.[5] On a regular basis, nearly all kind of media reported about the tax avoidance strategies of multinational companies and the COM's counter-actions through State aid procedures. That is not only due to the sheer amount of money involved – Ireland was ordered to recover around EUR 13 billion – but also because in times of austerity, tax avoidance and or tax evasion is not "a victimless crime".[6]

In the legal literature, these cases enjoyed similar attention, however, not due to the whole monetary spectacle, but rather due to a (legal) stunt by the COM: the COM had redefined the

---

[1] *Traversa, Edoardo/Flamini, Alessandra*, Fighting Harmful Tax Competition through EU State Aid Law: Will the Hardening of Soft Law Suffice?, EStAL, 3/2015, p. 323, 323 et seq.

[2] *European Commission*, 17.12.2014, Press Release IP/14/2742: State aid: Commission extends information enquiry on tax rulings practice to all Member States, available at http://europa.eu/rapid/press-release_IP-14-2742_en.htm, last checked on 24.07.2018. The Member States concerned are Cyprus, Ireland, Luxembourg, Malta, the Netherlands, and the UK (concerning the tax ruling practice) and Belgium, Cyprus, France, Hungary, Luxembourg, Malta, the Netherlands, Portugal, Spain, and the UK (concerning the taxation on IP).

[3] *European Commission*, 11.06.2014, Press Release IP/14/663: State aid: Commission investigates transfer pricing arrangements on corporate taxation of Apple (Ireland) Starbucks (Netherlands) and Fiat Finance and Trade (Luxembourg), available at http://europa.eu/rapid/press-release_IP-14-663_en.htm, last checked on 24.07.2018

[4] *European Commission*, 03.02.2015, Press Release IP/15/4080: State aid: Commission opens in-depth investigation into the Belgian excess profit ruling system, available at http://europa.eu/rapid/press-release_IP-15-4080_en.htm, last checked on 24.07.2018.

[5] See for example: *Barford, Vanessa/Holt, Gerry*, in: BBC News Magazine, 21.05.2013, Google, Amazon, Starbucks: The rise of 'tax shaming', available at http://www.bbc.com/news/magazine-20560359, last checked on 24.07.2018; *Garside, Juliette*, in: The Guardian, 11.06.2014, European commission to investigate tax affairs of Apple, Starbucks and Fiat, available at https://www.theguardian.com/world/2014/jun/11/eu-formal-tax-inquiry-apple-starbucks-fiat, last checked on 24.07.2018; and *Houlder, Vanessa/Oliver, Christian/Brunsden, Jim*, in: Financial Times, 21.08.2015, Multinationals seek cover as EU begins tax avoidance battle, available at https://www.ft.com/content/b4b66986-77fa-11e5-933d-efcdc3c11c89, last checked on 24.07.2018.

[6] *Barford/Holt*, in: BBC News Magazine, 21.05.2013, Google, Amazon, Starbucks: The rise of 'tax shaming', citing Dr. Stuart Roper.

notion of selectivity by introducing the arm's length principle as benchmark for the State aid conformity of tax rulings. Critics argued that this would constitute an unprecedented move, infringe the principle of legal certainty and would not happen on sound legal grounds.

I want to make this criticism the starting point for my thesis. I will analyse the reasoning behind the introduction of the arm's length principle, assess whether this is in line with the settled case law and cross-check whether the allegation of its unprecedented nature can be substantiated. Furthermore, I will analyse the conflation of the assessment of the element of selectivity and advantage to one assessment step.

This thesis is therefore a doctrinal analysis of the COM's case law with the help of the case law of the ECJ and informed opinions of legal scholars. In my analysis, I have taken into account the developments and discussions until the 24.07.2018.

Eventually, I will conclude, that the COM's approach is correct in principle, but lacks a sound legal reasoning. I will try to fill this gap and provide a consistent reasoning of the application of the arm's length principle and show that these cases are compliant with the principle of legal certainty. Furthermore, I will show problems in the process of assessing selectivity when the COM conflates this assessment step with the identification of an advantage.

This thesis is structured in six chapters, each divided into sub-chapters consisting of points and sub-points. First, I will give a rough overview over the normative framework, that is namely Art. 107 para. 1 TFEU[7] and the OECD arm's length principle (Part I). This Part should make the reader familiar with the fairly technical concepts of international tax law and explain relevant legal instruments and their purpose, such as the OECD transfer pricing methods or the concept of 'tax rulings'.

In Part II, I will present a thematic summary of an exemplary selection of the COM's most recent case law,[8] in which the COM applies its new approach for the first time. This will be necessary to gain a deeper understanding of both the underlying corporation structure that allowed for their aggressive tax strategy in the first place and how the COM subsumed this to the settled case law.

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7 *Treaty on the Functioning of the European Union*, consolidated version, OJ 2012/C 326/01.

8 I will also provide a more detailed summary of the cases in the Annex for who is interested in the technical side of them.

The arm’s length principle and the conflation of the element of advantage and selectivity as used by the COM in said cases will then be reviewed in Part III with the help of settled case law and comments of scholars, the legal arguments of the affected parties and the reasoning of the COM itself. I will use the bigger fraction of Part III to argue why integrated group companies and independent stand-alone companies are in a similar legal and factual situation, since I find this to be the key question for the COM’s new approach. I will conclude that the COM’s new approach concerning the arm’s length principle indeed withstands the criticism against it by providing the arguments on why integrated group companies and independent stand-alone companies are in a factually and legally comparable situation. In the second fraction, I will elaborate the conflation of the elements of selectivity and advantage and show that this is solely workable when it comes to the assessment of individual tax rulings.

Part IV will be a concluding summary of my findings. All in all, I will try to provide a sound legal argumentation and reasoning for these cases. This is necessary, because I am of the opinion that the COM has made some major leaps in its argumentations that would have needed more diligent elaboration.

Part I – General Framework

I will start my thesis by presenting the framework in which the decisions of the COM are imbedded. This will be the Legal Framework (Chapter 1) and the OECD Transfer Pricing Guidelines (Chapter 2). This Part is meant to provide a glossary-like overview of the legal basis that I will need to discuss later. With regard to conciseness, I will focus on aspects that are relevant for the following assessment of the sample cases only.

1. Legal Framework

Chapter 1 opens with a short overview of the prohibition of State aid enshrined in Art. 107 para. 1 TFEU (Sub-chapter 1.1.), including the *ratio legis* (Point. 1.1.1.) and the constituent elements with a focus on the elements of advantage and selectivity in tax matters (Point. 1.1.2.).

After that, there is a brief introduction to the concept of tax rulings, how they work and what they are good for (Sub-chapter 1.2.).

1.1. Art. 107 para. 1 TFEU

1.1.1. General Overview

Art. 107 para. 1 TFEU deems "any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods" as incompatible with the internal market, if it affects trade between the Member States.

Thus, the following cumulative elements constitute State aid: (i) granting of an advantage in any form whatsoever (ii) through State resources (iii) in a selective manner (arg. 'certain') that (iv) distorts or threatens to distort the competition and (v) affects intra-union trade between the Member States. The notion of State aid is, therefore, broader than the notion of subsidy, which by definition only comprises an active transfer of benefits. Contrary to that, State aid also includes the reduction of a financial burden through tax exemptions or any other favourable treatment if this has the same effect as a financial benefit.[9] Although the ECJ still emphasised

[9] *Heidenhain, Martin*, European State Aid Law (2010), Chapter 2 § 3 – General Principles, para. 6.

the need for a measure to have a distortive effect for it to be unlawful State aid,[10] it has never really developed a mature requirement for an anti-competitive analysis.[11]

Naturally, there is a lot of case law and literature dealing with and elaborating the individual elements. For this thesis, the element of advantage and the element of selectivity are important, which is why they shall be briefly touched.

1.1.2. Element of Advantage

In contrast to the notion of a 'subsidy', the notion of 'advantage' within the State aid framework has a broader meaning.[12] As early as in 1961, the ECJ held that the "concept of aid is nevertheless wider than that of a subsidy because it embraces not only positive benefits […] but also interventions which, in various forms, mitigate the charges which are normally included in the budget of an undertaking and which, without, therefore, being subsidies in the strict meaning of the word, are similar in character and have the same effect".[13]

A prominent example of such positions that are usually included in the budget of an undertaking are taxes. In this context, the ECJ stated that "a measure by which the public authorities grant to certain undertakings a tax exemption which, although not involving a transfer of State resources, places the persons to whom the tax exemption applies in a more favourable financial situation than other taxpayers constitutes State aid […]".[14]

Consequently, the ECJ does not only consider actual injections of capital as conferral of an advantage but includes also any relief from fiscal burdens that the undertaking would have normally included into its budget.[15]

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10 ECJ on the 02.07.1974, C-173/73, Italian Republic v Commission (Italian Textile), Reports of Cases 1974 00709, ECLI:EU:C:1974:71, para. 17, where it states "[…]in the application of Article 92 (1) [Art. 107 para. 1 TFEU], the point of departure must necessarily be the competitive position existing within the common market before the adoption of the measure in issue. […] the unilateral modification of a particular factor of the cost of production in a given sectore of the economy of a Member State may have the effect of disturbing the existing equilibrium. […]".

11 *Hancher, Leigh/Ottervanger, Tom/Slot, Pieter J.*, EU State Aids[4] (2012), para. 3-003.

12 For a fully detailed study of this, see *Rubini, Luca*, The Definition of Subsidy and State Aid - WTO and EC Law in Comparative Perspective (2009), p. 150 et seq.

13 ECJ on the 23.02.1961, C-30/59, De Gezamenlijke Steenkolenmijnen in Limburg v High Authority of the European Coal and Steel Community, Reports of Cases 1961 00003, ECLI:EU:C:1961:2, Point B) I 1. lit. a).

14 ECJ on the 15.05.1994, C-387/92, Banco de Crédito Industrial SA [now Banco Exterior de España SA] v Ayuntamiento de Valencia, Reports of Cases 1994 I-00877, ECLI:EU:C:1994:100, para. 14. Also, cf. *Commission Notice on the notion of State aid as referred to in Article 107 (1) of the Treaty on the Functioning of the European Union*, OJ 2016/C 262/01, para. 68, with reference to further ECJ case law.

15 Cf. *Mestmäcker/Schweitzer*, Art. 107 Abs. [para.] 1 AEUV [TFEU], para. 51.

1.1.3. Element of Selectivity

The second important element for the State aid assessment is the element of selectivity. It requires a differentiation in treatment in favour of certain undertakings. "Selectivity means that the measure in question results in an advantage being granted to certain undertakings or to categories of undertakings (based on their involvement in a given economic sector, their size, their legal form or other characteristics that they have in common)."[16]

In its Notice of the Notion of State aid, the COM distinguishes between material and regional selectivity. Material selectivity may be found where certain undertakings or certain groups of undertakings receive a privileged treatment in comparison to other undertakings in a similar legal or factual situation. This can either result from a *de jure* or a *de facto* differentiation.[17] The former is a measure targeted at individually specified undertakings (e.g. through an individual decision by an aid granting authority) and the latter is a measure drafted in a general manner, theoretically open to all market participants (e.g. a general law), but one that in fact applies only for certain undertakings and, thus, is in this sense selective.[18] It is worth noting, that for the assessment of the element of selectivity, the legislative appearance of a measure is irrelevant; what counts is the effect it has on the competitive market.[19] Only if a general measure fits the entire economy, it may fall outside the scope of Art. 107 para. 1 TFEU.[20]

The counter-part to material selectivity is the so-called regional selectivity. It can be found where a measure is not applicable in the entire territory of the Member State in question; it refers to a differentiation in treatment between different regions or federal states within the Member State's territory. That alone usually makes the treatment selective.[21]

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[16] *Nykiel-Mateo, Anna/Wiemann, Joachim*, Chapter 10 - Selectivity, in: *Pesaresi/van de Casteele/Flynn/Siaterli* (Edit.), EU Competition Law (2016), p. 263, 263 (para. 2.245).

[17] *Notice on the Notion of State aid*, rec. 119 et seq.

[18] Cf. the examples in *Bacon, Kelyn*, European Union Law of State Aid[3] (2017), para. 2.120 et seq. and *Notice on the Notion of State aid*, rec. 121.

[19] *Nykiel-Mateo/Wiemann*, in: *Pesaresi/van de Casteele/Flynn/Siaterli* (Edit.), EU Competition Law, p. 263, 291 (para. 2.237).

[20] *Hancher/Ottervanger/Slot,* EU State Aids (2012), para. 3-042.

[21] See *Notice on the Notion of State aid*, rec. 142 et seq.; Even if a measure in question only applies to a designated region within the Member State's territory, according to settled case law, such measure may escape the scope of Art. 107 para. 1 TFEU, if certain requirements are met. In its *Azores* decision, the ECJ has stated that a measure taken by an infra-state authority is not selective if it lies within the sole and exclusive autonomy of this infra-state authority. That means that there must not be the possibility of a central government interference (cf. rec. 144 of the Notice on the Notion of State aid). It is thus crucial, that this measure is a general measure within the legislative power of the respective infra-state authority. For the sake of conciseness, I will not be able to elaborate this further.

1.1.4. Assessment Scheme for Selectivity in Tax Matters

Starting with the *Italian Textile* Case, the European Courts held that a tax measure is selective, if it deviates from the normal application of the general tax system, unless there is a justification for the exemption on the basis of the nature or general scheme of this system.[22]

Later, the GC put this decision practice into a three-step assessment, when it stated that "in order […] to classify a tax measure as selective, [the COM] must begin by identifying and examining the common or 'normal' regime under the tax system applicable in the geographical area constituting the relevant reference framework. It is in relation to this common or 'normal' tax regime that the Commission must, secondly, assess and determine whether any advantage granted by the tax measure at issue may be selective by demonstrating that the measure derogates from that common regime inasmuch as the measure differentiates between economic operators who, in light of the objective assigned to the tax system of the Member State concerned, are in a comparable factual and legal situation […]".[23]

And it went on, stating that "[…] it is for the Member State to show that those differentiations are justified by the nature and general scheme of its tax system in that they derive directly from the basic or guiding principles of that system."[24]

This analysis scheme is usually referred to as the three-step test. However, due to the specific allocation of the burden of proof, one could also call it a two-step approach.[25] In its decisions, the COM has to elaborate what the reference system is and how the tax measure in question deviates from it. The burden of proof to show that the tax measure is justified by the nature and general scheme of the reference system lies with the Member State. As long as the Member State fails in bringing forward arguments for this, the COM has no obligation to investigate this by itself.[26]

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[22] ECJ (*Italian Textile*), para. 15.

[23] GC on the 18.12.2008, Joined Cases T-211/04 and T-215/04, Government of Gibraltar and United Kingdom of Great Britain and Northern Ireland v Commission, Reports of Cases II-3745, ECLI:EU:C:2011:732, para. 143 – 144. Also cf. *Faull, Jonathan/Nikpay, Ali* (Edit.), The EU Law of Competition[3] (2014), para. 17.108.

[24] GC (*Gibraltar*), para. 144.

[25] Cf. for example *Lang, John T.*, The Gibraltar State Aid and Taxation Judgment - A Methodical Revolution?, EStAL, 4/2012, p. 805, who refers to it as a "two step analysis". This seems logical to me, since unless the Member State brings forward grounds for a justification, the COM does not investigate on its own. It is therefore not really an assessment step, but the term 'three-step test' is well-established, so I will stick to that.

[26] Cf. the practice in European Commission on the 30.08.2016, SA.38373 (2014/C) (ex 2014/NN)(ex 2014/CP), Ireland and Apple, OJ 2017/L 187/01, para. 405 – 406.

In any event, this testing scheme has become the standard approach to examine whether a tax measure is selective or not.[27] In summary, the analysis of the selectivity in tax matters must consist of:

- the identification of the 'normal' tax regime, which shall serve as a reference system.
- the assessment whether the tax measure in question deviates from this reference system,
- and, if brought forward by the Member State, the reasons why the tax measure is not justified by the nature and general scheme of the reference system.

After having established the constituent elements of Art. 107 para. 1 TFEU, it is necessary to lay down the purpose of it.

1.1.5. Ratio Legis of Art. 107 para. 1 TFEU

The wording of Art. 107 para. 1 TFEU immediately reveals its objective. It states that any aid by the State or through State resources in any form whatsoever is forbidden if it distorts or threatens to distort competition. The prohibition of State aid, thus, serves the protection of the competition within the single market. In this vertical relationship between the State and undertakings, Art. 107 para. 1 TFEU is the 'sister provision' to classic cartel and antitrust provisions, which apply in a horizontal relationship, and is part of the bigger concert of competition law with its core objective of ensuring the competitive nature of the single market (cf. Art. 3 TEU[28]).[29] The enforcement of these rules lies with the European Union, which has an obligation to take any necessary action to ensure that competition is not distorted.[30]

In detail, the wording reveals more. It is not necessary that the aid in question actually distorts competition, but rather any negative impact in the level playing field amongst (even only potential) competitors is already sufficient to qualify as threat of distortion of competition.[31] Such negative impact could be seen in the improvement of a company's financial situation by a monetary transfer, but also in the plain guarantee for its solvency if this guarantee is granted on more favourable terms compared to the normal market conditions.[32] It follows from this,

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[27] Cf. for example *Notice on the Notion of State aid*, para. 128. For the sake of clarity, I will continue to refer to it as a three-step analysis.

[28] *Treaty on European Union*, consolidated version, OJ 2012/C 326/01.

[29] *Piernas López, Juan J.*, The concept of state aid under EU law[1] (2015), p. 36.

[30] Cf. *Protocol (No. 27) on the internal market*, OJ 115, 09.05.2008, p. 0309.

[31] ECJ on the 17.09.1980, Case 730/79, Philip Morris Holland B.V. v Commision, Reports of Cases 1980 02671, ECLI:EU:C:1980:209, para. 11; also cf. *Mestmäcker/Schweitzer*, Art. 107 Abs. [para.] 1 AEUV [TFEU], para. 307 – 310.

[32] ECJ on the 03.04.2014, C-559/12 P, French Republic v Commission (2014), published in the electronic Reports of Cases, ECLI:EU:C:2014:217, para. 96. Also, cf. for example *Luja, Raymond*, State Aid and the Financial Crisis: Overview of the Crisis Framework, EStAL, 1/2009, p. 145, 150, who describes how a plain guarantee

that Art. 107 para. 1 TFEU establishes a level playing field, which means that all competitors are bound to the same legal framework and the same conditions.[33]

This extremely wide understanding of 'distortion of competition' derives from a peculiarity of State aid law, which makes it necessary to distinguish between an antitrust-oriented understanding of distortion and a State aid law interpretation thereof. The prohibition of State aid does not only ensure competition between undertakings but prevents also a 'subsidy war' between Member States. The abolition of trade obstacles, like custom duties or discriminatory taxes, within the internal market necessarily requires a consistent control of the participating Member State's subsidy policy, because otherwise one could simply circumvent internal market provisions by according State subsidies.[34] Naturally, this interpretation has been highly controversial. With the publication of the COM's State aid action plan (SAAP),[35] some contributors hailed the rise of a rather antitrust-oriented, efficiency-driven State aid doctrine,[36] while others defended the ECJ's case law as the orthodox truth.[37]

I find the latter convincing. While it is undisputed that State aid law is about protecting the competition between the undertakings, it is equally a tool of the internal market. It becomes clear when one re-considers why there is State aid law in the first place, given that most other jurisdiction do not have comparable provisions (e.g. the USA). The reason lies in the distinction between State aid policy and State aid control.

State aid policy is the political evaluation of which undertaking is eligible for State aid and the decision to grant it to them, or in the European context: to notify it to the COM. State aid control, on the other hand, is the supervision of this procedure. Usually both aspects fall together in a central government. In the EU, however, the competences are divided between the Member States, who shall have prerogative over the State aid policy, and the EU, who shall overlook the

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about the solvency of a financial institution can constitute a competitive advantage compared to other even fundamentally sound competitors.

[33] *Mestmäcker/Schweitzer*, Art. 107 Abs. [para.] 1 AEUV [TFEU], para. 2.

[34] *Buendina Sierra, José L./Smulders, Ben*, The Limited Role of the 'Refined Economic Approach' in Achieving the Objectives of State Aid Control: Time for Some Realism, in: *Sutton* (Edit.), EC State Aid Law - Le droit des aides d'Etat dans la CE (2008), p. 1, 8 et seq.

[35] *European Commission*, 07.06.2005, State Aid Action Plan - Less and better targeted state aid: a roadmap for state aid reform 2005 - 2009 (COM (2005) 107 final), available at http://ec.europa.eu/competition/state_aid/reform/saap_en.pdf, last checked on 24.07.2018

[36] For example *Hildebrand, Doris/Schweinsberg, Andrea*, Refined Economic Approach in European State Aid Control - Will it Gain Momentum?, World Competition, 3/2007, p. 449; *Hancher, Leigh*, Towards an Economic Analysis of State Aids, EStAL, 3/2005, p. 425.

[37] For example *Biondi, Andrea*, The Rationale of State Aid Control: A Return to Orthodoxy, CYBELS2010, p. 35; *Buendina Sierra/Smulders*, in: *Sutton* (Edit.), EC State Aid Law - Le droit des aides d'Etat dans la CE, p. 1.

State aid control.[38] A centralised State aid control through the COM ensures that the Member States' State aid policy does not lead to asymmetries on the internal market. Such asymmetries "would create not just distortions in competition between undertakings, but also – and perhaps more importantly – distortions in competition between Member States, having the effect of attracting investments and economic activities to their territories."[39] State aid law is therefore also a tool of the internal market.

Given this understanding of State aid law, it becomes clear why the ECJ does not put much emphasis on the (threat of) distortion of competition, since more or less any aid granted might lead to this kind of 'subsidy wars'. This will be important for the question whether independent stand-alone companies and integrated group companies shall abide by the same rules from a formal or from a material point of view, which will be discussed below.[40]

1.2. Tax Rulings

Tax rulings play an important role in the State aid cases dealt with in this thesis. In this sub-chapter I will explain the concept of tax rulings and the function they have when it comes to the taxation of multinational companies, because it will later be important for the understanding of the cases.

Paying taxes on profits from international activities is as much of a challenge for the undertakings as is collecting these taxes for the tax authorities. The problem lies in the allocation of 'international' profit to the corresponding branches and affiliates, which is where tax rulings come into play. They complement the general tax law by setting a profit allocation method for the tax payer according to which the taxable base will be calculated. The general tax rate will then be applied to this taxable base. In other words: tax rulings are targeted at an individual undertaking in order to establish the premises under which its tax liability is going to be assessed.

The OECD defines tax rulings as an "[…] arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate

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[38] This sharing of responsibilities has become more evident with the introduction of the General Block Exemption Regulation (GBER) and its antecedent exemptions, increasing the Member States' responsibility while confining the role of the COM to a supervisory body acting ex post. Cf. *Pesaresi, Nicola/Beranger, Thierry*, Chapter 2 - State aid modernisation, in: *Pesaresi/van de Casteele/Flynn/Siaterli* (Edit.), EU Competition Law (2016), p. 5, 16 (para. 1.34).

[39] *Buendina Sierra/Smulders*, in: *Sutton* (Edit.), EC State Aid Law - Le droit des aides d'Etat dans la CE, p. 1, 8.

[40] See Point 5.2.3, p. 47 et seq.

adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time."[41]

In case they are issued where factors such as transfer pricing methods have to be set beforehand, they are also referred to as 'Advanced Pricing Agreements' or 'Advanced Pricing Arrangements' (APA). Where they are issued in order to set a certain interpretation of the tax law applied to the addressee, they are sometimes referred to as 'Advanced Tax Ruling' (ATR).[42] It seems that the (general) notion of 'tax ruling' has a wider meaning, however. Depending on national tax law, this could also include any kind of ruling issued by a tax authority, for example a declaratory ruling or a private tax ruling.[43] On the other hand, an APA is a tax ruling aimed at endorsing transfer pricing methods for a multinational company. Since I will not deal with any other kind of tax ruling, the term 'tax ruling' shall be used in this thesis.

With such advanced rulings, the tax authorities have an instrument that allows for greater legal certainty by interpreting tax laws and providing clarification of tax arrangements in advance.[44] This helps simplifying the calculation of the tax liabilities under often very complicated and complex cross-border conditions. As such, they provide a degree of comfort to the multinational tax payer ('comfort letters').[45] Additionally, even though the procedure to receive a tax ruling may be rather time consuming and costly for the company, it is safe to assume that the company is still better off compared to the costs arising from a potential tax audit. This does not only hold true for the tax payer but also for the tax authorities. Tax rulings free up a tax authority's audit resources and allow for a redeployment of such resources to where they are needed most.[46]

Tax rulings can be either unilateral, meaning that they are issued by a national tax authority independently, or multilateral, meaning that they are issued in collaboration with a tax authority of another State.[47] Unilateral tax rulings bear the risk of causing double taxation or double non-

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[41] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017[1] (2017), p. 214 (Chapter IV.F., para. 4.134).

[42] *Luja, Raymond*, General Report, in: *da Cruz-Vilaça/Moniz/Vasconcelos/Saavedra* (Edit.), Taxation, State Aid and Distortions of Competition - Fiscalité, Aides d'État et Distortions de la Concurrence - Steuern, staatliche Beihilfen und Wettbewerbsverzerrungen (2018), p. 53, 58.

[43] Cf. OECD TP Guidelines (2017), p. 216 (Chapter IV.F., para. 4.143).

[44] *Micheau, Claire*, Tax selectivity in European law of State Aid: legal assessment and alternative approach, E.L. Rev., 3/2015, p. 323, 331; see also OECD TP Guidelines (2017), p. 219 (Chapter IV.F., para. 4.153)

[45] *Viehe, Karl W.*, Advance Pricing Agreements: Stability for Transfer Pricing, ITJ, 1/1991, p. 46, 49. See also *Traversa/Flamini*, EStAL, 3/2015, p. 323, 329, *Krmek, Tomislav*, EU Tax Probe, State Aid & the Case of Amazon, BETR, 1/2017, p. 40, 42., who speaks of 'comfort letters'.

[46] *Kerschner, Ina/Stiastny, Marion*, The Experience with Advance Pricing Agreements, Intertax, 11/2013, p. 588, 589. Cf. OECD TP Guidelines (2017), p. 220 (Chapter IV.F., para. 4.155).

[47] OECD TP Guidelines (2017), p. 415 (Chapter IV.F., para. 4.140).

taxation due to a lack of coordination between the respective tax authorities. We will see later that both *Apple* and *FFT* were recipients and beneficiaries of unilateral tax rulings.[48]

2. THE OECD TRANSFER PRICING GUIDELINES

After having presented the relevant hard law, I will continue with what is the sticking point in this thesis: the concept of 'dealing with someone at arm's length' and the respective OECD soft law framework. This is closely connected with the problem of Double Taxation Treaties (DTT).

As their name suggests, DTTs serve to avoid double taxation of multinational tax payers between the treaty parties. On a global level, States maintain more than 2,500 bilateral DTTs in force, most of which are bilateral and founded on the work of the OECD and its predecessor organisations. Most of the OECD Member States use the so-called OECD Model Tax Convention[49] as a starting point for DTT negotiations, which was first published in 1963 and updated regularly.[50] Even though enjoying wide international acceptance, the OECD Model Tax Convention is a non-binding international soft-law instrument. It is, therefore, not *per se* part of the legal framework, because how much of it will find its way into the final version of the DTT is subject to the discretion of the States.[51]

However, as the internationally accepted standard for transfer pricing methodology, the Model Tax convention and the explanatory material is often consulted when further guidance on the arm's length principle and its application is needed. In fact, starting with the *Forum 187* Case,[52] the COM has regularly referred to it as the 'international consensus on transfer pricing'.[53] For the understanding of the cases in Part II, it is therefore necessary to take a closer look at it.

First, I will go along with the structure of the OECD Transfer Pricing Guidelines (OECD TP Guidelines) and open with the arm's length principle (sub-chapter 2.1.), followed by an

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[48] See for a detailed description of those tax rulings Annex, I. 1. c), p. 91 (for *Apple*) and Annex, II. 1., p. 95 (for *FFT*).

[49] *OECD Model Tax Convention*, condensed version as it reads on 21.11.2017, available at http://dx.doi.org/10.1787/mtc_cond-2017-en, last checked on 24.07.2018.

[50] *Uckmar, Victor*, Chapter 6: Double Taxation Conventions, in: *Amatucci* (Edit.), International Tax Law (2012), p. 161, 161 – 162.

[51] *Uckmar*, in: *Amatucci* (Edit.), International Tax Law, p. 161, 163.

[52] ECJ on the 22.06.2006, Joined Cases C-182/03 and C-217/03, Kingdom of Belgium and Forum 187 ASBL v Commission, Reports of Cases 2006 I-05479, ECLI:EU:C:2006:416, para. 94.

[53] Cf. for example *Notice on the Notion of State aid*, para. 173.

overview of the Transfer Pricing Methods considered to lead to an adequate outcome (sub-chapter 2.2.). Next, I will touch the ECJ's case law about the application of the arm's length principle when it comes to the Member States' power-to-tax (sub-chapter 2.3.). I will close this Chapter with the question whether the OECD TP Guidelines are a source of law or not (Sub-chapter 2.4.).

2.1. The Arm's Length Principle

In a capitalistic, competitive market, an undertaking tries to maximise its profit, which is the driving force behind undertakings offering and demanding a product at a certain price. The price setting mechanism is, therefore, an outside force, which usually cannot be influenced by the undertakings. Within a corporate group, however, goods and capital can be transferred at prices that are set by the common parent company; the price setting mechanism comes from within the corporate group.[54] The intra-group transaction is therefore a 'controlled transaction'.

This phenomenon can be used to maximise the company group's overall benefit by shifting profits from one affiliate situated in a country with high corporation tax to another related company situated in a low-tax-country by setting the transfer prices accordingly. On an international level, this problem is the reason for the implementation of the 'OECD arm's length principle'[55] into the OECD Model Tax Convention.

The idea behind the arm's length principle is that such intra-group transactions should be treated as if they had accrued between two independent companies. Since the intra-group transfer price has not been subject to an outer market force, the arm's length principle requires the adjustment of this intra-group price so that it resembles what would have been the price between two independent companies doing business (market-based outcome). This should help avoiding artificial transfer prices that do not reflect a market-based outcome. The tax authorities should do so "by establishing the conditions of the commercial and financial relations that they would expect to find between independent enterprises in comparable transactions under comparable circumstances".[56]

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[54] OECD TP Guidelines (2017), p. 33 (Chapter I.A., para. 1.2).

[55] As I will argue later in this thesis (Point 5.1.2., p. 39 et seq.), there can only be one arm's length principle. I will henceforth use the OECD materials as source, since this is the most relevant codification of the arm's length principle.

[56] OECD TP Guidelines (2017), p. 34 (Chapter I.A., para. 1.3).

This wording indicates that the benchmark for the market-based outcome must be a comparison with other companies which are in a comparable factual and legal situation, which is reflected in Art. 9 para. 1 OECD Model Tax Convention stating:

"[Where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."

In order to make this principle more tangible, it is helpful to demonstrate it with the help of an example:[57]

> *Parent Company Ltd.* is the parent company of a company group with an affiliate called *Irish Branch Ltd.* in Ireland and another affiliate called *Austrian Branch GmbH* in Austria. *Austrian Branch GmbH* is an operative facility producing highly profitable bikes. It has a turnover of EUR 20 million and production costs of EUR 6 million.
>
> *Irish Branch Ltd.* provides after sales services for and manages the accounting of *Austrian Branch GmbH* for which it receives a remuneration of EUR 12 million per year. This price was set by the *Parent Company Ltd.* even though any third party providing the same services would have charged no more than EUR 4 million per year.
>
> *Austrian Branch GmbH* declares taxes as follows:

Gross income from selling bikes	EUR in mio.	20,00
Production costs	EUR in mio.	- 6,00
Payments to Irish Branch Ltd. for services	EUR in mio.	- 12,00
Taxable income (taxable base)	**EUR in mio.**	**2,00**
25% due income tax	**EUR in mio.**	**0,50**

> The payment to *Irish Branch Ltd.* is an intragroup transfer at a transfer price of EUR 12 million. However, any third party would only have charged EUR 4 million. Due to the overcharged services, the taxable income of *Austrian Branch GmbH* in Austria is reduced to EUR 2 million, which are subject to 25% corporation tax. Simultaneously, the EUR 12 million were transferred to Ireland where they are subject to only 12.5% corporation tax.

57 This example is purely fictional.

The arm's length principle stipulates that the price of intragroup transfers should be corrected as if two independent companies had negotiated the price, that is 'at arm's length'. Since Austria integrated the arm's length principle into its tax law, the Austrian tax authority would be entitled to correct the tax balance accordingly. The taxable income will be calculated as follows:

Gross income from selling bikes	EUR in mio.	20,00
Production costs	EUR in mio.	- 6,00
Payments to Irish Branch Ltd. for services	~~EUR in mio.~~	~~- 12,00~~
adjusted to arm's length price	EUR in mio.	-4,00
Taxable income (taxable base)	**EUR in mio.**	**10,00**
25% due income tax	**EUR in mio.**	**2,50**

The arm's length principle is therefore a tool to avoid artificial intragroup transfer prices, whose purpose is the avoidance of tax. The most difficult part in this exercise, however, is determining what a third party would have charged for the transaction. This is done by choosing and applying a transfer pricing method, which I will deal with in the next sub-chapter.

2.2. Transfer Pricing Methods

For the calculation of an adequate transfer price, tax authorities apply one of the so-called 'transfer pricing methods', whose result is considered to be an adequate transfer price. Tax authorities set a transfer pricing method that they consider appropriate in an individual tax ruling. This procedure does not only allow the tax authority to tailor the transfer pricing method to the specific properties of the ruling's recipient, but the ruling recipient has the possibility to challenge its ruling by appeal.

The OECD suggests five transfer pricing methods that are found adequate to produce a market-based price, providing enough flexibility for a case-by-case choice of the most appropriate transfer pricing method. They can be divided into 'traditional' and 'transactional' transfer pricing methods:[58]

- traditional transfer pricing methods
    - the *Compared Uncontrolled Price method (CUP-method)*, which compares the intra-group transaction to a comparable uncontrolled transaction.

[58] OECD TP Guidelines (2017), p. 97 (Chapter II. Part I A., para. 1.1). For a detailed description of the transfer pricing methods, see OECD TP Guidelines (2017), p. 101 et seq. (Chapter II, Part II and Part III).

- the *Resale Price method*. As a starting point, this method takes the price for which the purchaser resells the product to an independent company. From this price an adequate gross-margin is subtracted.
- the *Cost-Plus method*, which is the sibling method to the Resale Price method. Instead of subtracting a margin from the resale price, the transfer price is reached by adding an adequate margin to the (production) costs of the seller.

- transactional transfer pricing methods
    - the *Transactional Net Margin Method (TNMM)*, which compares the net profit of a controlled transaction to an appropriate benchmark (e.g. costs). This method works similar to the Resale Price method and the Cost-Plus method.
    - the *Transactional Profit Split method*, which examines how independent parties would have split the profits.

Tax payers seeking an APA are allowed to propose a transfer pricing method that they think will fit the peculiarities of their corporation structure the best. In the end, however, it is up to the tax authorities' discretion to choose the method leading to the most adequate outcome, even though the OECD TP Guidelines acknowledge that this process may include negotiations between the tax payer and the tax authority.[59] Of course, the 'most adequate' price is not necessarily the one leading to the highest tax liability, but rather the one that reflects the economic reality the best. Despite the possibility to negotiate the choice of transfer pricing methods to a certain extent, it was pointed out that there is an at least informal hierarchy that should be followed and that the addressee's of the tax rulings cannot pick out the most convenient one for them.[60] The COM interprets this as a more or less clear 'picking order'[61] from preferable direct transfer pricing methods, like the CUP-method, down to less preferable indirect methods.[62]

[59] OECD TP Guidelines (2017), p. 214 (Chapter IV, F. para. 4.134). The fact that a tax ruling is subject to negotiations does not suffice to make it 'selective' for State aid purposes; cf. ECJ on the 04.06.2015, C-15/14 P, European Commission v MOL Magyar Olaj- és Gázipari Nyrt, published in the electronic Reports of Cases, ECLI:EU:C:2015:362, para. 34 in connection with para. 69.

[60] *Lyal, Richard*, Transfer Pricing Rules and State Aid, FILJ, 38/2015, p. 1017, 1022 et seq.

[61] *Luja, Raymond*, Do State Aid Rules Still Allow European Union Member States to Claim Fiscal Sovereignty?, EC Tax Rev., 5-6/2016, p. 312, 323.

[62] *Notice on the Notion of State aid*, para. 174, lit c).

It is important to note – and I will argue this later in detail[63] – that the arm's length principle is the goal, while the transfer pricing methods are the tools, with the help of which one can reach this goal.

After having established how the arm's length principle is applied in a tax ruling, it is necessary to take a look at its relevance for European Union law.

2.3. The Arm's Length Principle and the Power to Tax

Since direct taxation is a national prerogative, the arm's length principle has not been subject to an ECJ decision very often. The cases dealing with it were about the so-called 'power-to-tax', which can basically be described as the question which Member State has the right to tax which (part of the) profit of a multinational company. Such disputes affect the principle of Free Movement of Capital enshrined in the Treaties, which is why the ECJ was called on to decide whether the arm's length principle is an adequate means to allocate the profits of a multinational between the Member States.

These decisions give a good insight in how the ECJ evaluates and sees the arm's length principle, which will also be gainful for the State aid cases in question. How and why the underlying issues of power-to-tax decisions are relevant for State aid proceedings will be argued in Point 2.3.1. and followed by two important ECJ decisions (Points 2.3.2. and 2.3.3.). From these decisions arose a controversy about the term of 'commercial justification', which I will discuss in Point 2.3.4. I will conclude on this in Point 2.3.5.

2.3.1. General Overview: Why is it relevant?

To begin with, one immediately observes that 'the power to tax' and State aid are not exactly the same thing. The latter deals with the relationship between a Member State granting an advantage to a company, which is a vertical relationship and might potentially be unlawful State aid, while the former deals with States determining which of them is competent to tax what part of the profit by applying rules from a tax treaty between them, which is a horizontal relationship.

In my opinion, it is possible to draw *general conclusions*[64] from the ECJ's findings in the cases concerning the power-to-tax for this thesis, because companies declare taxes only once a year

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[63] See Point 5.1.2., p. 39.

[64] It is worth noting, that this does not anticipate whether the arm's length principle *must* be applied in Member States that have not incorporated it in their national law (e.g. Ireland). However, it gives an idea on what the ECJ thinks about the arm's length principle and its adequacy when it comes to determining taxable bases.

with only one tax balance. In other words, if the ECJ argues that transfer pricing methods in line with the arm's length principle are adequate for the allocation of a multinational's taxable profit between Member States and that, with the help of this, Member States can determine their taxing power, then it follows that this must also apply for the allocation of profit between Member States with the help of transfer pricing methods in line with the arm's length principle for State aid purposes. While these scenarios are different from a legal perspective, they both share the very same factual basis, or the other way around: a method to allocate profit according to economic reality cannot be adequate in one field and inadequate in the other, since both require a profit allocation according to the economic reality.[65] This shall be explained with the help of a follow up to the example from above:[66]

> *Austrian Branch GmbH* could appeal the adjustment of its balance and argue that Austria withholds capital, which would constitute an infringement to the Principle of Free Movement of Capital. On the other hand, Austria could answer with the argument that if it had not adjusted the tax balance it would confer unlawful State aid because this would lead to a reduction of *Austrian Branch GmbH*'s tax liability.
>
> Both allegations refer to the very same facts, that is the adjustment of the tax balance. If the ECJ rules that adjusting a tax balance according to the arm's length principle is an adequate method to allocate the profit between Member States, this will hold true for using the arm's length principle in order to define the corporate tax liability, since it refers to the common factual basis and follows the exact same objective. In other words: how can the allocation of profit in one case be considered to lead to an adequate reflection of the economic truth but in the other case not?

Taking a closer look at the cases concerning the power to tax will therefore help for this thesis, because these cases are an explicit confirmation of the arm's length principle as an adequate instrument for profit allocation.[67]

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[65] Cf. *Schön, Wolfgang*, Transfer Pricing, the Arm's Length Standard and European Union Law, in: *Richelle/Schön/Traversa* (Edit.), Allocating taxing powers within the European Union (2013), p. 73, 80. *Schön* argues that the act of profit allocation is relevant for both the power to tax as well as for State aid purposes simultaneously, which is why he calls it the "double sided nature of transfer pricing rules".

[66] See p. 13.

[67] *Becker, Katharina/Sydow, Sabine*, Das EuGH-Urteil in der belgischen Rechtssache C-311/08 SGI und seine Implikationen für die Frage der Europarechtmäßigkeit des § 1 AStG, IStR, 6/2010, p. 195, 198.

2.3.2. Thin Cap v Commissioner of Inland Revenue (Case C-524/04)

The *Thin Cap* decision was about a provision in British tax law according to which any interest on a loan from a foreign affiliated company was treated as distribution of profits. In other words: If a company received a loan from its foreign affiliate, even reasonable interest payments were – as distribution of profit – subject to corporation tax unless a DTT overruled this provision. In the latter case, the interest payment was split; the interest up to a threshold that resembled what would have been agreed upon at arm's length between independent parties was deductible, while any interest exceeding that threshold was subject to corporation tax.[68]

This provision was contested by a group litigation eventually leading to a request for a preliminary ruling as to whether the contested provisions are compatible with the EU Treaties, especially with the Free Movement of Capital.[69]

The ECJ held that while these provisions breached EU Primary law, they may be justified by the need to fight abusive practices.[70] The ECJ states that "legislation of a Member State may be justified by the need to combat abusive practices where it provides that interest paid by a resident subsidiary to a non-resident parent company is to be treated as a distribution only if […] it exceeds what those companies would have agreed upon on an arm's-length basis, that is to say, the commercial terms which those parties would have accepted if they had not formed part of the same group of companies."[71]

Provisions like the British one are justified, if two conditions are met. First, it must provide the opportunity for the tax payer concerned to prove that the transaction is commercially justified and, second, it may only treat the interest payments as distribution of profit to such extent as it exceeds what would have been agreed upon at arm's length.[72]

The *Thin Cap* case dealt with the question how interest payments to related companies should be treated for tax purposes. The British tax provision, however, did not include the possibility of an actual adjustment of the tax balance. Nevertheless, it paved the way for the *SGI* case, which some contributors to the literature deem "the first fully-fledged transfer pricing case ever".[73]

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68 ECJ on the 13.03.2007, C-524/04, Test Claimants in the Thin Cap Group Litigation v Commissioner of Inland Revenue, Reports of Cases 2007 I-02107, ECLI:EU:C:2007:161, para. 4 – 8.
69 ECJ (*Thin Cap*), para. 16.
70 ECJ (*Thin Cap*), para. 72.
71 ECJ (*Thin Cap*), para. 80.
72 ECJ (*Thin Cap*), para. 92.
73 *Schön*, in: *Richelle/Schön/Traversa* (Edit.), Allocating taxing powers within the European Union, p. 73, 76.

2.3.3. *SGI v Belgium (Case C-311/08)*

The *Société de Gestion Industrielle SA* (*SGI*) was a company incorporated in Belgium holding a majority of a French affiliate, to which it granted an interest-free loan. The Belgian tax authorities deemed this to constitute an unusual and gratuitous advantage granted to a foreign subsidiary and adjusted it for tax purposes in such way as if an interest of 5% had been agreed upon.[74] This adjustment was made according to a provision in the Belgian tax law, which is based on Art. 4 OECD Arbitration Convention suggesting comparable adjustments in case transfer prices between related companies deviate from the arm's length principle.[75]

This adjustment was subject to an appeal before the 'tribunal de première instance de Mons', which presented the case to the ECJ and asked for a preliminary ruling on whether such adjustments are compatible with the Freedom of Establishment and the Free Movement of Capital.[76]

Like in the *Thin Cap* Case, the ECJ stated that while this provision breached the respective Freedoms it would be justified. This is, because allowing companies to choose where their profits or losses are taken into account "carries the risk that, by means of artificial arrangements, income transfers may be organised within companies having a relationship of interdependence towards those established in Member States applying the lowest rates of taxation or in Member States in which such income is not taxed".[77] The ECJ goes on and states in para. 69 that power-to-tax legislation which stipulates adjustments according to the arm's length principle is compatible with the EU treaties.

However, similar to the *Thin Cap* case, the compliance with the EU treaties is bound to two conditions. First, the companies concerned shall be given the opportunity to prove that the transaction is commercially justified and, second, the adjustment shall not go beyond what would have been agreed upon between two independent companies.[78]

2.3.4. *The Controversy about 'Commercial Justification'*

The wording of the ECJ's request for a 'commercial justification' led to a controversy on what this actually should mean. Following one reading, some scholars argued that a deviation from the arm's length principle is always possible as long as the reasons are of a commercial nature,

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[74] ECJ on the 21.01.2010, C-311/08, Société de Gestion Industrielle (SGI) v Belgian State, Reports of Cases 2010 I-00487, ECLI:EU:C:2010:26, para. 9 and 12.

[75] ECJ (*SGI*), para. 59.

[76] ECJ (*SGI*), para. 14 – 17.

[77] ECJ (*SGI*), para. 67.

[78] ECJ (*SGI*), para. 71 and 72.

meaning that on the contrary only tax-related motives, such as avoiding tax, would be harmful to any justification.

One of the arguments for this conclusion is the fact that the ECJ knowingly did not cite AG *Kokott*'s opinion on this. In her opinion she had required that in order to prove the contrary to the tax authority's perception, tax payers needed to prove how the transfer price is economically justified by showing that independent companies acting at arm's length would have dealt with each other under the same conditions.[79] The ECJ did not only ignore this statement, but rather referred back to the *Thin Cap* case instead, where it had held that for any legislation endorsing the possibility to adjust transfer prices not to go beyond what is necessary to prevent abusive tax avoidance, it is crucial to give the tax payer the opportunity "to provide evidence of *any commercial justification that there may have been* for that arrangement".[80] The fact that the ECJ ignored AG *Kokott*'s phrasing of the justification was interpreted as allowing for more and broader grounds to justify a deviation of the arm's length principle.[81]

Others draw this conclusion from the decision of the High Court of England and Wales (EWHC), which followed the ECJ's preliminary decision.[82] In this decision, the EWHC understood the possibility of a 'commercial justification' as implementation of a business purpose test that would follow the arm's length assessment. As such, the need for business terms at arm's length could be overruled by business-related considerations, as long as they would serve the 'commercial logic of the group'.[83]

Both conclusions lead to the same argument, which is that the *SGI* case would allow for a deviation from the arm's length principle to be justified by any commercial reason except for gaining a tax advantage.[84] In other words, the ECJ would have narrowed the arm's length principle in such way that any transfer price which is commercially rational for the multinational must be a valid excuse for a deviation from the arm's length principle.[85]

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[79] Cf. the wording in AG Kokott on the 10.09.2009, Opinion of Advocate General Kokott on Case C-311/08 (SGI), para. 78, who actually did not refer to the arm's length principle, but to the legal provision in Belgian tax law. See the argumentation below.

[80] ECJ (*Thin Cap*), para. 82 (emphasis added).

[81] Cf. e.g. *Scheipers, Thomas/Linn, Alexander*, Einkünfteberichtigung nach § 1 Abs. 1 AStG bei Nutzungsüberlassungen im Konzern - Auswirkungen des EuGH-Urteils SGI, IStR, 13/2010, p. 469, 473; also referring to other scholars supporting this claim.

[82] EWHC on the 17.11.2009, HC03C04130 and Others, Test Claimants in the Thin Cap Group Litigation v Commissioner for Her Majesty's Revenue and Customs, [2009] EWHC 2908 (Ch).

[83] *Jiménez, Adolfo M.*, Transfer Pricing and EU Law Following the ECJ Judgement in SGI: Some Thoughts on Controversial Issues, BIT, May 1/2010, p. 271, 277.

[84] *Scheipers/Linn*, IStR, 13/2010, p. 469, 473.

[85] *Schön*, in: *Richelle/Schön/Traversa* (Edit.), Allocating taxing powers within the European Union, p. 73, 96.

In my opinion, this view is erroneous. There is indeed no possibility to circumvent the arm's length principle in this context. In the respective preliminary ruling ahead of the EWHC decision, the ECJ stated that:

"The fact that a resident company has been granted a loan by a non-resident company on terms which do not correspond to those which would have been agreed upon at arm's length constitutes […] an objective element which can be independently verified in order to determine whether the transaction in question represents […] a purely artificial arrangement, the essential purpose of which is to circumvent the tax legislation of that Member State. In that regard, the question is whether, had there been an arm's-length relationship between the companies concerned, the loan would not have been granted or would have been granted for a different amount or at a different rate of interest."[86]

Taking a closer look to the wording, one could argue that the ECJ defined the arm's length principle as benchmark for determining the artificial nature of a transaction. The Court states that the fact that it deviates from the arm's length principle is an objective element determining whether the transaction is purely artificial or not.

Another argument draws the same conclusion from the logic behind the arm's length principle. Since the arm's length principle is a legal idea in order to prevent tax avoidance, there is consensus about the fact that tax avoidance shall not be a valid reason to depart from the arm's length principle. For practical reasons, this cannot be restricted to wilful tax evasion. Rather this must also include cases where tax payers set the transfer price with good faith and due diligence but fail in producing an adequate price in line with the arm's length principle.[87]

In addition to that, it is hard to imagine a cross-border transaction that is commercially reasonable, but not tax-related. If a cross-border transaction does not deviate from the arm's length principle, it could, from a commercial point of view, be concluded with any third-party as well. If, for commercial reasons, it is only reasonable to conclude it with a related party at a price that is below the arm's length price, then it includes the avoidance of tax automatically and is, thus, inadmissible as justification.[88]

[86] ECJ (*Thin Cap*), para. 81.

[87] *Glahe, Moritz*, Transfer Pricing and EU Fundamental Freedoms, EC Tax Rev., 5/2013, p. 222, 228.

[88] The ECJ has accepted a cross-border profit/loss compensation only in case of a final loss compensation. Cf. ECJ on the 13.12.2005, C-446/03, Marks & Spencer plc v David Halsey (Her Majesty's Inspector of Taxes), Reports of Cases 2005 I-10837, ECLI:EU:C:2005:763, para. 55 – 56. Also see *Glahe*, EC Tax Rev., 5/2013, p. 222, 228, who considers this the only commercially justified deviation from the arm's length principle.

This is why a commercial justification necessarily means that the company concerned shall be given the opportunity to show that the transfer price is in fact in line with the arm's length principle, meaning that not the allegedly overly beneficial transfer price is justified in the sense of an exemption from the arm's length principle (follow-up business test), but that the price is market conform in the first place.

This view is backed by the reason for these cases, which is the Member States' tools to prevent tax avoidance. Outside the world of tax avoidance, however, there is no room for the application of rules ensuring an arm's length transfer price since the arm's length principle is an instrument to prevent tax avoidance only. This is why the arm's length principle cannot be circumvented with an economic argument as any deviation leads to the avoidance of tax.

2.3.5. Preliminary Conclusion

In the *SGI* decision, the ECJ states that the arm's length principle and the transfer pricing methods in line with it are an adequate tool to allocate profit between Member States and to calculate the taxable base of a multinational. As I have indicated above already, this should also hold true for State aid purpose. Since profits are allocated in the same manner, irrespective of whether this is for determining the power to tax (vertical relationship) or for deciding which affiliate should declare which part of the profit (horizontal relationship), we can draw the conclusion, that the arm's length principle and the transfer pricing methods recommended by the OECD would – according to the ECJ – be the right tools for the COM to determine multinational's tax liability.

In case a Member State had not implemented the arm's length principle, however, the Free Movement of Capital would not have been affected in the first place. A Member State that does not implement the arm's length principle, practically waives its right to tax a part of the profit. It is therefore important to keep in mind, that the Court did only allow Member States to use transfer pricing methods according to the arm's length principle for the profit allocation but did not set up an obligation to do so.

2.4. The OECD Transfer Pricing Guidelines as Source of Law?

The OECD TP Guidelines encourage the OECD Member Countries to implement the arm's length principle into their domestic tax regime and to follow the TP Guidelines.[89] The TP

[89] OECD TP Guidelines (2017), p. 18, rec. 16.

Guidelines are, therefore, a non-binding instrument *per se* and cannot serve as source of law without further implementation and/or reference of (national) tax law to them.

However, the OECD Model Tax Convention as well as the OECD TP Guidelines enjoy a broad acceptance amongst both Member Countries and non-members around the world. According to *Calderón* this trend has led to a global division of countries following the OECD TP Guidelines and countries being less receptive. On the international tax stage, however, the latter are "classified as 'tax havens' which are considered the 'renegades' in the international tax arena".[90] It derives from this acceptance that the OECD Model Tax Convention was used as a template for many DTTs and, therefore, transformed the arm's length principle in many jurisdictions from soft law to hard law.

To what extent the OECD soft law may have factual and legal influence on domestic hard law, especially when it comes to possible restraining effects on a deviating national provision, is subject to a broad discussion.[91] Without going deeper into that, for the subject of this thesis, it is enough to conclude that the OECD's arm's length principle, Art. 9 OECD Model Tax Convention and the OECD TP Guidelines mainly enjoy factual,[92] but not legal, authority due to their worldwide and more or less consensual acceptance: "a fact which – as everybody will agree – is of high value in itself".[93]

All these aspects together form the framework in which tax rulings are imbedded. I will now present a selection of cases for the analysis conducted in this thesis.

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[90] *Calderón, Jose*, The OECD Transfer Pricing Guidelines as a Source of Tax Law: Is Globalization Reaching the Tax Law?, Intertax, 1/2007, p. 4, 5.

[91] Cf. the overview by *Calderón*, Intertax, 1/2007, p. 4 et seq. with further references to different opinions.

[92] Empirical data suggests that modern DTTs have a 80 % similarity in language to the OECD Model Tax Convention; see *Ash, Elliott/Marian, Omri Y.*, 28.06.2017, The Making of International Tax Law: Empirical Evidence Using Natural Language Analysis, available at https://ssrn.com/abstract=2994217, last checked on 24.07.2018.

[93] *Schön*, in: *Richelle/Schön/Traversa* (Edit.), Allocating taxing powers within the European Union, p. 73, 74.

PART II – CASES TO BE ASSESSED

Upon media reports of multinationals profiting from significant tax cuts with the help of tax rulings, the COM started investigations into the tax ruling practices of the Member States in June 2013.[94] This led to State aid investigations against Ireland (*Apple*),[95] the Netherlands (*Starbucks*),[96] Belgium due to its Excess Profit Exemption,[97] and Luxembourg (*Fiat Finance and Trade, Amazon*, *McDonald's*, and *GDF Suez*).[98]

In this thesis, I will focus on the *Apple* case, the *FFT* case, and the *Belgian Excess Profit Exemption* case. The *Starbucks* and the *Amazon* case follow more or less the line of argumentation in the *FFT* case.[99] All three cases deal with a jurisdiction that has implemented the arm's length principle and whose tax authority is accused of having accepted an overly beneficial transfer pricing method. In order not to confuse with too many cases, I will treat the *FFT* case therefore as a representative for the others, even though where appropriate, I will also cross-reference to them. As of 08.06.2018, both the *McDonald's* case and the *GDF Suez* case have not been published yet and can therefore not be considered in this thesis.

I will start by giving an introductory overview of the facts (Chapter 3) and focus on the COM's selectivity assessment later (Chapter 4). A more detailed summary of these cases is annexed to the end of this thesis.[100]

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[94] *European Commission*, 11.06.2014, Press Release IP/14/663: State aid: Commission investigates transfer pricing arrangements on corporate taxation of Apple (Ireland) Starbucks (Netherlands) and Fiat Finance and Trade (Luxembourg); *Jaeger* stated that the COM's attention to the tax arrangements of multinational companies was triggered by Lux Leaks, an investigative disclosure of tax arrangements of over 300 multinational companies; cf. *Jaeger, Thomas*, Tax Concessions for Multinationals: In or Out of the Reach of State Aid Law?, JECL, 4/2017, p. 221, 221. This cannot be the case, since Lux Leaks was made public only in late November 2014. However, Commissioner *Vestager* stated that the COM will use the Lux Leaks information for the State aid procedures; cf. European Commission Audiovisual Services, *Press Conference on 20.11.2014 by Commissioner Margrethe Vestager on Commission state aid decisions regarding illegal tax advantages granted by Luxembourg (Fiat) and the Netherlands (Starbucks) and on the optical disk drives cartel*, available at http://ec.europa.eu/avservices/video/player.cfm?ref=I110761&sitelang=en, last checked on 24.07.2018.

[95] European Commission, SA.38373 (2014/C) (ex 2014/NN)(ex 2014/CP), Ireland and Apple, OJ 2017/L 187/01 on the 30.08.2016.

[96] European Commission on the 21.10.2015, SA.38374 (2014/C ex 2014/NN), The Netherlands and Starbucks, OJ 2017/L 83/38.

[97] European Commission, SA.37667 (2015/C) (ex 2015/NN), Belgian Excess Profit Exemption, OJ 2016/L 260/61 on the 11.01.2016.

[98] European Commission, SA.38375 (2014/C) (ex 2014/NN), Luxembourg and Fiat Finance and Trade, OJ 2016/L 351/1 on the 21.10.2015, European Commission on the 04.10.2017, SA.38944 (2014/C) (ex 2014/NN, The Netherlands and Amazon, European Commission on the 03.12.2015, SA.38945 (2015/C) (ex 2015/NN), Opening Decision to McDonald's, OJ 2016/C 258/11, and European Commission on the 19.09.2016, SA.44888 (NN/016)(ex EO/2016), Opening Decision to GDF Suez, OJ 2017/C 36/13.

[99] *Jaeger*, JECL, 4/2017, p. 221, 223.

[100] See p. 85 et seq.

3. FACTS OF THE CASES

3.1. Commission v Ireland/Apple (Case SA.38373)[101]

Apple Inc. is the parent company of the *Apple Group*, which also had several affiliates and sub-affiliates in Ireland. Two of these affiliates, *Apple Operations International (AOI)* and *Apple Operations Europe (AOE)* with an affiliate of its own named *Apple Sales International (ASI)*, were not tax resident in Ireland, even though they were incorporated there. The possibility of being Irish incorporated but not tax resident was a speciality of the Irish tax law[102] that – since it was not necessary to be resident in another jurisdiction – allowed for a company to become basically 'stateless', meaning not tax resident in any tax jurisdiction.

Apple had developed substantial IP that was necessary for the production and distribution of *Apple* products. It conferred the IP rights to *AOE* and *ASI* who contributed to the development of the IP according to a cost-sharing agreement (CSA).

In 1991, the Irish tax authority (hereinafter 'Irish Revenue') issued a tax ruling for profit allocation according to which *AOE* and *ASI* should be divided into a Headquarter (HQ) located for tax purposes in the USA and an Irish part of the company (Irish branch), stating that income from their IP should be allocated to the HQ. The Irish Revenue accepted this proposal.

Since they were considered to be resident outside Ireland and were allegedly taxed in another jurisdiction, the tax rulings aimed at defining how much of the overall profit of *ASI* and *AOE* needed to be allocated to their Irish branches, not to them as a whole. Since the rest of the profit was allocated to the HQ in the USA, it remained untaxed by Irish Revenue and is only theoretically subject to deferral taxation in the USA, which, however, only applies in case of repatriation.

3.2. Commission v Luxembourg/Fiat (Case SA.38375)[103]

FFT forms a part of the *Fiat* group with its parent company *Fiat Chrysler Automobiles N.V.*, has its seat in Luxemburg and provides financial and treasury services to Europe based affiliates

[101] See Annex, I. 1., p. 89 et seq. for further information and references.
[102] The UK had had a similar provision, however abandoned it in 1988 upon which Ireland quickly became a preferred tax haven in Europe, cf. *McHugh, Jennifer A.*, Balancing Reputation and Foreign Investment Incentives: Ireland's Second Attempt at Combating the Abuse of Irish Registered Non-Resident Companies, BJIL2001, p. 1207, 1210.
[103] See Annex, II. 1., p. 95 et seq. for further information and references.

of the *Fiat* group. *Fiat* affiliates that are funded by the *FFT* have to pay interest according to the group's weighted average cost of capital (WACC) plus a margin.

In order to calculate its annual tax liability, *FFT*'s tax advisor submitted a transfer pricing analysis to the Luxembourg tax authorities in 2012 and suggested the TNM-method (TNMM) as most appropriate method to determine this profit in line with the OECD TP Guidelines. *FFT*'s tax advisor then compared the intra-group transactions and *FFT*'s risks with transactions of other companies that the advisor found to be in a comparable situation. Since *FFT* provided bank-like services to its affiliated companies without being a bank, the tax advisor used banking regulation *per analogiam* to calculate the tax liability, which results in a more beneficial balance for tax purposes.

The Luxembourg tax authorities accepted this proposal and confirmed that it was according to Luxembourg tax law, which required intra-group transactions to be in line with the OECD TP Guidelines. Thus, they acknowledged that it complied with the OECD TP Guidelines.

3.3. Commission v Kingdom of Belgium (Case SA.37667)[104]

The Belgian tax law stipulated special provisions for Belgian companies that belong to a multinational group or permanent establishments of foreign resident companies that are part of a multinational group (hereinafter 'Belgian group companies'). This provision allowed for a tax exemption of this part of the profit that exceeded the profit of a hypothetical independent stand-alone company carrying out comparable activities. Belgium explained this exemption by stating that any excess to that of a comparable independent stand-alone company would accrue from synergies, economies of scale and other advantages resulting from the multinational corporate structure. Therefore, Belgium argued that it would in fact only tax the arm's length profit.

It was not required to declare the part of the profit that was subject to the tax exemption (that is the excess) in another State's tax declaration, thus leaving it free of tax unless another State made it subject to its tax (unilateral tax ruling).[105]

[104] See Annex, III. 1., p. 99 et seq. for further information and references.

[105] See also *Luja*, in: *da Cruz-Vilaça/Moniz/Vasconcelos/Saavedra* (Edit.), Taxation, State Aid and Distortions of Competition - Fiscalité, Aides d'État et Distortions de la Concurrence - Steuern, staatliche Beihilfen und Wettbewerbsverzerrungen, p. 53, 67.

4. FINDINGS OF THE COMMISSION ON THE ELEMENT OF SELECTIVITY

In each of these cases, the COM came to a negative State aid decision. In this chapter, I will present the reasoning the COM gave to individual aspects of the decision concerning the element of selectivity, namely the determination of the reference framework (Point 4.1.) and the identification of an advantage (Point 4.2.), which basically are step 1 and 2 of the three-step selectivity test.

4.1. Commission's Findings concerning the Reference Framework

The COM starts its reasoning by identifying the reference framework against which it is going to test the deviation later. In all three cases, the COM considers the ordinary rules of taxation for companies in the respective Member State as the reference framework.

In the *Apple* case, the COM identified the reference system as "the ordinary rules of taxation of corporate profit under the Irish corporate tax system, which have as their intrinsic objective the taxation of profit of all companies subject to tax in Ireland".[106] In the same manner, it considered the ordinary Luxembourg corporate income tax rules as reference framework in the *FFT* case, since its aim would be to tax the profits of standalone as well as incorporated companies resident in Luxembourg.

In both cases, the COM refers to the *Paint Graphos* decision of the ECJ where it stated that "Corporation tax must therefore be regarded as the legal regime of reference for the purpose of determining whether the measure at issue may be selective."[107] This reference is rather surprising, since the *Paint Graphos* decision was about a tax exemption for farming cooperatives and therefore had neither an international context nor did it concern transfer prices.

It is different with the *Belgian Excess Profit Exemption* case. There, the COM referred to the *Forum 187* decision of the ECJ[108] when it considered "the reference system to be the ordinary system of taxation of corporate profits under the general Belgian corporate income tax system,[...] which has as its objective the taxation of profit of all companies subject to tax in Belgium as well as Belgian branches of non-resident companies."[109] The outcome is the same

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[106] European Commission (*Apple*), para. 228.

[107] ECJ on the 08.09.2011, Joined cases C-78/08 to C-80/08, Ministero dell'Economia e delle Finanze und Agenzia delle Entrate gegen Paint Graphos Soc. coop. arl (C-78/08), Adige Carni Soc. coop. arl, in Liquidation gegen Agenzia delle Entrate und Ministero dell'Economia e delle Finanze (C-79/08) und Ministero delle Finanze gegen Michele Franchetto (C-80/08), Reports of Cases 2011 I-07611, ECLI:EU:C:2011:550, para. 50.

[108] ECJ (*Forum 187*), para. 95.

[109] European Commission (*Belgian Excess Profit Exemption*), para. 121.

but the case law the COM relies on different, which is surprising given that both the *Paint Graphos* as well as the *Forum 187* case were both available already and could have been cited together. The reason why the COM chose to cite one in this case and the other in the other case remains a secret.

Having established that the ordinary rules of taxation should serve as a reference framework, the COM then goes on and reasons how it comes to this conclusion. In all three cases, the narrative is that the ordinary rules of taxation must apply because all companies subject to corporation tax would be in a similar legal and factual situation as defined by the objective of the corporate tax.

In detail, the COM argued that in the *Belgian Excess Profit Exemption* case that the corporate tax system's objective is taxing both companies resident in Belgium as well as Belgian branches of non-resident companies. "In both cases, Belgian corporate income tax is payable on the total profit, either worldwide or Belgian sourced. In general, therefore, all undertakings generating income in Belgium are considered to be in a similar legal and factual situation from the perspective of corporate income taxation."[110] Consequently, the fact that the Excess Profit Exemption aims at adjusting the company's taxable profit for determining the corporate income tax in Belgium would make it only logical to assess this measure against the corporate income tax system, which, therefore, should serve as a reference system for the assessment of a selective advantage.

In the *Apple* case, this argument was countered by both *Apple* and Ireland. They reasoned that it did not take into account the special status of non-integrated group companies that are not resident in Ireland. The COM argued that the objective of this reference system is the taxation of all companies, integrated and non-integrated ones, as well as resident or not-resident companies. Consequently, there would not be a separate reference system for integrated, non-resident tax subjects, such as *Apple*. This means in turn, that the COM measures all companies – irrespective of their status as resident or non-resident Irish companies – according to the same reference systems.

In the *FFT* case, the presence of selectivity was a bit easier to prove, since the provisions of Luxembourg tax law and a Circular for the application of the tax rules expressly compared the functions of an intra-group financing company, like *FFT*, with the functions of an independent

[110] Ibid.

financial institution (banks). Furthermore, the intrinsic objective of the contested tax ruling would be the determination of the taxable profit "for the purpose of levying corporate income tax under the general Luxembourg corporate income tax system".[111]

4.2. Identification of the Conferral of an Advantage

After having set the reference framework, the COM goes on to identify the advantage by looking for a derogation of said reference framework.

4.2.1. Concerning Apple/Ireland

Apple had structured its group in a way that the Irish affiliates in question, that is *ASI* an *AOE*, held substantial IP. Also, due to a speciality of Irish tax law, their HQ was considered to be in the USA, but according to US tax law in Ireland. *ASI* and *AOE* were classic hybrid companies that exploited a loophole between two tax jurisdictions that derives from a different interpretation of their legal quality. Their Irish tax ruling allocated that part of the profit that derived from royalties to *ASI*'s and *AOE*'s HQ in the USA. Given these facts, the COM found it necessary, to apply a profit allocation method that leads to a market-based outcome in order to allocate the profits of the intangibles within the same company as if the HQ and the Irish branch were two separate and independent companies.

With reference to the *Forum 187 d*ecision of the ECJ,[112] the COM went on and stated that Art. 107 para. 1 TFEU required the profit allocation to be based on the arm's length principle, even though the arm's length principle was not part of the Irish law at this time. The COM argued that this would be the case, because since there has to be a profit allocation in order to calculate an Irish branch's taxable base, this profit allocation has to resemble a market-based outcome in line with the arm's length's principle. If it was not according to the arm's length principle, it would selectively favour integrated companies over non-integrated, standalone companies.

The COM argued that it would not resemble an arm's length transfer price if the royalty income of *AOE* and *ASI* would be allocated to the HQ, since this HQ neither had employees nor an office or any other facility and therefore did not contribute to the management of the IP whatsoever.[113] Since *AOE* and *ASI* had contributed to the development of the IP already by CSA-payments, any third-party would not have accepted another payment for the IP to the

[111] European Commission (*Fiat*), para. 194, 198 and 199.
[112] ECJ (*Forum 187*).
[113] Otherwise it would have been subject to US taxation, see for further information Annex I. 1. c), p. 91 et seq.

(fictionally independent) HQ. By accepting this profit allocation method, Irish Revenue would leave this part of the profit untaxed, because, due to the hybrid nature of *ASI* and *AOE*, it was not subject to US-taxation either.

In an alternative line of reasoning, the COM also observed, that in many other tax rulings with other multinational corporations, Ireland had actually used the arm's length' principle for allocating profits of non-resident Irish branches since the 1990s and that Ireland would therefore deviate from its own ruling practice. Furthermore, it observed that the Irish practice had followed a catalogue of criteria that is essentially the same as what is laid down in Art. 7 para. 2 of the OECD Model Tax Convention for profit allocation of a non-resident company. This would be necessary in order to apply Sec. 25 TCA97 in an objective way.

Even if the arm's length principle was not part of Irish tax law, the COM stated *in eventu* that the tax rulings would confer a selective advantage to *ASI* and *AOE*, because in such case they would have been the result of discretion exercised by Irish Revenue without relying on objective criteria.

This approach seems rather cumbersome, because Member States have to respect European Union law, and more specifically Art. 107 TFEU, when issuing tax measurements or passing taxation legislation anyway.[114] The COM notes that "the granting of a tax ruling must respect the State aid rules".[115] However, if the ECJ requires a profit allocation to be according to the arm's length principle, as the COM argued, then it does not matter whether the arm's length principle is part of the Irish law or not.

Following from that, the COM could have argued without much effort that Ireland needed to use a reliable and *objective* profit allocation method which implements the arm's length principle and supported this argument by referring to the Irish tax ruling practice. This would have been especially sound, because it is the Irish tax ruling practice that shows that Ireland usually used objective criteria for profit allocation. With such argumentation, one could have proven that the tax rulings for *ASI* and *AOE* departed both from the reference framework – that is the Irish taxation law including the arm's length principle – and the Irish Revenue's ruling practice.

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[114] ECJ on the 17.09.2009, C-182/08, Glaxo Wellcome GmbH & Co. KG v Finanzamt München II, Reports of Cases 2009 I-08591, ECLI:EU:C:2009:559, para. 34 with reference to earlier decisions; or more recently ECJ on the 29.03.2012, C-417/10, Ministero dell'Economia e delle Finanze and Agenzia delle Entrate v 3M Italia SpA, published in the electronic Reports of Cases, ECLI:EU:C:2012:184, para. 25.

[115] European Commission (*Apple*), para. 244.

It would have followed from this that the Irish Revenue either had exercised arbitrary discretion when issuing the tax rulings for *ASI* and *AOE*, which could be indicated by the minutes of the meetings suggesting that the profit allocation was rather negotiated than substantiated. Or that Irish Revenue unlawfully departed from the usually applicable tax provisions.

4.2.2. Concerning FFT/Luxembourg

Apart from the specialities due to *Apple*'s corporate structure, the COM argued the *FFT* case in a similar manner. In the assessment whether the tax ruling allowed a deviation from the reference framework, the COM laid down how a deviation from tax rules and how a deviation from the arm's length principle confer a selective advantage on a beneficiary. The COM assessed the element of selectivity and the element of advantage together arguing that a deviation from the ordinary rules would coincide with the identification of an advantage.

Contrary to the *Apple* case, where the COM had to argue why the arm's length principle should apply in the first place, the Luxembourg tax law had already stipulated its application. In a nutshell, the COM reprimanded the use of inadequate (or beneficial) parameters for the calculation of the arm's length price. While it emphasized the fact that the method and parameters need to be chosen in such a way that a market-based outcome is reached, it also acknowledged that the use of a second-best method does not automatically raise concerns about a potential conferral of an advantage if it is combined with respectively conservative parameters. On the other hand, even the most appropriate method could lead to an unsatisfying outcome, if combined with overly favourable parameters.

The COM concluded, that the chosen parameters would not lead to an arm's length price, but rather to an outcome below that. By accepting this calculation method, the Luxembourg tax authorities had conferred an advantage on *FFT*.

The factual basis is rather different to that of the *Apple* case. The reference framework in the *Apple* decision did not have any provision or requirements for transfer pricing according to the arm's length principle; they were implicit at best. On the other hand, the Luxembourg tax regime actually requires incorporated companies to comply with the arm's length principle. Not only is it indicated in Art. 164 LIR but also expressly stated in the Circular that transfer prices between intra-group companies must be compliant with the OECD TP Guidelines.

In the reasoning, it is therefore not the COM's priority to argue why the arm's length principle should be applicable. Rather, the COM needed to prove that the tax ruling had endorsed a

transfer pricing method that is not in line with what the OECD TP Guidelines would have deemed appropriate, even though the Luxembourg tax authorities had confirmed before that the transfer pricing method was compliant with the arm's length principle. In summary, the COM's accusation is that the transfer pricing method was not applied correctly.

It is also worth noting that the COM gave a statement on the application of the transfer pricing methods. In para. 243 it acknowledged that while the best method chosen might not be appropriate with the wrong parameters, it might as well be that the second-best method does the job satisfactorily, if handled correctly. Nevertheless, this statement can be read in two ways. Either it has an optimistic connotation and means that every sincere attempt to reach a market-based outcome will fall within the acceptable arm's length range, or it has a quite arbitrary one stating that in the end it is up to the COM to decide whether the result is acceptable or not.

Within a broader reading of the reasoning, however, one can detect a certain concession of the COM. In rec. 246 it concludes that the transfer pricing method chosen by *FFT*'s tax advisor is adequate, because the basically more preferable and more direct CUP method would require a comparison of every individual loan that *FFT* provides with a comparable transaction of a non-integrated company in a factually and legally comparable position, which would constitute an excessive administrative burden. Therefore, the choice of method must be subject to proportionality. Together with this, the COM's wording of the *FFT* case like 'reliable approximation', 'best estimate' and 'arm's range', indicate that there must be some kind of benefit of the doubt for the tax payer.

4.2.3. Concerning the Belgian Excess Profit Exemption Regime

Similar to the *FFT* case, the national tax law in question stipulated the application of the arm's length principle. However, contrary to the cases against Ireland and Luxembourg, the *Belgian Excess Profit Exemption* case is not about an individual tax ruling, but about a general aid scheme.

The notion of 'aid scheme' is defined by Art. 1 lit. d) Regulation No. 2015/1589[116] as any act that is drafted in a general and abstract manner, on the basis of which individual aid can be awarded without further implementing measures being required. This is also the case, where

[116] *Council Regulation (EU) 2015/1589 of 13 July 2015 laying down detailed rules for the application of Article 108 of the Treaty on the Functioning of the European Union (codification)*, OJ 2015/L 248/9.

the benefit derives from a tax ruling relying on such a general measure as long as this tax ruling does not implement further substantial measures.

The COM observed that the Belgian corporate income tax system usually taxes the total profit, meaning the profit that is actually recorded. By relieving a certain part of that profit from the burden of taxation, the Excess Profit Exemption scheme would both deviate from this pattern of the ordinary tax system and grant an advantage to the companies benefitting from it, even though they are in a similar factual and legal situation to other companies that cannot benefit from this.

As an indicator for the comparability of integrated and independent companies, the COM states that the Belgian corporate tax system has as its objective the taxation of all corporate taxpayers on their actual profits, irrespective of their size, legal form or corporate structure (integrated or independent). Consequently, since the corporate tax system does not distinguish between companies in any way whatsoever, but the Excess Profit exemption does by being applicable only to multinational companies, it is *de jure* selective.

Despite this fact, the COM used a selectivity assessment scheme that conflated the elements of selectivity and advantage. Eventually, it assessed the case as if it had been an individual tax ruling granted to an individual corporate tax payer. The COM stated that „[i]n relation to that second step of the selectivity analysis, whether a tax measure constitutes a derogation from the reference system will generally coincide with the identification of the advantage granted to its beneficiaries under that measure. Indeed, where a tax measure results in an unjustified reduction of the tax liability of beneficiaries who would otherwise be subject to a higher level of tax under the reference system, that reduction constitutes both the derogation from the system of reference and the advantage granted by the tax measure."[117]

As in all of the recent State aid decisions concerning tax measures, the COM therefore conflated the assessment of the existence of an advantage with the assessment of its selective nature. I will show later that when it comes to the assessment of aid *schemes*, this approach should be avoided.[118]

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[117] European Commission (*Belgian Excess Profit Exemption*), para. 131.
[118] See Sub-chapter 6.2., p. 76.

PART III – ANALYSIS OF THE COMMISSION'S FINDINGS

After having laid down the cases in detail, I will now continue to scrutinise what is new about these cases. This is, first, the introduction of the arm's length principle as benchmark for the question whether tax rulings fall within the scope of State aid prohibition, and, second, the conflation of the element of advantage and the element of selectivity, which the COM assessed in one single analysis-step.

5. THE ARM'S LENGTH PRINCIPLE AS NEW BENCHMARK?

In the cases above, the question arose whether a deviation from the arm's length principle necessarily means that there is also a selective conferral of an advantage to the beneficiaries. In this chapter, I will show that it is.

I will start my argumentation with the question to which arm's length principle the COM refers to (sub-chapter 5.1.), continue with arguing why in cases regarding tax rulings the reference system should always be the ordinary rules of (corporate) taxation (sub-chapter 5.2.), show that, therefore, the deviation from the arm's length principle is also always a deviation from the ordinary rules of taxation (sub-chapter 5.3.) and give a short excursus on the arm's length principle and the aspect of legal certainty (sub-chapter 5.4.). I will conclude my findings by arguing why I find the COM's new approach concerning the arm's length principle to be consistent with settled case-law and coherent with the aim of State aid prohibition (sub-chapter 5.5.).

5.1. To which Arm's Length Principle does the Commission refer to?

The COM refers to the *Forum 187* decision of the ECJ, when it states that tax measures accepting intra-group charges that do not reflect prices reached under conditions of free competition – that is if they do not resemble prices negotiated by independent undertakings under comparable circumstances at arm's length – constitute a selective advantage.[119] The COM argues that this decision is a precedent that endorses the arm's length principle as benchmark for the profit allocation for State aid purposes. It also included this reading of the decision in the Notice on the Notion of State aid, when the COM states in rec. 171 with referral to this ECJ decision:

[119] For example in European Commission (*Apple*), para. 250; European Commission (*Fiat*), para. 222; European Commission (*Starbucks*), para. 258.

"The Court of Justice has held that a reduction in the taxable base of an undertaking that results from a tax measure that enables a taxpayer to employ transfer prices in intra-group transactions that do not resemble prices which would be charged in conditions of free competition between independent undertakings negotiating under comparable circumstances *at arm's length* confers a selective advantage […]."[120]

In the literature, there has been a broad discussion on whether the ECJ really established or wanted to establish the arm's length principle as inherent part of Art. 107 para. 1 TFEU. Rather doubtful voices argue that the COM 'overstretches' the *Forum 187* decision. Eventually, it comes down to the question, whether the ECJ equates the term 'conditions of free competition' with the term 'at arm's length'. I will elaborate this in the following Points.

5.1.1. Forum 187 Decision

In the *Forum 187 Decision* the ECJ had to deal with the Belgian tax regime for coordination centres. Coordination centres are a part of a company group, whose only task within the group is to provide services and financial activities to the other members of the group, such as centralised accounting, common advertising and marketing etc. In order to qualify as coordination centre under Belgian law, they must refrain from any other commercial activities.[121] Given the narrowed scope of possible activity and due to the fact, that coordination centres only interact within their group, the Belgian tax regime provided special provisions for taxation, especially for determining the taxable base.[122]

Usually, the taxable base of a coordination centre was calculated according to the Cost-Plus method. With the Cost-Plus method the annual taxable income is determined by the costs and expenses of the tax subject to which a profit margin is added. In the Belgian tax regime, coordination centres were also able to subtract staff and certain financial costs and were exempted from withholding tax, property tax etc.[123] The COM argued that a provision that allows the deduction of staff and certain financial costs only for coordination centres would breach Art. 87 para. 1 EC (now: Art. 107 para. 1 TFEU) and ordered Belgium to abandon the tax regime or amend it so that it complies with State aid law. The Government of Belgium appealed to the ECJ against this decision.

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[120] *Notice on the Notion of State aid*, rec. 171 (emphasis added).
[121] For further details to Belgian coordination centres at the time of the contested tax rulings, cf. *Becker, Helmut*, Coordination Centres in Belgium and Germany, Intertax, 10/1989, p. 430.
[122] ECJ (*Forum 187*), para. 6 and 8.
[123] ECJ (*Forum 187*), para. 9 – 13.

With approval of the COM's statement in para. 95 of the contested COM decision,[124] the ECJ stated that an assessment whether a method confers an advantage or not requires a comparison between the outcome of the method in question and outcome that would have been reached under the ordinary tax rules. This comparison should be "based on the difference between profits and outgoings of an undertaking carrying on its activities in *conditions of free competition*".[125]

Finally, the ECJ finds that the exemptions as set out above (deduction of staff and other financial costs) do not lead to transfer prices which would be charged in conditions of free competition.[126]

5.1.2. Discussion

The phrasing of this paragraph and the COM's interpretation of it opened a discussion about whether the ECJ meant to create a precedent and introduce the arm's length principle, of which the COM had spoken in the contested decision, when it referred to the conditions of free competition.

One side argues that the ECJ did not have the arm's length principle in mind, when it referred to the conditions of free competition. This opinion is founded on the fact that the ECJ never actually used the term 'at arm's length' in this decision, but only referred to the 'conditions of free competition'. The profit allocation method used in the Belgian tax regime was in fact a modified Cost-Plus method, according to which the taxable base was calculated on the basis of the costs but excluding any staff cost and certain financial expenses. Due to the fact that the ECJ deemed this way of calculating the taxable base inappropriate, it would be more likely that the reference to the conditions of free competitions means that such a method must include all costs, otherwise it would confer an advantage on the tax subjects.[127]

This view can further be substantiated by the fact that the Court obviously knew the COM's argumentation and terminology. While the COM expressly based its argumentation on the OECD transfer pricing principles, the Court did not do so.

Another side of the discussion states that the ECJ had the arm's length principle in mind, however, this was the OECD arm's length principle set out in Art. 9 OECD Model Tax

[124] European Commission on the 17.02.2003, 2003/755/EC, Belgium and Forum 187, OJ 2003/L 282/25
[125] ECJ (*Forum 187*), para. 95 (emphasis added)
[126] ECJ (*Forum 187*), para. 96.
[127] *Nicolaides, Phedon*, State Aid Rules and Tax Rulings, EStAL, 3/2016, p. 416, 420.

Convention. This clarification would be necessary, because the ECJ only mentioned the 'conditions of free competition' but does not use the term 'arm's length principle'. This leaves the reader with two possible understandings of this decision.

It could be either the OECD principles for transfer pricing, as the recital of the contested COM's decision that was cited by the ECJ had mentioned them. However, it could also be the case that the COM had used an arm's length principle *sui generis*, given the non-binding character of the OECD's arm's length principle, and that the ECJ referred to this kind of arm's length. This last option might seem plausible whenever the COM stated that it is not applying Art. 9 OECD Model Tax Convention,[128] which could indicate that the COM had tried to build up its own arm's length principle before.

The discussion is twofold. On the one hand, the COM claims that the ECJ introduced the arm's length principle as benchmark, on the other hand there is an academic dispute about 'which arm's length principle the COM refers to' giving the impression that there would be several ones.

Nicolaides criticized the COM's reading of the *Forum 187* decision, because there would be different arm's length arrangements, each with different outcome, and that this would emphasise the outcome over the method. According to his observation, in the end, what matters is the method and not the result, because one cannot know in advance if a method produces market-based outcomes or not. This approach would raise the question, if this is not rather an expansion of the COM's power into the fiscal sovereignty of the Member States.[129]

In order to answer to this concern, it seems to me that there has to be clarity over the terminology. An arm's length arrangement is basically an arrangement endorsing a transfer pricing method in line with this principle, not the arm's length principle itself. Such arrangements follow the arm's length principle, which states that intra-group members have to be treated like independent companies for tax purposes, by endorsing a method that leads to an outcome within the arm's range.

The OECD TP Guidelines do not 'stipulate' the application of one method, since different starting points, different circumstances and different company structures need be treated in a flexible manner. Focusing on only one method might lead to a broad range of outcomes when

[128] European Commission (*Fiat*), para. 228, European Commission (*Starbucks*), para. 264. Further discussed below, p. 40.
[129] *Nicolaides*, EStAL, 3/2016, p. 416, 419.

applied to all kind of multinational's corporation structures, which would automatically result in different treatment of companies by tax authorities. This is why the focus on the economic outcome should be preferred over the focus on the method, meaning that one needs to start at the end or in other words: put the cart before the horse. Of course, starting with a market-based outcome makes it necessary to consider aspects of legal certainty when deciding this market-based outcome.[130]

Furthermore, the answer to the question which arm's length principle, if at all, the ECJ referred to, needs to be elaborated together with the COM's contested decision in the *Forum 187* decision. On this front there is a wide consensus[131] that the ECJ, if at all, referred to the arm's length principle as described by the OECD and that it did not establish a genuinely new European understanding of the arm's length principle. This comes from the broader reading of the contested COM decision and the ECJ's judgement. Not only does the Court deal with the OECD's Cost-Plus method in the prior paragraph, but it is also the OECD transfer pricing rules that are mentioned in para. 95 of the COM's contested decision, which the Court refers to with approval. This becomes even clearer when one considers that the COM itself indicated the equation of the terms 'conditions of free competition' and 'at arm's length' in rec. 43 of its decision, where it states:

"[…] the exclusion of certain costs and expenditure from the basis of assessment [of the Cost-Plus method] is compatible with OECD guidelines, which state that it is not always necessary to add a profit margin in order for the price to satisfy competition requirements (at arm's length)."[132]

In detail, the ECJ and the COM assessed the Cost-Plus method, which is one of several methods that are within the so-called arm's range, according to the OECD TP Guidelines. The arm's range is a range of different outcomes that are all nonetheless within an acceptable deviation from the arm's length conditions.[133] The result of the assessment of the ECJ (and the COM) was that the method applied according to the Belgian coordination centre tax regime was not sufficient under the State aid rules; not because the method itself was incompatible – even the

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[130] In this context, I advocate for a benefit of doubt in favour of the tax payer. Cf. Point 5.3.3, p. 69 et seq.

[131] Cf. *Kyriazis, Dimitrios A.*, From Soft Law to Soft Law through Hard Law: The Commission's Approach to the State Aid Assessment of Tax Rulings, EStAL, 3/2016, p. 428, Fn. 53.

[132] European Commission (*Forum 187*), para. 43; The binding French version states "[…] l'exclusion de certains frais et dépenses de la base de calcul du cost plus est compatible avec les recommandations de l'OCDE qui établissent qu'il n'est pas toujours nécessaire d'inclure une marge bénéficiaire pour qu'un prix réponde aux conditions de concurrence (at arm's length)."

[133] Cf. also OECD TP Guidelines (2017), p. 23.

exclusion of certain costs and expenses are not considered to necessarily jeopardize an outcome within the arm's range –, but because in this very case, the method did not produce an outcome that was comparable to the situation of other companies under the conditions of free competition.

This leads to the conclusion that the ECJ, indeed, followed an outcome-based approach that considers only the result of a method in question. In the *Forum 187* decision the ECJ did not establish the OECD TP Guidelines as a set of rules that is inherent to Art. 107 para. 1 TFEU, but rather accepted the transfer pricing methods therein as a set of tools that would produce an acceptable outcome.

Consequently, it is not possible to distinguish between several arm's lengths or arm's lengths principles, since this term does not deal with a method but with a result. It can, therefore, be concluded, that the term 'under conditions of free competition' and 'at arm's length' are synonyms and that the ECJ requires a method that leads to an outcome *at arm's length*.

The reason why there is so much confusion about which arm's length principle the COM allegedly applies is the clarification the COM has repeatedly brought forward, and which did more harm than good. For example, in *Starbucks*[134], *Belgian Excess Profit Exemption*,[135] and *FFT*[136] it states in the same wording:

"[…] for any avoidance of doubt, the arm's length principle that the Commission applies in its State aid assessment is not that derived from Article 9 of the OECD Model Tax Convention, which is a non-binding instrument, but is a general principle of equal treatment in taxation falling within the application of Article 107(1) of the TFEU, which binds the Member States and from whose scope the national tax rules are not excluded[…]."

While this might sound like the COM wants to establish something on its own, the COM wanted to say something different, as it is indicated in the Notice on the Notion of State Aid. There it constantly refers back to the OECD soft law, stating, for example, that "the arm's length principle [is] inherent in Article 107(1) of the Treaty" and that the COM "may have regard to the […] 'OECD Transfer Pricing guidelines for Multinational Enterprises and Tax Administrations'". The OECD TP Guidelines would "capture the international consensus on

134 European Commission (*Starbucks*), para. 264.
135 European Commission (*Belgian Excess Profit Exemption*), para. 150.
136 European Commission (*Fiat*), para. 228.

transfer pricing" and it would, therefore, be unlikely that a tax ruling gave rise to State aid, if the OECD TP Guidelines are applied correctly.[137]

It follows from this that the COM did not want to establish its own arm's length principle. To do so it would have been necessary to provide in depth guidance on how this new arm's length principle needed to be applied, which the COM has not done. So far, it is more likely that the – maybe unfortunately phrased – statement of the COM should clarify the legal basis for the application of the arm's length principle. According to that, the legal basis cannot be the OECD Model Tax Convention, because it is a non-binding instrument, but the legal basis is Art. 107 para 1 TFEU itself, which necessarily requires non-discriminatory transfer prices between integrated companies.

5.2. The Reference System: The Ordinary Rules of Taxation

It was established in the last sub-chapter, that the ECJ requires a transfer pricing method that leads to an outcome at arm's length. In the reasonings of the recent State aid cases in question, the COM set the ordinary tax rules as reference system for the assessment and held that the contested tax rulings had conferred an advantage, because they deviated from the arm's length principle. It is thus necessary to elaborate, what the reference system should be.

I will build up my argument by starting with a claim that the arm's length principle itself should be the reference system, because this shows the necessity to take a look at the *ratio legis* of Art. 107 para. 1 TFEU (Point 5.2.1. – 5.2.2.). Then, I will continue with assessing whether integrated and independent companies are in a factually and legally comparable situation (Point. 5.2.3.). I will conclude with the result, where I find that the reference system should be the ordinary rules of taxation (Point. 5.2.4.). Furthermore, I will show in Point 5.2.5. that this automatically means that a deviation from the ordinary rules of taxation is also a deviation from the arm's length principle.

5.2.1. The Arm's Length Principle as Reference System?

Cachia argued that the arm's length principle itself would constitute the normal reference system. With reference to para. 54 of the Opening Decision in the *Amazon* case[138] he states that "the method of assessment of the taxable income needs to be compared to the ordinary tax

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[137] *Notice on the Notion of State aid*, rec. 173.

[138] European Commission on the 07.10.2014, SA.38944 (2014/C), Opening Decision to Amazon, OJ 2015/C 44/13.

system […]. Furthermore, the [COM] goes on to say that market conditions may be arrived at through transfer pricing established at arm's length. Therefore, we infer that the [COM] is using the [arm's length principle] as the benchmark or reference 'normal' tax system […]."[139] Since the three-step test starts by establishing what the tax payer's tax liability had been without the measure in question, there could not be a deviation from the arm's length principle if it is not implemented in the national tax law, like in Ireland.[140]

While a method of assessment of the taxable income is a transfer pricing method of some kind (either in line with the arm's length principle or not), the ordinary tax system is a set of rules. This set of rules can stipulate that the determination of an integrated company's taxable base should happen according to transfer pricing rules in line with the arm's length principle or not, but in the end, there has to be a method of whatever kind. Indeed, even in the *Apple* case, which distinguishes itself from all other cases because the Irish legal system had not required transfer prices being determined according to the arm's length principle, Ireland itself acknowledged that there must be a profit allocation method to determine the taxable base.[141]

The overall question is not, whether the profit allocation between integrated companies is in line with the arm's length principle or not, but if integrated companies and independent companies are – in the light of State aid – in a factually and legally comparable situation. If this is the case, any profit allocation must follow the arm's length principle; if not, the transfer pricing rules itself are the benchmark and *Cachia* is right in assuming that the arm's length principle needs to be implemented in the national tax law.

While I will argue later why it is consistent to infer that the arm's length principle and the rules of ordinary taxation coincide, it is nevertheless misleading to infer that the arm's length principle itself can be used as a reference system. This is because it anticipates the outcome without any further elaboration why this is the case and does not consider that the arm's length principle cannot function without the ordinary rules of taxation as benchmark.

5.2.2. Inadequacy of Tax Ruling Practice as Reference Framework

Naturally, the undertakings affected by the State aid decisions in question go with the latter. They argue that the COM should have compared the tax ruling to the tax ruling practice of the Member State. For example, *FFT* claimed that "to prove a selective treatment benefitting FFT

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139 *Cachia, Franklin*, Analysing the European Commission's Final Decisions on Apple, Starbucks, Amazon and Fiat Finance & Trade, EC Tax Review, 1/2017, p. 23, 34.
140 *Cachia*, EC Tax Review, 1/2017, p. 23, 34.
141 European Commission (*Apple*), para. 248.

as a result of the contested tax ruling, the Commission should compare that ruling to the administrative practice of the Luxembourg tax administration”.[142] *Apple* claimed something similar.[143] In a nutshell, due to substantial differences between integrated and independent companies, they claim that their tax ruling should not be compared to the general rules of taxation but to all other tax rulings issued in favour of third-party multinationals or at least a comparison to something like a ‘general tax ruling system’ or ‘tax ruling practice’ deduced thereof. This way, the treatment of multinationals would be assessed against the treatment of other multinationals.

This or similar claims were also supported by some authors in the legal literature. For example, *Gonzales* pointed out that what the COM says and what it does would be contradictory; on the one hand it has been asserting that the concept of tax rulings ensured legal certainty, while on the other hand it chose the ordinary rules of taxation as reference system. In order to be consistent with this assertion, the COM should show that the tax rulings constitute an exception to the ordinary rules of taxation.[144]

Furthermore, as it was brought forward by *Nicolaides*, there would be a problem with the COM’s approach in the first place. From a purely factual point of view, group companies can set the prices of intra-group transfers as they wish. This is the reason tax law stipulates such instruments as tax rulings in the first place. If multinationals can manipulate their taxable base by setting the transfer prices in a way that allows them to shift profits, then the only way to determine the ‘ought to be’ taxable base of a group company is to make them subject to a tax ruling which adjusts the transfer prices. Even if the COM was right in assuming that the ordinary rules of taxation alone were the reference system, this assumption might ultimately lead to a lower tax liability of group companies that have been previously manipulated intra-group prices, because this necessarily would not include the possibility to endorse a transfer pricing method in a tax ruling. Therefore, the ordinary rules of taxation necessarily need to be supplemented by the tax ruling practice and only this combined system could be an adequate reference framework.[145]

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[142] European Commission (*Fiat*), para. 318.
[143] European Commission (*Apple*), para. 231.
[144] *Gonzales, Saturnina M.*, State Aid and Tax Competition: Comments on the European Commission's Decisions on Transfer Pricing Rulings, EStAL, 4/2016, p. 556, 565.
[145] *Nicolaides*, EStAL, 3/2016, p. 416, 425.

However, in the cases subject to this thesis, the COM argued that the tax ruling practice in Luxembourg would be too inconsistent, would fail in producing a continuous practice and would thus not allow the deduction of an appropriate reference system[146] while the tax ruling practice in Ireland would follow the basic idea of the arm's length principle anyway.[147] Whether the COM's interpretation is objective or rather driven by the goal to make a case will have to be decided by the Court, because out of confidentiality reasons there are no substantive information about these rulings in the public version of the decision.

Nevertheless, this reveals a substantive flaw in *Nicolaides'* suggestion. For the tax ruling practice to constitute or supplement the reference system, it has to follow objective criteria, because otherwise it would simply be arbitrary. If it was arbitrary or inconsistent beforehand, it could not be seen as 'the normal application' of the tax law, which is why an arbitrary tax ruling practice cannot serve as (supplement to) the reference system.

If the tax ruling practice would follow objective criteria, however, one can distinguish between two possible situations: either the objective criteria are in line with the arm's length principle or they are not. In the first case, there is no need to compare any tax rulings to each other, because eventually, all tax rulings would adjust the transfer prices in such a way that the normal rules of taxation can be applied to the taxable base. In this context, one has to bear in mind that "the reference 'normal' taxation is not the one resulting from the nominal tax rate applied to the commercial income reported in the accounts of the taxpayer but the one that the administration would have normally accepted if it had followed the required process in determining the arm's length standard to apportion its share of the taxable income."[148] Therefore, in reality in the first case, it would be the ordinary rules of taxation serving as reference system.

Only in the second case, which is where the general tax ruling practice would follow objective criteria but not the arm's length principle, *Nicolaides'* suggestion of a combined reference system is workable.[149] Nonetheless, this solution does not answer the question whether such a

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[146] European Commission (*Fiat*), para. 336. Luxembourg had submitted a list of 5,323 tax rulings of which 14 covered a company with a treasury function like *FFT* (para. 332).

[147] European Commission (*Apple*), para. 371.

[148] *Rossi-Maccanico, Pierpaolo*, A New Framework for State Aid Review of Tax Rulings, EStAL, 3/2015, p. 371, 375.

[149] Nevertheless, the only case where the national tax regime did not expressly stipulate the arm's length principle is the *Apple* case with the Irish corporation tax regime. Even in this system, the COM observed that the tax ruling practices requires the Irish tax authority to exercise judgment by taking into account criteria that are essentially the same criteria laid down in Art. 7 para. 2 OECD Model Tax Convention. In this light, the COM argues that it had not been able to identify "any other objective standard besides the arm's length principle that

reference system would be compliant with State aid rules, because it remains unanswered whether such treatment is lawful. Given that this would mean a more beneficial treatment compared to purely resident and/or independent companies, its State aid compliance is highly doubtful. I will show later in the thesis,[150] that in the end it is Art. 107 para. 1 TFEU itself requiring the application of transfer pricing methods that are in line with the arm's length principle, because integrated and independent companies are in a similar legal and factual situation.

Concluding the foregoing, the tax ruling practice is, therefore, not an adequate reference system and this holds true even if it does follow objective criteria. In the *FFT* case, the COM was not able to identify a consistent tax ruling practice, which is why the tax ruling practice cannot serve as reference system. On the other hand, the tax ruling practice in Ireland followed the idea of the arm's length principle anyway, which is why there is no need to compare a single tax ruling to others.

5.2.3. Integrated and Independent Companies in a comparable Situation?

This Point will discuss the question whether integrated and independent companies are in a similar legal and factual situation. It has been noted that the ECJ has adopted a broader understanding of which undertakings are in a similar legal and factual situation in cases with measures of general application, while it has had a narrower understanding when it came to the assessment of very specific measures, like for example airport charges.[151] In the current cases, this can mean basically everything, which is why it is necessary to argue it through.

I will present the arguments of both options from an economic and a legal stand and discuss them afterwards. In a nutshell, the two possible sides can be divided into a formalistic opinion and a material opinion. One could either argue that tax authorities should apply the tax law in a mechanically equal (and therefore formal) manner so that the same law applies to everyone. Or one could argue that they should apply it in a materially equal manner with adjusted balances and transfer prices so that both companies bear the same economic burden. This leads to the question whether integrated and independent companies are in a similar factual and legal situation, which is one of the most critical issues for this thesis.

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ensures Section 25 TCA 97 is applied in a consistent manner ensuring that all integrated non-resident companies are treated equally under that provision.", European Commission (*Apple*), para. 371.

[150] See Point 5.2.3.6., p. 60.

[151] *Rapp, Julia/Ianus, Ramona*, Institutional Report, in: *da Cruz-Vilaça/Moniz/Vasconcelos/Saavedra* (Edit.), Taxation, State Aid and Distortions of Competition - Fiscalité, Aides d'État et Distortions de la Concurrence - Steuern, staatliche Beihilfen und Wettbewerbsverzerrungen (2018), p. 101, 114.

A proper evaluation of the arguments should allow a precise analysis. I will start with the economic arguments and show that they are not sufficient to show that integrated and non-integrated companies are in a similar factual and legal position.

5.2.3.1. Economic Arguments against Comparability

The discussion about the comparability of integrated and independent companies also concerns economic arguments. This includes the argument, that considering integrated and independent companies as comparable would contradict the very reason a group was set up for in the first place.

Nicolaides brought forward three arguments for this claim. First, it could be the case that the subsidiary can produce at lower cost and therefore it could be justifiable to charge lower prices. Second, it could be irrational for the parent company to make profit from its affiliates if it wants to avoid the phenomenon of 'double marginalisation'. Third, integrated companies can sell and its affiliate can buy at lower cost, because there would be less risk involved due to the better knowledge about the business partner. This is, why there is no economic justification to compare intragroup transactions with transactions on a competitive market.[152] This was also referred to as 'transfer price range of ambiguity'.[153]

This ambiguity results from the fact that independent companies dealing with each other have to calculate costs related to the transaction and the risks occurring when interacting with a third-party. With reference to the theory of the firm, it was brought forward that the arm's length principle seemed systemically inapplicable and questionable for the determination of an economically reasonable price. While it would be well established in theory that transfer pricing methods in line with the arm's length principle would lead to a market-based outcome, this approach would lack practical applicability. Due to the lack of costs for risks and the processing of the transaction, intra-group transactions would be more efficient, which is why they could not be compared to uncontrolled transactions as it is suggested by the arm's length principle.[154]

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[152] *Nicolaides*, EStAL, 3/2016, p. 416, 421 – 422.
[153] *Higinbotham, Harlow N./Levey, Marc M.*, When Arm's Length Isn't Really Arm's Length: Issues in Application of the Arm's Length Standard, Intertax, 8-9/1998, p. 235, 236 (see above, Point 2.3.5., p. 24 et seq).
[154] *Wendt, Carsten*, A Common Tax Base for Multinational Enterprises in the European Union (2009), p. 87 – 88.

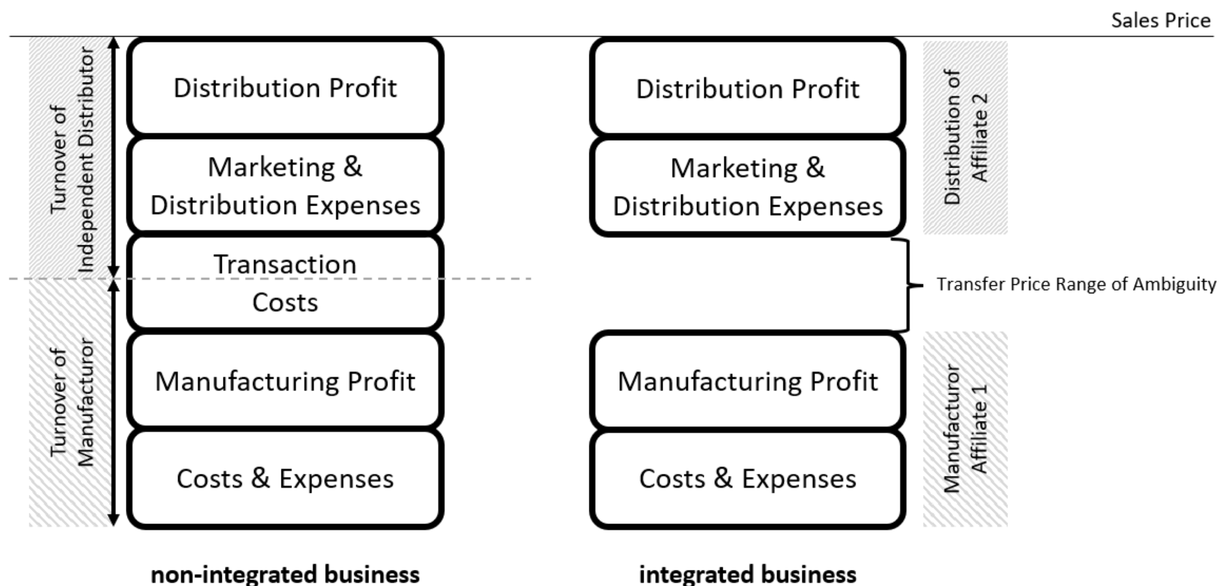

Figure 1 – The Transfer Price Range of Ambiguity according to *Higinbotham/Levey*

Such positions do not occur in the calculation of integrated companies, since the information flow between affiliated companies usually ensures that the contracting parties are fully aware of the reliability of the counter-party. Consequently, the attempt to tax them in the same way as independent companies would be taxed for comparable transactions, would leave them with a higher tax burden.[155]

Furthermore, *Nicolaides* points out that tax rulings would not be automatic, rather companies would have to seek a tax ruling. Companies would do so in order to avoid later disputes about the real tax liability. To give a metaphoric idea, he states that a "tax ruling is like an insurance. You buy it, if you believe you will be better off. […] But it is possible to say with a high degree of certainty that a company will not accept a tax ruling that results in the same tax liability as that which it would incur if the ordinary tax system would apply with proxy prices, as the Commission demands."[156] This argument derives from the view that tax rulings are the only means of a State to avoid profit shifting meaning that if it was not for the tax ruling the multinational companies could exploit their corporate structure and lower their tax liability by (legally) shifting profits to tax havens. Therefore, if it was not for the tax rulings, the company's tax liability would be much lower and the only incentive for them to enter a tax ruling would be avoiding the costs of future disputes about the tax liability. This in turn would mean that each company would have its own understanding of the tax ruling's intrinsic value, that is the cost of a possible dispute about the tax liability. In short: only if the additional tax liability

[155] *Higinbotham/Levey*, Intertax, 8-9/1998, p. 235, 235 – 236; also cf. *Nicolaides*, EStAL, 3/2016, p. 416, 422.
[156] *Nicolaides*, EStAL, 3/2016, p. 416, 424.

deriving from a tax ruling is lower than the estimated costs of a possible legal dispute about the normally due tax, companies would accept the ruling like an insurance against the dispute.[157]

5.2.3.2. Insufficiency and Invalidity of Economic Arguments

The economic arguments brought forward in support of the view that integrated and independent companies are not in a similar legal and factual situation are not as sound as they might seem. For instance, the problem with the economic effect of 'double marginalisation' highly depends on the market situation and is, thus, not a sufficiently general argument.

When economists speak of 'double marginalisation' they refer to a pricing phenomenon according to which a vertically integrated monopoly may lead to lower prices (more public welfare) than two or more independent monopolies along a supply chain. Under certain conditions, it could therefore be more reasonable to integrate vertically, because sometimes a vertically integrated monopoly can charge lower prices but still be more profitable.[158]

However, which part of the supply chain should charge which prices mainly depends on the market power of each link in the supply chain on its market. If both manufacturer and retailer have a monopoly in their respective market and both decide to merge in order to avoid double marginalisation, one could indeed expect lower prices of the product. Moreover, not only in its pure assumption of a monopolistic position of both companies, the phenomenon of double marginalisation arises on all markets in which both chain links have some market power, which is why integrated companies may be able to be more profitable.

Nevertheless, the double marginalisation effect becomes less effective the more uncertainty and competition there is within these two markets. Therefore, it is not possible to claim that double marginalisation happens in all integrated supply chains. It is not a general principle of pricing or a fact that integrated companies can always produce at lower cost compared to independent companies.[159] Consequently, one cannot conclude that selling at a price below the market price is always rational for integrated companies within a supply chain.

Furthermore, the fact that in this or that case a subsidiary may be able to produce at lower costs than any other third-party competitor does not reveal a substantial difference between group companies and independent companies. Rather, this may be true only in individual cases. However, whenever such case arises the arm's length principle including the five adequate

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[157] Ibid.
[158] Cf. *Motta, Massimo*, Competition Policy - Theory and Practice (2004), p. 307 et seq.
[159] *Motta,* Competition Policy (2004), p. 307 – 309.

transfer pricing methods as proposed by the OECD are flexible enough to deal with it, because it seems that this is actually a problem of which transfer pricing method to choose.

The fact that a subsidiary is able to produce at lower cost compared to third-parties may indicate that a transfer pricing method using the costs and expenses as profit level indicator (e.g. Cost-Plus method) may be preferable to methods that compare the transaction with independent third-party transactions (e.g. CUP-method). This line of argumentation shall be made more tangible with the help of an example:

> *High Tax Production Site* GmbH is a company that is tax resident in a high tax country and that produces lawn mowers. It belongs to *LawnMowerInternational (LMI)*, which is an international company group that has another affiliate in a low tax country, *Low Tax Distributor* Ltd.
>
> A comparable third-party lawn mower distributor pays a wholesale price of EUR 150,00 for each lawn mower (market price). Since it is *LMI*'s goal to minimise its tax liability, it sets the transfer price between its two affiliates to the production costs of EUR 100,00, and as such below the price a third party would have paid. With this transfer price it avoids shifting the re-sale profits *Low Tax Distributor* Ltd. makes from selling the lawn mowers to the *High Tax Production Site* GmbH where it would be subject to higher taxation.
>
> Whether in this constellation a transfer price of EUR 100,00 is justified form an arm's length perspective is subject to individual variables. It might be the case that due to the specific market structure and the effect of double marginalisation or that due to the transfer price range of ambiguity the said price is justified. It might as well be not the case. Eventually, one cannot assume – like the authors mentioned above seem to do – that these considerations are universally valid and hold true for every individual case, since the individual variables of each case may change the whole picture.
>
> On the contrary, these individual parameters are to be taken into account when it comes to the choice of the profit level indicator and the most adequate transfer pricing method. Consequently, neither the effect of double marginalisation nor the transfer price range of ambiguity reveal flaws in the arm's length principle that would preclude it from application to integrated companies.

In addition to that, whatever is economically rational does not necessarily mean that it is also legally relevant. It is also worth noting that a tax ruling is not a gamble where a company chooses how it is better off. In my understanding and as I will show later,[160] the goal of a tax ruling is the endorsement of a method that will result in a taxable base by a competent tax administration.[161] Applying the ordinary rules of taxation only makes sense if it is applied to this corrected taxable base.

Furthermore, I am of the opinion that at this detailed level of law any economic arguments should not be able to overturn binding law. Economic rationality may be a guidance for the legislator to pass rational and sensible law or for the tax authority to choose the most adequate parameters for the transfer pricing method, therefore always only when it comes to make the best of the future law (*de lege ferenda*). However, once a legal act is in force, it necessarily must trump economic rationality and its validity can only be challenged on legal grounds (*de lege lata*). Therefore, I find that the discussion about whether integrated and independent companies are in a similar legal and factual situation may be enriched by economic reason but should eventually be decided on legal grounds. I will continue to show that they are comparable from a legal point of view.

At this stage of the thesis, it is sufficient to conclude that even if transfer pricing methods that are in line with the arm's length principle do not necessarily reflect the commercial or economic reality, the ECJ still considers them to lead to an appropriate taxable base.[162] This is, because eventually they prevent an arbitrary treatment of taxpayers by endorsing methods that at least approximate the economic truth in an objective way.[163] With that one can ensure that the prices and, connected therewith, the tax liability are not set by a company manager to the sole profit of the multinational.

5.2.3.3. Legal Arguments against Comparability

As a negative argument against the similar treatment of integrated and independent companies, it was brought forward that this would contradict factual reality. Not only the mere fact, that one of them is part of a group while the other is not, indicated a difference between the two, but it would also be undisputed that tax authorities cannot revise normal business decisions of

[160] See Point 1.2., p. 11 et seq.
[161] *Rossi-Maccanico*, EStAL, 3/2015, p. 371, 373.
[162] *Rossi-Maccanico*, EStAL, 3/2015, p. 371, 374.
[163] For instance, with respect to economies of scale: they cannot be allocated within a group company following objective criteria, cf. OECD TP Guidelines (2017), p. 36 (Chapter I, Part I B., para. 1.10).

independent companies, "even if they lead to more/less profit than a 'better' businessman would make".[164] Furthermore, tax law would clearly distinguish between stand-alone companies and integrated companies when it stipulates special provisions for them, for example limitation of the deductibility of intra-group borrowing cost.[165]

Jaeger makes a similar argument, however, does not provide any additional reasons for this claim. With reference to the *Gibraltar* decision,[166] he states: "Unlike the distinction between onshore and offshore, a distinction between companies which operate in a transfer pricing setting and companies which do not seems sensible – economically and tax-wise."[167]

Another argument that was brought forward stresses the fact that transfer pricing rules can only be applied to multinationals.[168] Without this given legal prerequisite, the transfer pricing rules do not make any sense, which is why, in such questions, the treatment of one multinational should be compared to the treatment of another multinational. Consequently, multinationals "are specific species which share peculiar legal and factual characteristics which are not shared by other undertakings operating within a jurisdiction. Therefore, when it comes to the application of cross-border transfer pricing rules, multinationals should be segregated as a separate category and the assessment as to whether there is selectivity must be done within the context of that category."[169] This would mean that the treatment of multinationals must be compared to the treatment other multinationals receive instead of comparing that to the tax liability of every other company.

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[164] *Luja, Raymond*, State Aid Benchmarking and Tax Rulings: Can We Keep It Simple?, in: *Richelle/Schön/Traversa* (Edit.), State Aid Law and Business Taxation (2016), p. 111, 114 et seq.

[165] *Luja*, in: *da Cruz-Vilaça/Moniz/Vasconcelos/Saavedra* (Edit.), Taxation, State Aid and Distortions of Competition - Fiscalité, Aides d'État et Distortions de la Concurrence - Steuern, staatliche Beihilfen und Wettbewerbsverzerrungen, p. 53, 76 et seq. A prominent example to come is the interest limitation rule in Art. 4 *Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market (ATAD)*, as amended by Council Directive (EU) 2017/952, OJ 2016/L 193/1.

[166] ECJ on the 15.11.2011, Joined Cases C-106/09 P and C-107/09 P, Commission and Kingdom of Spain v Government of Gibraltar and United Kingdom of Great Britain and Northern Ireland, Reports of Cases 2011 I-11113, ECLI:EU:C:2011:732.

[167] *Jaeger*, JECL, 4/2017, p. 221, 226.

[168] In her argument, *Gormsen* only mentions multinationals. The applicability of transfer pricing rules, however, can also be of interest for purely national company groups, for example to shift profits in a way that allows the deduction of prior losses. Nevertheless, in this thesis, I will usually refer to multinationals only.

[169] *Gormsen, Liza L.*, EU State Aid Law and Transfer Pricing: A Critical Introduction to a New Saga, JECL, 6/2016, p. 369, 377.

5.2.3.4. Legal Argument in Favour of Comparability: Legal Form is not an Obstacle to Comparability

Since the ECJ has never given concrete guidance whether integrated or non-integrated companies are in a similar factual and legal situation, a solution could be to draw conclusions from what it found in other cases. It could be fruitful to consider the different judgements in the proceedings of the *World Duty Free/Spanish Goodwill* case, especially the comparison between what the GC had ruled and how this was turned over by the ECJ.

The Spanish tax law had stipulated a provision for a special goodwill deduction. In detail, when a company that had been subject to Spanish corporation tax had acquired a shareholding of a foreign company equal to at least 5% of that company's capital and held it for at least one year, the Spanish parent company could deduct the goodwill from its own profits.[170]

The COM found this to be a selective treatment, because it would favour companies performing multinational operations that had the capacity to determine a foreign companies fair market value. Furthermore, it would only be applicable to Spanish tax subjects with already existing business in Spain.[171]

The GC overrode this finding stating that, given the circumstance that there was no minimum shareholding threshold, the acquisition of a foreign company share was a purely financial operation and as such *a priori* open to every undertaking regardless of the nature of the activity of this undertaking. Therefore, this measure would not be selective.[172]

The ECJ, however, then again overrode the findings of the GC. The measure was considered selective, because it was not open to Spanish companies that acquired a shareholding of another *Spanish* company, but only to Spanish companies that acquired a shareholding of a foreign company.[173]

Interesting for the question whether integrated and stand-alone companies are in a similar legal and factual situation is another remark of the ECJ given with respect to the findings of the GC. "[… T]he potentially selective nature of the measure at issue is in no way called into question by the fact that the essential condition for obtaining the tax advantage conferred by that measure

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[170] For more details, cf. European Commission on the 28.10.2009, SA.22309 (C 45/2007)(ex NN51/2007, ex CP9/2007), Spanish Goodwill, OJ 2011/ L 7/48, para. 21.

[171] European Commission (*Spanish Goodwill*), para. 70 – 71.

[172] GC on the 07.11.2014, T-219/10, Autogrill España SA v Commission (Spanish Goodwill), published in the electronic Reports of Cases, ECLI:EU:T:2014:939, para. 56 – 61.

[173] ECJ on the 21.12.2016, C-20/15 P, European Commission v World Duty Free Group SA [former Autogrill España] and Others, published in the electronic Reports of Cases, ECLI:EU:C:2016:981, para. 92.

is that there should be an economic transaction, more particularly an 'entirely financial' transaction, for which no minimum investment is required and which is available regardless of the nature of the business of the recipient undertakings."[174] It is worth noting, that mentioning the minimum threshold and the business nature do not add a condition that narrows this statement, but rather widens its general meaning by setting the bottom line of selectivity for this case. In other words, the ECJ basically said that *even if* the beneficial tax measure does not require a minimum investment and *even if* it is available regardless of the nature of the business of the recipient undertakings, it does not necessarily preclude that it is eventually selective.[175]

If one inverts the idea of this statement, it becomes clear that for the assessment of selectivity in tax purposes it is *prima facie* irrelevant if a company has acquired (parts of) another company or not. This *prima facie* assumption only changes, if additional factors are added to this assumption.

However, having acquired (parts of) another company cannot be different to having set up an affiliate, because eventually it leads to the same effect, which is that a company owns (parts of) another company. It follows from the statement above that as long as there are no additional distinguishing factors, integrated (group-) companies and independent stand-alone companies are *prima facie* in a similar legal and factual situation until proven different.

For the arguments brought forward concerning the comparability of (multinational) group companies and stand-alone companies, this means that the mere fact that one is part of a group and the other is not may not be a sufficient argument by itself to negate the comparability of them. It would need additional arguments to substantiate this claim. In the same way, the opposite claim, which is that they are comparable, needs further elaboration as well. In other words, I find that the legal structure or form of a company alone is neither proof for a difference between integrated and independent companies, nor is it an obstacle to find they are comparable.

It follows from this that for the definition of the reference framework, one cannot only confine oneself to the argument that multinationals are group companies and must therefore be measured against the treatment of other group companies. The reference framework is to be set by additional factors – one could say 'outside factors', which I will explore in the next Sub-Point.

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[174] ECJ (*World Duty Free/Spanish Goodwill*), para. 81.

[175] This is indicated by the wording of para. 81 of the verdict and the use of an indefinite relative clause, which is used to add additional information, not to narrow the term it refers back to.

5.2.3.5. Legal Argument in Favour of Comparability: Objective of Tax Law hints at Comparability

Another argument can be found by taking a closer look at the objectives of the legal provisions. I will demonstrate that both the objective of competition law as well as the objective of tax law require that integrated and independent companies are considered to be in a similar legal and factual situation. This is an important benchmark, since the ECJ has held that "[t]he elements which characterise different situations, and hence their comparability, must in particular be determined and assessed in the light of the subject-matter and purpose of the Community act which makes the distinction in question. The principles and objectives of the field to which the act relates must also be taken into account […]."[176] The solution for the question whether integrated and independent companies are in a similar legal and factual situation, therefore, might lie in the objective of the applied law.

The COM considers integrated and non-integrated companies to be in a similar legal and factual situation. Everything else would be an artificial distinction on the grounds of their corporation structure.[177] In its initial Draft Notice on the Notion of State Aid, the COM was still quite clear that, generally, all companies with an income are considered to be in a similar legal and factual situation from the perspective of direct company taxation.[178] Even though this clear statement was lost in the course of passing the Notice, the COM's stance on this has not changed. This becomes visible if one looks at the recent decision practice.

In the *Apple* decision, for instance, the COM elaborates which benchmark it takes to determine whether companies are in a factually and legally comparable situation or not. First it interprets the objective of the Irish tax regime as taxing all companies that fall under its scope of application.[179] The critical point is that, usually, the tax system taxes all companies regardless of their corporation structure:

"The Irish corporate tax system does not distinguish between companies which derive their profit from market transactions only, such as non-integrated standalone companies, and companies which derive their profit through internal dealings between companies of the same

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[176] ECJ on the 16.12.2008, C-127/07, Société Arcelor Atlantique et Lorraine and Others v Premier ministre, Ministre de l'Écologie et du Développement durable and Ministre de l'Économie, des Finances et de l'Industrie, Reports of Cases 2008 I-09895, ECLI:EU:C:2008:728, para. 26.

[177] European Commission (*Fiat*), para. 213.

[178] *Draft Commission Notice on the Notion of State Aid*, available online at http://ec.europa.eu/competition/consultations/2014_state_aid_notion/draft_guidance_en.pdf, f n. 195.

[179] European Commission (*Apple*), para. 228; with reference to ECJ (*Paint Graphos et al*), para. 50.

corporate group or between parts of the same company, such as integrated companies. Both types of companies are subject to corporation tax on their taxable profit at the standard corporate tax rate under the ordinary rules of taxation of corporate profit in Ireland. Thus, non-integrated and integrated companies subject to tax in Ireland should be considered to be in a comparable factual and legal situation as regards those rules."[180]

The COM's approach in this matter is compliant with the settled case law of the ECJ.[181] For example, in the *3M Italia* decision, the ECJ stated that the 'normal' tax regime is defined by the light of the objective assigned to the tax system of the Member State concerned. A measure, therefore, may be selective, if it deviates from the normal tax regime by treating economic operators differently, even though they are, in the light of the objective of the tax system, in a comparable factual and legal situation.[182] Further, the Court has held in the *Gibraltar* decision, that the objective of its (corporate) tax system is the taxation of all undertakings established in Gibraltar,[183] which was later affirmed in the *World Duty Free* decision.[184]

One has to bear in mind, that this case law deals with general tax regimes that are selective, because they confer an advantage to a certain group of undertakings (e.g. to offshore companies in the *Gibraltar* decision). However, while the Court has not explicitly affirmed the comparability between integrated and independent companies, it did so implicitly as a closer look at the case reveals.

A general measure is by its nature drafted in a way, that, theoretically, it is open to every undertaking. Nevertheless, such measure can be considered selective, if it favours certain undertakings due to their specific features or properties.[185] From this statement, in which the ECJ distinguishes between undertakings that benefit due to specific properties and undertakings that cannot benefit from a favourable treatment, one can deduce that the ECJ considers all undertakings subject to general taxation in a factually and legally comparable situation, because otherwise there would be no reason to condemn a general measure as being (unlawfully) selective. In other words, it is a legally desirable situation that the general tax system treats all undertakings in the same way regardless of their specific features or properties, which implies

[180] European Commission (*Apple*), para. 229.
[181] *Jochimsen, Claus/Kleve, Guido*, Steuerpraktiken und das Verbot unzulässiger Beihilfen - merkliche Zuspitzung einer komplexen Fragestellung, IStR, 7/2017, p. 265, 269 – 270.
[182] ECJ (*3M Italia SpA*), para. 49; cf. also *Micheau*, E.L. Rev., 3/2015, p. 323, 335.
[183] ECJ (*Gibraltar*), para. 101.
[184] ECJ (*World Duty Free/Spanish Goodwill*), para. 73 – 74.
[185] ECJ (*World Duty Free/Spanish Goodwill*), para. 74.

that independent as well as internationally or nationally integrated companies are in a factually and legally comparable situation.

This point of view cannot be challenged by the argument that tax authorities usually do not have the competence to revise normal business decisions or that group companies face special tax provisions, which would, therefore, make integrated and independent companies not comparable. Indeed, this may even indicate the contrary.

The fact, that tax authorities are under certain circumstances able to second-guess intra-group transactions by adjusting the transfer price,[186] leads to the question, why a legislator would equip them with such competence. A possible answer may be, that the legislator assumes competition would regulate the normal business activity between independent companies, while integrated companies lack this competitive corrective. And yet, usually, it is in the legislator's interest that their profit is subject to taxation in the same way that the profit of an independent company is, which is why tax authorities are legally competent – if certain requirements are met – to revise manipulative intra-group transactions and, by doing so, adjust the taxable basis of the intragroup company.

The same holds true for other special provisions applying to group companies only. The fact that there are special intra-group deduction provisions is an indication that tax law *considers* them comparable to each other otherwise such alignment would be contradictory. In the end, these deduction rules stem from the possibility a stand-alone company has when it deducts its losses from its profits.[187]

However, from these differences in tax law it was deduced that independent and integrated companies are *not* in a comparable situation, even though this would not mean the reference system should be limited to integrated companies only.[188] This opinion differs from the one argued here only in terminology but is nevertheless erroneous, since it mixes the differences in

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[186] Art. 9 *OECD Model Tax Convention*.

[187] A counter-argument, according to which an interest limitation rule like in Art 4 ATAD would only be applicable to integrated companies and would not stem from similar provisions for stand-alone companies, would seem rather artificial given that it is indeed only targeted at artificial arrangements and only applicable for interest payments over EUR 3 mio. per year and only if the interest payment exceeds 30 % of the tax payers EBITDA. A simulation of its impact in Austria resulted in a figure of 0.4% of the companies which will be affected; *Chroustovsky, Stefanie/Petutschnig, Matthias*, Was bringt die EU-Zinsschranke? - Eine Simulation der Umsetzung von Art 4 der EU-Anti-Tax-Avoidance-Directive in Österreich, ÖStZ, 18/2017, p. 477. Most of the integrated companies therefore fall outside of its scope.

[188] *Luja*, in: *da Cruz-Vilaça/Moniz/Vasconcelos/Saavedra* (Edit.), Taxation, State Aid and Distortions of Competition - Fiscalité, Aides d'État et Distortions de la Concurrence - Steuern, staatliche Beihilfen und Wettbewerbsverzerrungen, p. 53, 78.

treatment (specific rules for integrated companies, such as intra-group loss deduction, documentation of transfer prices etc.) with the differences in essence. If there were essential differences between them, there would not be the need to have special rules for integrated companies that lead to an alignment with the situation independent companies are in.

Therefore, it could be concluded from the ECJ's case law, that integrated and independent companies are in a legally and factually comparable situation. This derives mainly from the fact that, outside of special provisions, the tax system itself does not differentiate between the undertakings.[189]

However, while it seems relatively clear what conception the ECJ has is in this matter, there could be a causal problem if one relies solely on this argument. This causal problem could be described in a hen-or-egg-question: Is it the fact that all companies are in a similar legal and factual situation that defines the objective of the tax law or is it the objective of the tax law that makes us consider them being comparable? In other words: Did the legislator decide to tax all companies in the same way, because they had been the same before, or does the fact that the tax law does not differentiate between them mean that they became the same upon introducing the tax law.

To answer this question, one has to depart from the idea that the legal personality of a company[190] is a given. Rather, the foundation of a company separates the undertaking from its founder to make it an own legal entity, which derives from the principle of separation and which is undoubtedly respected by tax law. It follows from this, that the ownership of a legal entity must be strictly separated from the legal entity itself. In this sense, for logical reasons, it cannot make a difference whether a company is owned by a natural person or another parent company.

Thus, since the ordinary rules of taxation respect the principle of separation between owner and company they also do not differentiate between companies owned by a natural person and companies owned by a parent company. The answer to the said question, therefore, is that the objective of the ordinary rules of taxation capture all companies so that they are in a similar legal and factual situation.

[189] Cf. *Lyal*, FILJ, 38/2015, p. 1017, 1032.

[190] In this sense, I consider 'companies' to have legal capacity and, therefore, use this term as synonym for 'legal entitiy'. The taxable treatment of partnership companies that do not have legal personality is a completely different and not subject to this paper.

All in all, it becomes clear that tax law strongly hints towards the comparability of integrated and independent companies. The argument is not crystal-clear, however. For example, the legislator's intent to tax all companies equally might not always be given. Especially in the course of the (unfair) tax competition some countries deliberately offered beneficial tax treatments to attract foreign multinational companies, a good example of which is Ireland. Nevertheless, those practices are currently under State aid scrutiny. Arguing that the comparability is not given because of a fact that is the subject of the question whether it is given or not would be circular. Furthermore, due to the fact that base erosion and profit shifting can only happen in a cross-border situation, such special treatment normally serves to lure in foreign companies only and is not designed to benefit domestic company groups as well – otherwise the whole tax law would collapse if everyone could circumvent basic rules of corporate taxation by setting up an affiliate. Therefore, in almost all cases, tax law considers both types of companies comparable.

In any event, the claim that integrated and independent companies are in a similar factual and legal situation is not (only) decided by tax law, but also by the objective of State aid law. The next sub-Point will provide the missing bit for a consistent argumentation.

5.2.3.6. Legal Argument in Favour of Comparability: Objective of Competition Law makes Them comparable

The assumption that the ordinary rules of (corporate) taxation should serve as a reference system is not only indicated by the objective of tax law but also from the *ratio legis* of competition law. In this context, it was brought forward, that a reference system should be found with the help of a *tertium comparationis*, which should serve as a benchmark in determining whether companies are in a similar legal and factual situation.

The term *'tertium comparationis'* describes a quality that is common to two objects of comparison. *Lang* suggests that the *tertium comparationis* should be the objective of Art. 107 para. 1 TFEU. He states that it is not the objective of Art. 107 para. 1 TFEU to ensure equal treatment amongst all undertakings which are in a competitive relationship, but to prevent unequal treatment that may lead to a distortion of competition. It would follow from this that all undertakings in a competitive relationship are potentially in a legally and factually comparable situation. Whether this competitive relationship is strong enough to make them

indeed comparable should ultimately be decided by a judge.[191] „In both the factual as well as the legal aspect, the comparability is subject to an individual judgement – eventually by the ECJ."[192] Consequently, it should be up to the judge to determine the reference framework depending on his/her own evaluation on who is in a similar legal and factual situation.

In the context of fundamental freedoms and their objective of ensuring fair competition, it was brought forward that the comparability between multinational and purely domestically active companies should be *assumed* as a rule if they are linked by at least a certain degree of competition. Only if they do not compete with each other at all, the comparability between them should be negated. According to this approach, independent and integrated companies are nearly always in a comparable situation.[193] This approach is consistent with the internal market argument above because any act that does not have any impact on the cross-border trade between Member States falls outside the application of internal market rules. Parallelly, the impact on the trade between Member States for State aid matters is measured with the assessment whether other European companies could enter the market and compete with the beneficiary.[194] Therefore, purely domestic companies that do not compete against any multinational fall outside both internal market rules and the prohibition of State aid.

Naturally, such cases are extremely rare. This is mainly, because the distortion or threat of distortion of competition is traditionally a rather broad concept.[195] Contrary to other competition provisions, like Art. 101 and 102 TFEU, Art. 107 para. 1 TFEU and the ECJ's settled case law do not even require the COM to define the affected market. The ECJ accepts a fairly broad definition of that criterion and negates a distortion of competition only if it is inconceivable.[196] On the contrary, a distortion of competition is always present when the

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[191] *Lang, Michael*, State Aid and Taxation: Selectivity and Comparability Analysis, in: *Richelle/Schön/Traversa* (Edit.), State Aid Law and Business Taxation (2016), p. 27, 36; See also *Lang, Michael*, State Aid and Taxation: Recent Trends in the Case Law of the ECJ, EStAL, 4/2014, p. 411, 420.

[192] *Lang, Michael*, Die Rechtsprechung des EuGH zu den direkten Steuern - Welcher Spielraum bleibt den Mitgliedstaaten? (2007); translated by the Author. The original German text says: „Sowohl in faktischer als auch in rechtlicher Hinsicht bedarf die Vergleichbarkeit einer – letztlich vom EuGH zu treffenden – Wertentscheidung.".

[193] *Glahe*, EC Tax Rev., 5/2013, p. 222, 224 – 225 with reference to *Englisch, Joachim*, Taxation of Cross-Border Dividends and EC Fundamental Freedoms, Intertax, 4/2010, p. 197, 203.

[194] *Mestmäcker/Schweitzer*, Art. 107 Abs. [para.] 1 AEUV [TFEU], para. 317.

[195] *Derenne, Jacques/Verouden, Vincent*, Chapter 5 - Distortion of Competition and Effect on Trade, in: *Werner/Verouden* (Edit.), EU State Aid Control - Law and Economics (2017), p. 169, 170. This derives from the understanding that State aid law also protects the internal market, not only the competition between undertakings; see for that Point 1.1.5., p. 9.

[196] ECJ on the 03.03.2005, C-172/03, Heiser v FA Innsbruck, Reports of Cases 2005 I-01627, ECLI:EU:C:2005:130, para. 35. See also *Heidenhain,* European State Aid Law (2010), Chapter 2 § 4 – The Concept of State Aid, para. 72 – 73.

economic position of a beneficiary is strengthened irrespective of the extent of the advantage[197] so that one could say the distortion of competition is presumed when all other conditions of Art. 107 para. 1 TFEU are met.[198]

If the conferral of an advantage is enough to indicate the distortion of competition, then this criterion is fulfilled irrespective of the own corporate structure or the corporate structure of the competitor. A market specific impact assessment on whether only multinational competitors or only national competitors are affected is not necessary. Put the other way around, competition happens regularly between independent and integrated companies and does not halt at the corporate structure.

Since the goal of Art. 107 para. 1 TFEU is to ensure competition and since competition happens irrespective of how the competitors have structured their companies, one can infer that Art. 107 para. 1 TFEU does not distinguish between integrated and independent companies. If, furthermore, one understands State aid law as a tool to prevent a 'subsidy war' between Member States, this conclusion is equally valid, since any aid granted could provoke a reaction from other Member States. Consequently, both companies have to be measured by the same standards, which means that they are in a similar legal and factual situation from a State aid point of view.

5.2.4. Conclusion on the Reference System

Having argued that the comparability between integrated and independent companies is given, it can be concluded that the reference can only be the ordinary rules of taxation. Some contributors to the literature support the view that the ordinary rules of taxation should be held as the reference system. However, usually, this comes without any further elaboration of the legal background.

In the light of the argumentation above, group-companies and stand-alone companies are in a similar factual and legal situation, which is why it is according to the *ratio legis* of Art. 107 para. 1 TFEU crucial to ensure a level playing field for all undertakings. It follows from this that the reference framework for the assessment of selectivity must be a 'least common multiple'

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197 *Mestmäcker/Schweitzer*, Art. 107 Abs. [para.] 1 AEUV [TFEU], para. 307 with reference to further case law. The GC once stated "Where the benefit is limited, competition is distorted to a lesser extent, but it is still distorted.", GC on the 30.04.1998, Case T-214/95, Het Vlaamse Gewest (Flemish Region) v Commission of the European Communities, Report of Cases 1998 II-00717, ECLI:EU:T:1998:77, para. 46.

198 *Rapp/Ianus*, in: *da Cruz-Vilaça/Moniz/Vasconcelos/Saavedra* (Edit.), Taxation, State Aid and Distortions of Competition - Fiscalité, Aides d'État et Distortions de la Concurrence - Steuern, staatliche Beihilfen und Wettbewerbsverzerrungen, p. 101, 120.

of both requirements within the range of the jurisdiction's power. This least common multiple is naturally the corporate income tax regime, because its corresponding objective is the taxation of all undertakings. I, therefore, conclude that the ordinary rules of (corporate) taxation should necessarily be the reference framework when it comes to the assessment of the element of selectivity.

5.2.5. Deviation from Ordinary Rules of Taxation is Deviation from Arm's Length Principle

The previous sub-chapters have shown three things. First, the arm's length principle is not a method itself. Rather, it requires the application of transfer pricing methods correcting the taxable base in a way that the distorting effects of aggressive intra-group transactions are adjusted to what would have been the outcome in a competitive market. Second, integrated group companies are in a similar legal and factual situation compared to independent stand-alone companies, which, third, leads to the conclusion that the reference system in the selectivity assessment test must be the ordinary rules of taxation.

If all companies are in a similar legal and factual situation and if their treatment has to be compared to the stipulated treatment under the ordinary rules of taxation, which is the reference system, then it is obvious that all companies have to be assessed on equal grounds.

While the taxable base of independent stand-alone companies is subject to the corrective of a competitive market, the taxable base of integrated group companies must be adjusted with transfer pricing methods that are in line with the arm's length principle. Only with this adjustment one can reach the equal treatment that is required by the objective of both tax law (taxation of all companies) and competition law (ensuring a level playing field).

To ensure a fair taxation of multinationals, tax rulings can be an efficient tool. However, if a ruling does not endorse a transfer pricing method that is in line with the arm's length principle it leads to a shrinkage of the group company's taxable base and to a lowering of its corporation tax liability. This is, because in such case the normal tax rate would only be applied to a fraction of the (hypothetical) profit that should have been taxed. In this sense one can interchangeably say this constitutes a deviation from what the beneficiary *should have been taxed* and this is a deviation from what it *would have been taxed* if it had been an independent stand-alone company.

It follows from this that a deviation from the arm's length principle necessarily is a deviation from the ordinary rules of taxation. That also means that the tax rulings, therefore, must endorse a transfer pricing method that is in line with the arm's length principle in order to be compliant with the objective of the tax law and to comply with the prohibition of State aid.

5.3. Application of the Arm's Length Principle as a Breach of Principle of Legal Certainty?

Apart from the confusion about to which arm's length principle the COM has referred to (sub-chapter 5.1.) and whether the arm's length principle can serve as a reference framework for the three-step-test (sub-chapter 5.2.), the COM's decisions were also widely criticised for allegedly breaching the principle of legal certainty. In this sub-chapter I want to explore these claims.

I will argue that the arm's length principle is a well-established principle for profit allocation of multinationals when it comes to the power-to-tax and that it was expressly connected with the idea of State aid through beneficial tax measures.

5.3.1. General Remarks

According to *Ávila*, the three constitutive elements of the principle of legal certainty are knowability, reliability and calculability. Knowability means that norms are published, clearly written and interpreted according to an objective method, enabling the legal subjects to learn about and understand the law governing their affairs. Reliability means, that norms are not applied retroactively and a *res iudicata* is respected. Calculability means that one cannot only predict, but also calculate/predict future norms and decisions of Courts.[199]

In a similar manner, the ECJ stated that the principle of legal certainty "requires in particular that rules involving negative consequences for individuals should be clear and precise and their application predictable for those subject to them […]".[200]

The principle of legal certainty is general and, basically, also applies in the field of tax law.[201] Naturally, legal certainty is also an important principle in State aid law (cf. Art. 16 para. 1

[199] *Ávila, Humberto*, Certainty in Law (2016), p. 172 et seq. N.b. that this book was published with respect to the Brazilian Constitution, but mostly contains universally valid statements (cf. Dr. *Riccardo Guastini* in the Preface of the book, p. V stating "it is probably the most comprehensive and systematic study ever produced on this subject using the analytical method"). Naturally, my summary is far too narrow, but, for the sake of conciseness, cannot be extended in this thesis.

[200] ECJ on the 07.06.2005, C-17/03, Vereniging voor Energie, Milieu en Water and Others v Directeur van de Dienst uitvoering en toezicht energie (VEMW), Reports of Cases 2005 I-04983, ECLI:EU:C:2005:362, para. 80; with reference to more case law.

[201] *Ávila,* Certainty in Law (2016), p. 195.

Regulation No. 2015/1589), which is especially important, when it comes to the recovery of unlawful State aid.

In the European judicial practice, the Courts of the EU have connected the idea of legal certainty with the principle of good faith. For State aid purposes, this means that a beneficiary of an unlawful aid can only seek protection by legitimate expectation, if a 'prudent and well-informed' market participant could not have identified the measure as constituting unlawful State aid, which, according to settled case-law of the ECJ, may only be invoked in exceptional circumstances. Usually, a prudent and well-informed market participant may only expect the legitimacy of a granted aid, if it was duly notified to the COM.[202]

In any event, it was pointed out that in State aid proceedings, the protection of legitimate expectation can only be invoked if the behaviour of the COM itself had created this expectation in the first place. The acts of national authorities are not able generate it.[203]

When it comes to the cases above, one has to distinguish between two potential problems with legal certainty, addressing all three constituent elements of legal certainty. On the one hand, the COM's new approach challenges the legitimate expectation all tax payers may have concerning the *knowability* and the *reliability* of the tax rulings and the potential effects they have. On the other hand, it is the fact that the arm's length principle is not 'an exact science', which might cause problems with the requirement of *calculability* of legal actions and consequences, such es the recovery order. I will start discussing these issues with the allegation that the COM's new approach was unprecedented and, therefore, would breach the principle of legal certainty by being unforeseeable (Point 5.3.2.) and continue with the problems deriving from the calculation of the tax liability (Point 5.3.3.).

5.3.2. The Commission's New Approach is not Unprecedented

5.3.2.1. Predictability of the Arm's Length Principle

As I have already mentioned earlier in this thesis, *Gonzales* pointed out that it is a contradictory approach when the COM promotes tax rulings as being a tool to ensure legal certainty in tax

[202] ECJ on the 20.09.1990, C-5/89, Commission of the European Communities v Federal Republic of Germany, Reports of Cases 1990 I-03437, ECLI:EU:C:1990:320, para. 14. Also cf. *Gormsen, Liza L./Mifsud-Bonnici, Clement*, Legitimate Expectation of Consistent Interpretation of EU State Aid Law: Recovery in State Aid Cases Involving Advanced Pricing Agreements on Tax, JECL, 7/2017, p. 423, 426.

[203] *Rossi-Maccanico*, EStAL, 3/2015, p. 371, 377. See also ECJ on the 30.06.2016, C-270/15 P, Kingdom of Belgium v European Commission, published in the electronic Reports of Cases, ECLI:EU:C:2016:489, para. 147; *Rapp/Ianus*, in: *da Cruz-Vilaça/Moniz/Vasconcelos/Saavedra* (Edit.), Taxation, State Aid and Distortions of Competition - Fiscalité, Aides d'État et Distortions de la Concurrence - Steuern, staatliche Beihilfen und Wettbewerbsverzerrungen, p. 101, 137.

matters and then, on the other hand, scrutinizes them for compliance with the ordinary rules of taxation. [204] A high ranking *Apple* representative criticised the seemingly unrestricted retroactive application of the arm's length principle in the *Apple* case, even though in the *Forum 187* decision, which is the only ECJ judgement the COM referred to, the ECJ had been ruling in the context of a tax regime familiar with the arm's length principle.[205]

On the other hand, some pointed out that the COM had started looking at tax rulings as early as in the 1990ies. Today's decisions in this matter would just be a "further step in a long development of case law and decision-making practice".[206]

In order to test these claims, I will take a look into former attempts to fight harmful tax competition. This will reveal that the application of the arm's length principle was not so unforeseeable as some claim.

5.3.2.2. The Code of Conduct and State aid as Enforcement Tool

On 01.12.1997, the Council of Economics and Finance Ministers (ECOFIN) passed the so-called Code of Conduct for Business Taxation.[207] While this was not meant to be a legally binding agreement, it nevertheless is considered to constitute a political commitment of the Member States. Some pointed out that the magnitude of its effectiveness would depend on the parties' political will. Apart from that it would neither constitute rights nor obligations, which would make it more of a *gentlemen's agreement*.[208] Others saw its political power in the fact that the COM's main argument of avoiding harmful tax competition could not really be challenged publicly.[209] Nevertheless, even if it remains a voluntary political agreement between the Council and the Commission, the Code of Conduct has proven to have great political power. This is mainly due to several specialities, like the intertwinement with hard State aid law and the parallelism to the OECD Guidelines.[210]

In the Code of Conduct for Business Taxation, the Member States committed themselves to a stand-still obligation, meaning that they should refrain from passing new harmful taxation, and

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[204] *Gonzales*, EStAL, 4/2016, p. 556, 563.
[205] *Sewell, Bruce*, Editorial: In Need of an Economic Reality Check - The Commission's State Aid Decision Regarding Ireland and Apple, JECL, 10/2016, p. 649, 650.
[206] *Lyal*, FILJ, 38/2015, p. 1017, 1018.
[207] *Conclusions of the ECOFIN Council Meeting on 1 December 1997 concerning taxation policy*, OJ 1998/C 2/1; hereinafter referred to as 'Code of Conduct' or 'Code of Conduct for Direct Business Taxation'.
[208] *Lambert, Thierry*, Marché intérieur et évasion fiscale, Petites Affiches, 97/2002, p. 34, II.A.
[209] *Pîrvu, Daniela*, Corporate Income Tax Harmonization in the European Union (2014), p. 40.
[210] *Santos, António C.d.*, L'Union européenne et la régulation de la concurrence fiscale (2009), p. 258 – 259; with further reasons for the efficacy of the Code of Conduct.

to a roll-back of existing, potentially harmful tax provisions (lit. C and D). They set the parameters which should be part of the assessment whether a tax measure was harmful or not (lit. B) and established a review process (lit. E – I).

For this thesis and the problem of legal certainty concerning the application of transfer pricing rules in line with the arm's length principle, there are two interesting points in the Code of Conduct for Business.

First, in lit. B the Code of Conduct defines the criteria with the help of which harmful tax measures should be identified. It states that "[w]hen assessing whether such measures are harmful, account should be taken of, *inter alia*: […] 4. whether the rules of profit determination in respect of activities within a multinational group of companies departs from internationally accepted principles, notably the rules agreed upon within the OECD […]".

Second, in lit. J the Council expressly notes that "some of the tax measures covered by this code may fall within the scope of the provisions on State aid […] The Commission […] commits itself to the strict application of the aid rules concerned, taking into account, inter alia, the negative effects of aid that are brought to light in the application of this code. […]".

In order to determine which tax measures lead to harmful tax competition, the Code of Conduct established a Code of Conduct Group under the Chairwoman and then-Paymaster General of the UK, Dawn Primarolo, which consisted of representatives of all Member States and whose task was to review a list of potentially harmful tax measures. The results were presented to the Council on 23.11.1999.[211] Interestingly, the Report explained in para. 41 that tax measures concerning the transfer pricing of intra group services were reviewed with the OECD arm's length principle as internationally accepted standard for transfer pricing.[212]

Additionally to the aforementioned, in lit. J concerning State aid, the Code of Conduct for Business Taxation also announces the publication of guidelines by mid-1998.[213] It is not a coincidence that these two soft-law instruments are connected to each other. Both are set up together as an intertwinement of a legal enforcement instrument (State aid) and a political agreement (Code of Conduct).[214] However, it is also worth noting, that State aid cannot cover

[211] The so-called 'Primarolo-Report' is online available at https://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/primarolo_en.pdf. Last checked on 24.07.2018.
[212] It is worth noting, that the Irish delegation did not object to this.
[213] *Commission Notice on the application of the State aid rules to measures relating to direct business taxation*, OJ 1998/C 384/3.
[214] *Traversa/Flamini*, EStAL, 3/2015, p. 323, 326.

all aspects of the Code of Conduct for Business Taxation. State aid measures are an instrument constituted by the Treaties and, therefore, have to respect their scope. In such cases, the enforcement of the Code of Conduct for Business Taxation has to happen within the review mechanism as the then-Commissioner *Monti* pointed out.[215]

It comes from this intertwinement that both the Code of Conduct and the Notice on Direct Business Taxation have to be read together. As I mentioned earlier already, the Code of Conduct takes into consideration whether tax measures comply with rules agreed upon within the OECD when assessing the harmfulness of such tax measures. This aspect concerns the determination of profits of integrated group companies with intra-group activity. In the same way, the Notice establishes a very broad definition of the element of selectivity and states in para. 20 that "[s]ome benefits are on occasion restricted to certain types of undertaking, to some of their functions (intra-group services, intermediation or coordination) or to the production of certain goods. In so far as they favour certain undertakings or the production of certain goods, they may constitute State aid […]". This reflected almost completely the case law of that time and affirmed a broad interpretation of the element of selectivity.[216]

This is not a biased reading *ex post*. Rather, the contemporary literature already acknowledges the intertwinement of these two soft-law measures and that transfer prices departing from consensually agreed upon OECD rules, namely the arm's length principle, are critical from a State aid point of view. To be fair, though, one has to try to get the full picture from this time. It seems as if lawyers just did not make the link between the obvious.

On the one hand, for example, in the discussion about the Code of Conduct of Business Taxation, an article from a practitioner mentions that the Irish tax system could produce an outcome that is not compatible with State aid if it significantly lowered the effective rate of taxation of Irish-incorporated-non-resident companies than the rate *generally applying* in Ireland.[217] On the other hand, the same article goes on later by stating: "[… M]any U.S. corporations typically set up their Irish manufacturing operations using an IRNR [Irish-incorporated-non-resident company] managed and controlled either in a tax haven country or in the United States.[…] Such an arrangement allows Ireland to tax only income connected with the Irish branch.[…] This leaves the surplus *cash free* to be transferred to the head office, based either in a tax haven

215 *Monti, Mario*, Editorial: How state aid affects tax competition, EC Tax Rev., 4/1999, p. 208, 210.
216 *Visser, Klaas-Jan*, Commission expresses its view on the relation between state aid and tax measures, EC Tax Rev., 4/1999, p. 224, 227; with reference to ECJ case law of that time in Fn. 37.
217 *McHugh*, BJIL2001, p. 1207, 1234 (including Fn. 184.).

country or the United States, from where it can be invested *free of Irish tax*."[218] The article's criticism on such corporate practice and the Irish tax law allowing for that confines itself to pointing out the damage this causes to the Irish reputation. It does not, however, touch on the State aid issue which can arise from a 'significant lowering of the effective tax rate' and which it has mentioned ten pages earlier. But what else can be a more obvious 'significant lowering of the effective tax rate' than having parts of the profit tax free?

Ireland's beneficial loophole is only one example of many. In these times, due to the ongoing tax competition, there were some very famous and beneficial loopholes in other Member States that are now under scrutiny, like for example the Belgian coordination centre exemptions.[219]

5.3.2.3. Conclusion: Indicators signalled the Use of the Arm's Length Principle

From what was mentioned above, one could have guessed that these practices are harmful and could probably become the subject of State aid investigation. This is mainly because the arm's length principle as a benchmark for determining a harmful tax measure was part of the discussion about aggressive tax competition from the very beginning. One could argue that this, in connection with the COM's *Notice on the Application of State Aid in Direct Business Taxation*, did give enough hints to future problems with tax provisions in favour of multinationals.

Consequently, from a purely legal point of view, it is questionable whether the use of the arm's length principle as a benchmark for the assessment of transfer pricing methods came out of the blue. It seems to me, that lawyers and practitioners were well aware of this possibility or simply did not made the obvious connection.

5.3.3. The Arm's Length Principle is not an Exact Science

The second problem with the principle of Legal Certainty is that the arm's length principle is not an exact science. Since usually tax payers have to suggest a transfer pricing method, there will always be uncertainty about which transfer price is adequate. This is especially critical, because one cannot follow a previously determined scheme that would automatically lead to an arm's length price resembling a market-based outcome.

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[218] *McHugh*, BJIL2001, p. 1207, 1244 (emphasis added). US-companies are subject to income tax on their global income, but only on repatriation. The construction *McHugh* talks about uses Irish-non-resident-companies that are controlled from the USA (or a tax haven). The Irish Revenue would exempt the said surplus from taxation while the USA would defer taxation until its repatriation. If this money is never repatriated, it remains untaxed.

[219] For more examples, cf. the list in *Williams, David W.*, EC Tax Law (1998), p. 170 – 171.

For the current State aid cases, *Gormsen* criticises that the COM interpreted the OECD TP Guidelines very rigidly. While the arm's length principle would aim at *estimating and approximating* a market-based outcome, the COM would demand a precise result. Generally, the application of the arm's length principle to tax rulings itself would cause less problems with legal certainty than the COM's strict interpretation of it.[220]

Furthermore, *Rossi-Maccanico*, himself a legal counsellor of the COM, stated that in reality, integrated companies would of course not act as if they were independent from their related companies. The solution would lie in the discretional power of the tax authorities, which would allow an adjustment to the economic reality.[221]

With all these opinions it becomes evident that there is a broad consensus. It is undisputed that it is not possible to precisely calculate the taxable outcome of an integrated company that it would have had under the conditions of free competition. Furthermore, *ex ante* assumptions can be different when looked at *ex post*.[222] There can only be a reliable approximation to what the outcome would most likely have been. Even the ECJ only requires a method that 'resembles' the prices which would be charged in conditions of free competition.[223] The COM states in the Notice on the Notion of State Aid that "[t]he search for a 'reliable approximation of a market-based outcome' means that any deviation from the best estimate of a market-based outcome must be limited and proportionate to the uncertainty inherent in the transfer pricing method chosen or the statistical tools employed for that approximation exercise."[224] In a working paper of the DG Competition, the estimative nature of the arm's length principle is met by the vow to focus only on *manifest* breaches of the arm's length principle.[225]

It follows from this, that both the COM and the ECJ are well aware of the problem that the calculation of a fictional tax basis for incorporated companies is always an either good or bad approximation, which naturally leaves room for substantiated deviation due to the given uncertainty. Also, the COM has already clarified that the transfer pricing methods of the OECD TP Guidelines will be accepted, which leaves the Member States with the choice of whatever

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[220] *Gormsen*, JECL, 6/2016, p. 369, 370.

[221] *Rossi-Maccanico*, EStAL, 3/2015, p. 371. 374.

[222] *Luja*, in: *da Cruz-Vilaça/Moniz/Vasconcelos/Saavedra* (Edit.), Taxation, State Aid and Distortions of Competition - Fiscalité, Aides d'État et Distortions de la Concurrence - Steuern, staatliche Beihilfen und Wettbewerbsverzerrungen, p. 53, 61. A periodical review of the rulings is therefore necessary.

[223] ECJ (*Forum 187*), para. 96.

[224] *Notice on the Notion of State aid*, rec. 171.

[225] *DG Competition*, 03.06.2016, Working Paper on State Aid and Tax Rulings, available at http://ec.europa.eu/competition/state_aid/legislation/working_paper_tax_rulings.pdf, last checked on 24.07.2018, para. 23.

method they find produces the best approximation of an arm's length price.[226] In theory, they do not even have to rely on the OECD methods, but are free to establish their own method, as long as it produces an outcome at arm's length. By doing so, it is far less transgressing in the Member State's fiscal sovereignty than by requiring a specific method the Member States would have to endorse in order to comply with State aid law.

In any event, "[a]t the end of the day, taxpayers must be able to determine whether their tax rulings and APAs are compatible from the EU perspective."[227]

In this context, I would suggest that the COM draws a parallel to the ECJ's case law in the field of taxing power. For example, in its *SGI* decision, the ECJ held that the restriction of the Freedom of Establishment and the Free Movement of Capital by adjusting intra-group transactions according to the arm's length principle is only justified, if, alongside with another condition, the adjustment does not go beyond what would have been agreed upon by independent parties.[228]

With this statement, the ECJ does not simply repeat the arm's length principle, but clearly shows the limit to what extent the COM may assume an arm's length price. Additionally, in this case, the ECJ made the arm's length price subject to a potential appeal and a double check by the European Courts because anything beyond an adequate arm's length price would breach said Freedoms. It is only consistent that the COM's arm's length calculation can be overridden by an independent third-party, meaning that the ECJ should have the last say in it.

One can observe in this context, that there is no substantial difference between a Member State overestimating the arm's length price (and trying to increase its tax revenue) and the COM going beyond what is the actual arm's length price. The comparability between the case law in power-to-tax cases dealing with the arm's length principle and State aid cases with the arm's length principle has already been argued above.[229]

Given these premises, legal protection must therefore comprise two elements. First, the COM's calculation of the arm's length price must be subject to appeal before the Courts and, second, the determination of the arm's length price must come with a certain degree of benefit of the doubt in favour of the tax payer, since given the natural range of possible outcomes, the

[226] *Lyal*, FILJ, 38/2015, p. 1017, 1022.
[227] *Gunn, Anna/Luts, Joris*, Tax Rulings, APAs and State Aid: Legal Issues, EC Tax Review, 2/2015, p. 119, 125.
[228] ECJ (*SGI*), para. 71.
[229] See Point 2.3.1., p. 18 et seq.

principle of legal certainty cannot be held up otherwise. To use the words of *Beiser*: "According to the case law of the ECJ, transfer prices that are within the arm's range of free competition must always be accepted for income purposes."[230]

5.3.4. Conclusion on Legal Certainty Issues of the Assessed Cases

The concerns with legal certainty are twofold. First, could *Apple*, *FFT* and the affected parties in the proceedings against Belgium predict the COM's State aid investigation and, second, does the calculation of the arm's length price by the COM raise issues with legal certainty? To conclude on the general remarks from above, I will connect them to the cases.

5.3.4.1. Calculability of the Arm's Length Price

As it was shown above, the COM requires a market-based outcome. While this is consistent with both settled case law and Art. 107 para. 1 TFEU, this leaves the tax payer with a major degree of uncertainty, because what the adequate outcome is might not necessarily be clear from the beginning. This was especially critical in the *FFT* decision, since the Luxembourg tax authorities had confirmed that the transfer pricing analysis would be in line with the arm's length principle. However, the COM has made it clear that legitimate expectation may only be caused by the COM itself and *FFT* does not seem to challenge that. It only claims that the new interpretation of the arm's length principle would create complete uncertainty and confusion.[231]

In the context of whether the arm's length principle is an exact science, the COM already seems to be aware of this problem. For example, it has indicated willingness to accept a second-best method with adequate parameters as well, if it leads to a reliable approximation of what is considered a market-based outcome.[232] This is in line with the idea behind the arm's range, which allows – due to the term's natural concept – two or more possible outcomes that fall within this range.

The ECJ has not yet ruled in this matter. On the contrary, in a decision that did not concern State aid, but still dealt with the allocation of profits between Member States using transfer prices, the German Bundesfinanzhof (Federal Fiscal Court) has already ruled that uncertainties

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[230] *Beiser, Reinhold*, Die Gestaltungsfreiheit der Unternehmer im Licht des arm's length-Prinzips, RdW, 10/2016, p. 708, 709.

[231] Fiat Chrysler Finance Europe (FCFE) on the 15.02.2016, T-759/15, Action brought on 29 December 2015 - Fiat Chrysler Finance Europe v Commission, OJ 2016/C 59/49, 3rd Point of Appeal.

[232] European Commission (*Fiat*), para. 368.

deriving from the determination of the transfer price may not be held against the tax payer, since it is usually not the tax payer's but the authority's task to calculate the transfer prices.[233]

It can therefore be concluded that the cases in question do not infringe the principle of legal certainty.

5.3.4.2. Predictability and Knowability of the Decisions

When it comes to the question whether these State aid decisions could be predicted, one has to take a look at the context they are embedded in. As shown above, these decisions are only the very latest development of the EU's fight against harmful tax competition and their potential to infringe State aid provisions has been on the table from the very beginning.

There have been strong hints in the past that the arm's length principle would be used as a benchmark to identify harmful tax practices. Whether a 'prudent and well-informed' market participant would have foreseen these State aid cases has to be decided by the Courts. I am of the opinion, however, that especially in the *Apple* case and the *Belgian Excess Profit Exemption* case, where the bigger part of the profits remained completely untaxed, any prudent and well-informed market participant needed to be suspicious and can, thus, not invoke any good faith retroactively.

The situation is a bit more delicate in the *FFT* case. The Luxembourg tax authority expressly confirmed that the tax ruling was in line with the arm's length principle and *FFT* – probably happily – accepted that. The line between optimising the tax liability and pushing aggressively to the lowest possible tax rate are quite blurry. Given that even the COM attested to the seriousness of *FFT*'s tax advisor's calculations, the outcome is completely open.

Nevertheless, the State aid proceedings did not come out of the blue. It has long been an agenda of the COM to help fight harmful tax practice where State aid applies, and this intertwinement has been on the table since the Code of Conduct was published.

5.4. Conclusion in the Light of the Assessed Cases

In this chapter, I tried to analyse the application of the arm's length principle and provide sound legal reasoning for many aspects which, in my opinion, the COM did not elaborate enough. For instance, it is rather confusing when the COM states, that it is applying an arm's length principle of its own which would be different to the OECD's version of it. Moreover, the COM should

[233] BFH on the 17.10.2001, I R 103/00, BStBl 2004 p. 171, reason III. A. 2. d) ff).

have provided an extensive reasoning why integrated and independent companies are in a similar legal and factual situation. On these questions, I conclude as follows.

First, the COM has not established an arm's length principle of its own. I argued above, that the arm's length principle describes an outcome, or to be more precise: requires an outcome, that resembles a market-based outcome within the arm's range. As such, there cannot be several different arm's length principles, since there is not more than one possible arm's range. In order to reach an outcome that lies within the arm's range, one needs adequate transfer pricing methods that are used for the determination of an adequate transfer price within the arm's range.

Second, due to the case-law on which the COM's reasoning is based, which is the ECJ's *Forum 187* decision, the COM does not apply its own understanding of the transfer pricing methods but relies on the materials provided by the OECD. In this context, the COM has stated that it does not apply 'the OECD arm's length principle', which would be an instrument of equal treatment. As such, it would also apply within the assessment of Art. 107 para. 1 TFEU. In my opinion, this statement does not mean that the COM wants to establish a completely new framework of a 'different' arm's length principle, but rather that the COM considers the arm's length principle as described by the OECD to be a standard of equal treatment and that this standard is required by Art. 107 para. 1 TFEU itself. Therefore, Art. 107 para. 1 TFEU constitutes a legal basis for its application, meaning that the COM actually only applied Art. 107 para. 1 TFEU. By doing so, the COM may exercise its supervisory authority over Member State's tax rulings.

Third, I argued that this does not give rise to concerns related to the principle of legal certainty, because the application of the arm's length principle could have been foreseen by a prudent and well-informed market participant. It has been a part of the fight against harmful tax competition for over 15 years, which explicitly mentioned the possibility of State aid problems occurring with too generous tax treatment.

All in all, I consider the COM's approach with respect to the arm's length principle as being correct and compliant with State aid law.

6. Conflation of the Elements of Selectivity and Advantage

Another peculiarity in the cases above is the conflation of the element of advantage with the element of selectivity. This approach has its roots in the COM's new approach concerning the arm's length principle and was criticised for allegedly disregarding the ECJ's undisputed case-law. In the following chapter, I will try to shed light on this matter.

I will do so, by laying down the way the idea of the conflation of these elements developed (Point 6.1.), continue with the discussion in the literature (Point 6.2.), and present a proposal for a possible solution of the underlying problems (Point 6.3.). I will close with the conclusion that the COM's new approach is only consistent when it comes to the assessment of individual tax rulings but leads to a muddle of different State aid aspects, when it comes to the analysis of general aid schemes, such as in the *Belgian Excess Profit Exemption* case (Point. 6.4.).

6.1. The Genesis of this Approach

The COM argues that in tax matters, the element of selectivity and the element of advantage conflate to one single assessment step when it comes to *individually* granted tax rulings. In this context, one has to distinguish between two 'evolutionary stages' of this new approach.

First, the ECJ held in its *MOL* decision that when it comes to individual aid measures the identification of an economic advantage in principle indicates that the measure is selective.[234] This presumption derives from the fact that the measure itself only addresses one beneficiary (or a closed circle of beneficiaries), while on the other hand, general aid schemes are drafted in general terms, allegedly open to all competitors. In other words: "After all, it is not logical to analyze whether selectivity is present in an advantage aimed at only a single taxpayer."[235]

This approach was further elaborated by the COM conflating the identification of an advantage with the assessment of its selectivity. It justified this conflation with the argument that step two of the selectivity assessment, which is identifying a deviation from the reference system, would basically be identical to the assessment of whether a measure confers an advantage or not.

This approach was used for the first time by the COM in the wave of recent State aid cases against multinational companies. For example, in *Apple*, the COM stated that both elements are the same "because the identification of the advantage flowing from the tax measure requires a

[234] ECJ (*MOL*), para. 60. ECJ (*Belgium v Commission*), para. 49.
[235] *Bobby, Christopher*, A Method Inside the Madness: Understanding the European Union State Aid and Taxation Rulings, CJIL, 1/2017, p. 186, 209.

comparison of the economic position of the beneficiary of that measure with the economic position of that undertaking had the measure not been granted, while the identification of the derogation from the reference system requires a comparison of the economic position of the beneficiary of that measure with the economic position of operators who are in a comparable factual and legal situation to the beneficiary in the light of the objectives of that reference system and who do not benefit from the tax measure in question."[236]

This might be plausible for individually granted tax rulings. However, in the *Belgian Excess Profit Exemption* case the COM also claimed this when it had to assess the selective nature of a general aid scheme. I will show in this chapter that such an assumption is not fully consistent.

6.2. Discussion over the Conflation

The conflation of these two elements was subject to wide criticism. First, it was pointed out, that para. 60 of the ECJ's *MOL* decision does not deliver enough ground to assume a conflation of both elements. Rather, the COM would disregard the paragraph before,[237] where the ECJ emphasized that both elements must be clearly distinguished.[238] This argument itself, however, disregards the whole *MOL* case, whose subject was a general aid scheme and not an individual measure.[239] The fact, that the ECJ emphasizes the importance of distinguishing the conferral of an advantage from the element of selectivity, is, thus, not a sufficient argument against the conflation of these two elements when it comes to individual tax rulings/individual aid.

Not only scholars, but also the Government of the USA criticised this new approach. In its white paper on the State aid investigations of transfer pricing rulings, it was pointed out that in all 65 State aid cases related to tax rulings or similar measures, the COM had always assessed both elements separately, the conflation of which, therefore, would constitute an unprecedented move. Moreover, individual tax rulings would be available to any taxpayer and are based on the application of the general tax law. The white paper states:

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[236] European Commission (*Apple*), para. 224.
[237] ECJ (*MOL*), para. 59.
[238] *Kyriazis*, EStAL, 3/2016, p. 428, 432.
[239] Cf. ECJ (*MOL*), para. 36, 65, 69, 76. The Hungarian Mining Act stipulated that mining rights were granted by an agreement establishing amongst other provisions a mining fee. Due to the lack of interest of third parties, the only company ever entering such agreement was *MOL*. By amending the Mining Act in 2007, the mining fees were cut, which was beneficial for *MOL* as the only party ever having entered a mining agreement. Eventually, this is a case about the provisions of a generally drafted law, suspect of constituting a general aid scheme by cutting the mining fee.

"The Commission's new approach of collapsing the advantage and selectivity requirements has important substantive significance. Now, the Commission can find advantage if it disagrees with the Member State's application of the arm's length principle […]. The Commission's new approach therefore reduces a State aid inquiry to whether the Commission believes that a transfer pricing ruling satisfies its view of the arm's length principle. This shift in approach appears to expand the role of the Commission's Directorate-General for Competition […] beyond enforcement of competition and State aid law under the TFEU in to that of a supra-national tax authority that reviews Member State transfer price determinations."[240]

Indeed, the question whether an advantage is present or not is linked to the benchmark against which it is assessed. Yet, the allegation that the conflation of advantage and selectivity would enable the COM to either introduce the arm's length principle or exercise a supervisory role over the Member State's tax law is not conclusive. Rather, the supervisory character derives from the fact that, the COM has to enforce Art. 107 para. 1 TFEU. As I have argued already above, the arm's length principle finds its legal grounds for application in Art. 107 para. 1 TFEU and is, therefore, binding for Member States. This, however, has nothing to do with the conflation of the elements of advantage and selectivity, but is a question of supremacy of EU law over national law.

The question about which benchmark is the right one closes the circle to the COM's statement, which I have cited above already.[241] As the COM points out, the assessment, whether the measure confers an advantage, is a comparison between the beneficiary and a hypothetical *alter-ego* of this very company, while the assessment of the selective nature of the measure is a comparison between the beneficiary and other companies in a similar factual and legal position. "Nonetheless, despite the above consideration, it seems that EU law does not carry out two different tests. Rather, it applies the same test, which is described in different ways."[242]

It seems that the solution lies in the question, which companies are in a similar factual and legal situation. As I have argued above, all companies under the span width of the reference system, which for cases concerning tax rulings is always the ordinary tax system, are comparable to each other. Consequently, the derogation from the reference system would indeed be identical

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[240] *U.S. Department of the Treasury*, 24.08.2016, White Paper on the European Commission's recent State aid investigations of Transfer Pricing Rulings, available at https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/White-Paper-State-Aid.pdf, last checked on 24.07.2018, p. 9.

[241] See sub-chapter 5.1., p. 37.

[242] *Micheau*, E.L. Rev., 3/2015, p. 323, 329 – 330.

to the differentiated treatment of other companies in a similar factual and legal situation, both of which confer an advantage on the recipient.

However, this may only hold true for the assessment of individual tax rulings because any general aid scheme is by definition drafted in such a way that theoretically all companies could benefit from it. A measure from which all companies would benefit irrespective of their size, legal form or other characteristics would not fall within the scope of Art. 107 para. 1 TFEU. It is, thus, necessary to elaborate why the allegedly general measure is only beneficial to a certain kind of undertakings and, due to this reason, draws an artificial distinction between companies that should be treated the same way.[243] In fact, the question whether a *general measure* confers unlawful State aid upon an undertaking requires a discrimination test.

However, even for the assessment of individual tax rulings, conflating the elements of advantage and selectivity is not logical. It is not the case that the identification of the advantage coincides with the identification of its selective nature, but rather that the selective nature follows from the deviation from the reference system automatically. The fact that these two elements go hand in hand should not be interpreted as if they were the same thing. Therefore, I argue that while the selectivity – usually – coincides with the conferral of an advantage they do not merge to one single element.

Thus, when it comes to the assessment of individual (tax) rulings, the assessment of the element of selectivity and the element of advantage 'coincide' only in such meaning that the presence of an advantage usually indicates selectivity as well.[244] On the other hand, when it comes to the assessment of a general measure, these two elements of State aid must be assessed separately, anyway. Consequently, the general statement according to which the assessment of the conferral of an advantage has become part of the selectivity assessment[245] is inconsistent.

6.3. Suggestions for Improvement: Selectivity as Discrimination Test

These considerations might indicate that the assessment of State aid should be cleared from such inconsistencies in order to ensure a precise procedure and prevent potential flaws happening due to the muddle of elements. In this sense, it was brought forward that wrapping

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[243] Interestingly, the COM emphasised this point in the *Amazon* case but did not mention it in the Belgian Excess Profit Exemption case; see European Commission (*Amazon*), para. 582.

[244] A clear distinction as suggested here, might help avoiding problems with the interpretation of borderline cases, like the *MOL* decision.

[245] Cf. for example *Linn, Alexander*, Die Beihilfeverfahren in Sachen Amazon, Apple, Fiat und Starbucks - eine neue Dimension der Selektivität?, IStR, 4/2015, p. 114, 116.

elements together without any justification would deprive affected parties of room for argumentation.[246]

6.3.1. *Moving the Justification of Selectivity to Assessment of Advantage*

In the light of the foregoing, it was proposed by *Jaeger* that the State aid assessment should be re-balanced by separating the element of selectivity from the element of advantage again. In detail, step three of the selectivity assessment scheme (justification by the nature or general scheme of the tax regime) should be moved to be part of the advantage assessment, because "[a]fter all, differentiated taxation seeks to establish equity among taxpayers. If equitable, a relatively lower tax burden is, if in line with tax logics, no advantage."[247]

This proposal helps wherever there is no need for a selectivity assessment, that is when assessing individual tax rulings where the selective nature is assumed by the existence of an advantage, since the examiner might be tempted to overlook the possibility of a justification.[248]

However, it is not very practical, when it comes to the assessment of aid schemes. A justification of a 'differentiated taxation' needs the identification of a differentiated treatment first, which is a typical part of the selectivity assessment. This confusion could only be avoided if one assesses the selectivity before the conferral of an advantage. I will suggest a re-design of the selectivity assessment scheme in the next Point.

6.3.2. *Re-Design of the Selectivity Assessment Scheme to Discrimination Test*

As was outlined above, the current conflation of advantage and selectivity is indeed a muddle of different aspects of State aid. It seems that the selectivity assessment is executed more or less by the rule of thumb and does not strictly follow a predetermined assessment scheme.[249] For example, if, as the ECJ has held in its *MOL* decision, an advantage conferred by an individual tax ruling usually indicates the existence of selectivity, then the deviation from the reference system actually is not part of the selectivity assessment but identifies the existence of an advantage.

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[246] *Jaeger, Thomas*, Tax Incentives Under State Aid Law: A Competition Law Perspective, in: *Richelle/Schön/Traversa* (Edit.), State Aid Law and Business Taxation (2016), p. 39, 50.

[247] *Jaeger*, in: *Richelle/Schön/Traversa* (Edit.), State Aid Law and Business Taxation, p. 39, 51, with further suggestions to the re-balancing of the element of advantage.

[248] Although, bringing forward arguments that would justify the measure in question lies in the responsibility of the Member State.

[249] See similar to that claim, *Lang*, in: *Richelle/Schön/Traversa* (Edit.), State Aid Law and Business Taxation, p. 27, 33, about the confusion between the ECJ and the GC due to unprecise terminology.

Following this idea, one can observe that this applies to general schemes as well. Indeed, as we saw in the *Belgian Excess Profit Exemption* case, the COM assessed the derogation from the reference system, which reveals in cases of *generally drafted* measures, solely a conferral of an advantage. The main question when it comes to selectivity, however, is that this advantage only benefits certain undertakings within a group of companies in a similar legal and factual situation.

Naturally, the COM did in fact conduct a discrimination test. Under the headline of 'selectivity analysis'[250] the COM, first, identified the conferral of an advantage following the three-step selectivity analysis and then stated that this advantage was not available "for all corporate entities that are in a similar legal and factual situation, which, in light of the objective of the Belgian corporate income tax system to tax corporate profits, consists of all companies subject to corporate tax in Belgium."[251]

Considering all this, it could be beneficial for a more precise and coherent practice to re-design the assessment of selectivity. Including the proposal of *Jaeger* as outlined above, it would be better if the COM redefined the whole State aid assessment as follows:

1. Intervention by the State or through State resources,
2. Existence of an Advantage,
    a. Definition of the Reference System (for example: ordinary rules of taxation)
    b. Derogation from that Reference *System*
    c. Justification by the nature and general principles of that Reference System
3. Selective Nature of that Advantage,
    a. Definition of which Companies are in a Similar Legal and Factual Situation (Reference Group)
    b. Different Treatment as compared to that Reference *Group*
    c. Justification
4. Affection of the trade between Member States and Threat of Distortion of Competition.

Such an approach would free up the selectivity test for a "fully fledged discrimination test".[252] This discrimination test is essential for the assessment of general aid schemes, because the general appearance of an aid scheme makes it necessary to show that it only benefits certain market participants in a selective manner, otherwise such generally drafted measure is indeed

[250] European Commission (*Belgian Excess Profit Exemption*), para. 131.
[251] European Commission (*Belgian Excess Profit Exemption*), para. 136, also cf. para. 138 – 140.
[252] *Jaeger*, JECL, 4/2017, p. 221, 226.

open to all other companies.[253] In the assessment of individual measures step 3 could be skipped, because the selectivity of the advantage is given by the individuality of the measure already.

It is worth noting, that AG *Mischo* has already implied that the element of selectivity is "the principle of equal treatment of undertakings in an identical or comparable position".[254] As such it shares similarities to internal market provisions, such as the Free Movement of Goods and Art. 110 TFEU.[255] Sometimes the whole State aid investigation is labelled as 'discrimination analysis' that would be followed by a justification inquiry.[256]

There have also been scholars opposing the view that State aid, and the element of selectivity in particular, would be some kind of anti-discrimination provision. Even though, it would show parallels with the principle of equal treatment or non-discrimination, its scope of application, however, would be confined to economic activities at least potentially affecting the trade between Member States.[257]

In my point of view, however, this argument does not rule out that the element of selectivity is indeed an element preventing discrimination. In its very nature, its task is to show where Member States treat 'certain undertakings' better than others. One could counter-argue in this respect, that the beneficial treatment of one is not a discrimination against all other companies which do not benefit, especially if the beneficial treatment is forbidden anyway.

But then again, given the wide understanding the ECJ has adopted concerning the notion of selectivity, this may be overruled. This is clearly visible in the *Gibraltar* case, where the ECJ has held that off-shore companies may not be treated differently from companies having a physical establishment in Gibraltar. Such broad extent of beneficial treatment automatically includes the discrimination of on-shore companies.

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[253] Cf. ECJ (*Gibraltar*), para. 104.

[254] AG Mischo on the 08.05.2001, C-143/99, Opinion of Advocate General Mischo on Case C-143/99 (Adria-Wien Pipeline), Reports of Cases 2001 I-08365, ECLI:EU:C:2001:250, para. 59; also cf.

[255] *Bousin, Julie/Piernas, Jorge*, Developments in the Notion of Selectivity, EStAL, 4/2008, p. 634, 642. The selectivity criterion and its interpretation is the sticking point in a dispute about the legal nature of Art. 107 TFEU, mainly about whether it only protects other competitors (thus being a provision of antitrust) or every other, even non-competing companies (thus being a tool of the internal market as well). In this debate, it was mentioned that "State aid 'DNA' shares more chromosomes with internal market rules than with antitrust rules.", *Buendina Sierra/Smulders*, in: *Sutton* (Edit.), EC State Aid Law - Le droit des aides d'Etat dans la CE, p. 1, 9; see also Point 1.1.5., p. 9.

[256] *Wattl, Peter J.*, Comparing Criteria: State Aid, Free Movement, Harmful Tax Competition and Market Distorting Disparities, in: *Richelle/Schön/Traversa* (Edit.), State Aid Law and Business Taxation (2016), p. 59, 62.

[257] *Nykiel-Mateo/Wiemann*, in: *Pesaresi/van de Casteele/Flynn/Siaterli* (Edit.), EU Competition Law, p. 263, para. 2.241.

In any event, even if one accepts the argument that the beneficial treatment of one single company does not necessarily mean the discrimination of all other companies, it is obvious that both concepts follow the exact same pattern.

One could argue that the prohibition of State aid comprises elements of a non-discrimination provision and, therefore, automatically includes a discrimination test. This follows from the fact that the element of selectivity requires an assessment of whether the beneficiary is treated differently to other companies that are in a *similar legal and factual situation* if this threatens to distort competition.[258] In my opinion, this test should be visible as what it is, namely as a discrimination test.

6.4. Conclusion in the Light of the Assessed Cases

Concluding the foregoing, one can observe that there is a necessity for a selectivity assessment separate from the element of advantage when it comes to the assessment of a *general aid scheme*. This comes from the idea that the traditional three-step analysis used in tax matters only reveals the conferral of an advantage but does not identify its selective nature. The element of selectivity needs thorough elaboration in cases concerning general aid schemes, because it is important to identify how the generally drafted measure only applies to a certain group of undertakings.

In the *Belgian Excess Profit Exemption* case, the COM, however, has stated that the identification of an advantage and the selectivity assessment would coincide, which is not compliant with what the COM actually does. Taking a detailed look on its reasoning reveals that, in fact, the COM had to argue both the element of advantage as well as the element of selectivity in order to reach a consistent conclusion. The COM did this in a more or less confusing manner, when it, first, identified an advantage under the headlines of the selectivity assessment by showing a deviation from the reference framework. As I have argued in the previous Point, a deviation from the reference framework does only reveal the conferral of an advantage, but when it comes to the assessment of a general measure which is drafted in general terms, it is not (yet) clear whether this general measure favours an undertaking or a certain group of undertakings over others in a comparable situation. Naturally, the COM felt that something is missing and continued intuitively palming off a discrimination test on the three-

[258] *Lang*, in: *Richelle/Schön/Traversa* (Edit.), State Aid Law and Business Taxation, p. 27, 36.

step test.[259] Only with this it could show the selective nature of a general measure. The end-result remains the same, but it certainly does not resemble a precise and consistent assessment scheme.

In the assessment of *individual tax rulings*, this is practically irrelevant since the identification of an advantage indicates its selective nature. As I argued in Point 6.2., the conflation of advantage and selectivity is adequate when it comes to the assessment of individual tax rulings, such as in the *Apple* and the *FFT* cases, because the selectivity assessment can be omitted. The identification of the reference framework necessarily requires the answer to the question which companies are in a similar legal and factual situation. The COM argued this in para. 198 of the *FFT* case and in para. 228 – 230 of the *Apple* case.

Considering this, I conclude that with the conflation of both elements the COM did not do itself a favours. Although, it may withstand scrutiny, these cases would have left less room for legal attack. The COM might want to overthink the assessment scheme when it comes to the analysis of general aid schemes. In this context, I would welcome a clearer and more precise course of action, which could follow the proposal above.

In a nutshell, I consider the COM's approach with regard to the conflation of the element of advantage with the element of selectivity as being correct, but imprecise. For the sake of clarity, the COM should give further guidance on this and respect the differences in analysis between individual fiscal aid and fiscal aid schemes.

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[259] In European Commission (*Belgian Excess Profit Exemption*), para. 135, the COM argues how a deviation from the reference system would constitute an advantage and goes on in para. 136 to arguing why this is only available to a certain group of undertakings.

PART IV – FINAL REMARKS

The element of selectivity experiences a new way of handling in the wave of the most recent State aid cases against multinationals and their tax strategies. This concerned the emergence of the arm's length principle and the merge of the selectivity with the advantage assessment. Naturally, these novelties were subject to wide criticism.

In this thesis, I argued that this criticism may be understandable to some extent but eventually does not change the fact that the COM's new approach is indeed quite sound from a doctrinal point of view. While one could expect more legal thoroughness and conscientiousness in the future, the outcome is compliant with both EU State aid law and the settled case-law of the ECJ. If these cases will pass the course of appeal before the European Courts – which I expect to happen –, they would constitute precedent cases for the future. The COM will be able to use State aid law as a policy tool to challenge Member State's tax regimes, which might help push them toward a common European corporation tax strategy.

I will conclude my findings with respect to the principle of legal certainty, the arm's length principle and the conflation of elements, as discussed above.

CONCLUSION WITH RESPECT TO THE PRINCIPLE OF LEGAL CERTAINTY

The COM did not just invent the arm's length principle. Rather, it has been part of the fight against harmful tax competition and tax avoidance strategies of multinational companies ever since the 1990ies. In this context, State aid investigations were expressly part of the plan as a means to tackle harmful tax competition between the Member States and therefore also against multinationals and their tax strategies. Consequently, the argument that the application of the arm's length principle would constitute a breach of the principle of legal certainty is questionable. This holds true from both a formal as well as a material point of view.

In a formal sense, the settled-case law of the ECJ in State aid matters stipulates that only actions from the COM can create legal expectations, which usually requires prior notice of the aid or aid scheme according to Art. 108 TFEU so that the COM can express its view on it. In all cases, the COM had not given any opinion to the compliance of these rulings with the prohibition of State aid until issuing the negative decisions. Only in the *FFT* case, the Luxembourg tax

authorities confirmed that the tax ruling would be in line with the arm's length principle. However, such a declaration does not have any value when it comes to the legitimate expectation of the compliance with State aid rules.

In a material sense, it appears to me that it was more or less a question of time when the COM would strike with the State aid club. Even though, it seems that lawyers at that time simply failed at connecting the obvious dots, this was not unforeseeable. This is particularly true where big parts of the profit were not taxed at all, for example in the *Belgian Excess Profit Exemption* case and in the *Apple* case. As I stated above, nothing is a more 'significant lowering of the effective tax rate' than when big parts of the profit escape any taxation whatsoever.

What remains, however, is the fact that the arm's length principle can only be an approximation to what it wants to achieve. If one wants to draw a parallel to Plato's Allegory of the Cave, then the market-based outcome is the idea, while the result from an arm's length conform transfer pricing calculation is not more than a shadow. Yet, the shadow is the most objective approximation to reality a tax authority can accomplish.

The COM seems to be well aware of this problem. In this context, I advocate for a certain degree of benefit of the doubt that the tax payer should enjoy, since it sometimes might be difficult to distinguish objects only by their shadow-appearance. In its *SGI* decision, the ECJ has indicated the potential for a Court's revision of overly protective taxation practices, because going beyond what is an arm's length price infringes (amongst others) the Free Movement of Capital. The same principle must apply for COM's decisions in which the COM orders Member States to reclaim more than what the arm's length principle would have been.

All in all, I conclude that there are no substantial problems concerning the principle of legal certainty with respect to the sample cases.

CONCLUSION WITH RESPECT TO THE ARM'S LENGTH PRINCIPLE

Furthermore, I argued above that the arm's length principle should be considered an inherent part of Art. 107 para. 1 TFEU, because it ensures an unbiased and objective treatment of all tax payers.

For this argument, I elaborated why integrated and independent companies are in a similar legal and factual situation from both a tax law and a competition law point of view. In this sense, Art. 107 para. 1 TFEU demands a level playing field between those who are deemed to be in such a comparable situation. It follows from this that, due to the evident differences to stand-alone companies and the potential of defining their own taxable base by setting the transfer prices accordingly, multinationals have to tolerate the adjustment of their balance according to the arm's length principle.

As I have argued above already, there can only be one arm's length principle. However, when it comes to the appropriateness of the transfer pricing methods, I found that every transfer pricing method leading to an arm's price is adequate and that the Member States are not bound to the five transfer pricing methods proposed in the OECD TP Guidelines. Nevertheless, those transfer pricing methods follow the internationally accepted standard for transfer pricing methods, which might be an authority on its own. In this sense, I am of the opinion that a transfer price calculated *lege artis* according to the OECD TP Guidelines must be accepted by the COM.

All in all, I conclude that the arm's length principle is directly applicable due to the provisions set in Art. 107 para. 1 TFEU.

CONCLUSION WITH RESPECT TO THE CONFLATION OF ELEMENTS

Lastly, the COM conflated the element of selectivity with the element of advantage. I argued above that this conflation is justified when it comes to the assessment of individual tax rulings, but not when it comes to the assessment of general aid schemes. Due to the fact that the identification of a conferral of State resources through an individual ruling automatically indicates its selective nature, the assessment of selectivity becomes obsolete. On the other hand, since general aid schemes are by definition drafted in such a way that they are theoretically open to all companies, it is crucial to elaborate why in this very case it is only beneficial for one undertaking or a certain group of undertakings.

Also, I tried to show that the consensually accepted assessment scheme for the element of selectivity (three-step test) does not identify any selective nature of a measure; neither in the case of individual nor in the case of general aid. Rather, it shows the existence of an advantage,

which makes it necessary to supplement this with a discrimination test. This is only necessary when it comes to the assessment of general aid schemes.

All in all, I conclude that the conflation of the elements of selectivity and advantage leads to an imprecise muddle, which should be avoided. In this sense, I advocate for a re-design of the assessment schemes and the establishment of a discrimination test in the selectivity assessment.

ANNEX – SUMMARY OF CASES

The cases that are subject to this thesis are very extensive. The Belgian Excess Profit Exemption case counts 56 pages, the *FFT* case 67 pages and the *Apple* case 130, most of which is fairly detailed information on corporate structure, tax law and other technical issues. When I read the cases for the first time I did not know more than before; only after reading and reading again, I started to understand them. Giving a summary of them in the argumentative part of the thesis is not compatible with their complexity. For the readers of this thesis that have not had the chance to fully engage with them, I shall provide a (still only superficial) summary of the main parts.

I. COMMISSION V IRELAND/APPLE (CASE SA.38373)

1. Factual Basis

a) Specialty of Irish Tax Law

Prior to its modification by Finance Act 2013 (FA13) and Finance Act 2014 (FA14), Irish Tax law distinguished between Irish incorporated companies that are tax-resident in the State and Irish incorporated companies that are not tax-resident. This distinction was found in section 23A TCA97 as amended by the Finance Act 1999.

The decisive element was the ultimate control over an Irish incorporated company of a person who is itself a tax resident in another European Member State or in a territory with the government of which arrangements have been made (subsection 1). If an Irish incorporated company was subject to such outside control, it would be regarded as *relevant company* and, therefore, if it carried on a trade in Ireland, or if it was related to a company which carried on a trade in Ireland, considered a non-tax resident company (section 23A subsection 3 TCA97 as amended by FA99).

Only with the amendment by FA13 (No. 2 Act) and FA14 did it become obligatory for the Irish incorporated affiliate to be a tax resident in another jurisdiction. Before, it could be regarded as 'not Irish' while it was not necessary to declare taxes in another State and, thus, be essentially stateless.

b) Apple's Corporation Structure in Ireland[260]

Apple Inc. is based in Cupertino, California and therefore a US-incorporated company. It is the parent company of the Apple Group, which also had several affiliates and sub-affiliates in Ireland. Some of these Irish incorporated affiliates were Irish tax resident, such as Apple Distribution International (ADI), Apple Operations and Apple Sales Ireland, and some of them were Irish incorporated, but not tax-resident, such as Apple Operations International (AOI) and Apple Operations Europe (AOE) with an affiliate of its own named Apple Sales International (ASI).

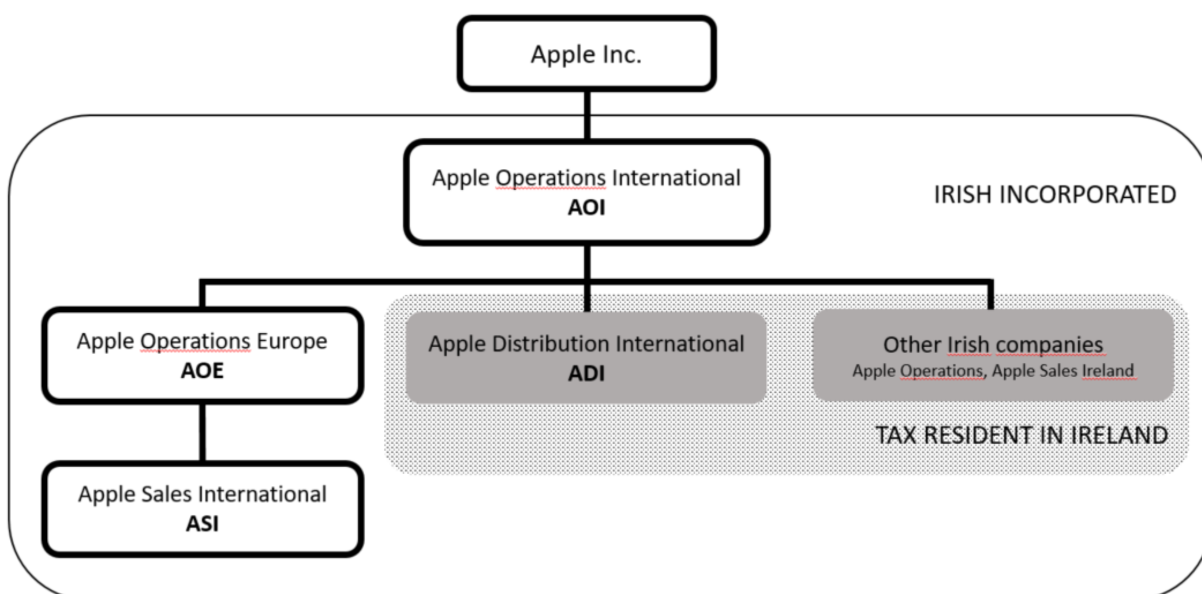

Figure 2 – Apple's corporate structure in Ireland as visualised by the European Commission[261]

Both AOE and ASI were Irish incorporated companies and still not tax-resident in Ireland, because they fulfilled the requirements of sec. 23A TCA97. They were both ultimately controlled by Apple Inc, which is resident in a State Ireland has a tax treaty with, and they carried out a trading activity in Ireland. Furthermore, the members of the board of directors of both AOE and ASI were employed either by Apple Inc. and located in the USA or located in Ireland but employed by ADI.[262] Together with the fact, that there was not a physical office of AOE or ASI in the USA, it follows that neither of them had a physical presence in another jurisdiction apart from the Irish, in which they were not considered to be tax resident.

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[260] The description of Apple's corporate structure is a summary of European Commission (*Apple*), para. 39 – 58. In an e-Mail to the Author from 10. October 2017, Apple would neither confirm nor specifically contest the statement of COM concerning its corporate structure. Apple states: "While we disagree with the Commission, both on legal grounds and on the facts, we cannot comment further in light of pending litigation." This leaves the Author with the COM's statements as the only extensive report about Apple's corporation structure.

[261] European Commission (*Apple*), para. 47.

[262] European Commission (*Apple*), para. 114.

"[…] ASI and AOE could therefore be best described as 'stateless' for tax residency purposes."[263]

c) The Contested Tax Rulings

In 1991, the Irish tax authority (hereinafter "Irish Revenue") issued a unilateral tax ruling in favour of AOE and ASI, which was later replaced by similar tax rulings in 2007. The tax rulings endorsed a profit allocation method that AOE and ASI hat brought forward and suggested to the Irish Revenue. Henceforth, they could determine their annual taxable profit with the aid of this profit allocation method. The 2007 tax ruling remained in force until the restructuring of Apple in 2014.[264]

According to *Apple*'s proposal for the 1991 ruling, AOE and ASI should be divided into a Headquarter (HQ) and the Irish part of the company (Irish branch), which was then accepted by Irish Revenue. This Headquarter did not have any employees nor any offices or any other physical presence; it existed on paper only. The board members were all employed by *Apple* Inc. or other Apple affiliates.[265]

Roughly speaking, the taxable base of ASI's Irish branch would be calculated as 12.5% of the operating costs excluding costs such as charges from Apple affiliates and material costs. The standard tax rate would then be applied to this basis. Later, the 2007 ruling copied this method, but changed the percentage. According to the tax ruling, the taxable basis of AOE's Irish branch was calculated as 65% of the branch's operating cost up to a cap somewhere between 60 and 70 million USD,[266] and 20% of the branch's operating costs for everything exceeding that cap.[267]

Since they were considered to be resident outside Ireland and were allegedly taxed in another jurisdiction, the tax rulings aimed at defining how much of the overall profit of *ASI* and *AOE* needed to be allocated to their Irish branches, not to them as a whole. Since the rest of the profit was allocated to the HQ in the USA, it remained untaxed by Irish Revenue. Apple exploited a classic ‚hybrid mismatch', which means that Irish Revenue and the US tax authority consider the fiscal quality of its affiliates differently. The US only tax upon repatriation of the profits, which is why they still remain untaxed until today.

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[263] European Commission (*Apple*), para. 52.
[264] European Commission (*Apple*), para. 39.
[265] European Commission (*Apple*), para. 52, 114 and
[266] Note that due to confidentiality reasons, the COM did not publish exact figures.
[267] European Commission (*Apple*), para. 59 et seq.

Furthermore, it is worth noting, that the profit allocation method proposed by Apple was not substantiated by any scientific study. The COM quotes the note of a meeting of 30 November 1990 as follows:

"[Irish Revenue] asked [Apple's tax advisor] to state if was there any basis for the figure of $30-40m and he confessed that there was no scientific basis for the figure. However, the figure was of such magnitude that he hoped it would be seen to be a bona-fide proposal." [268]

Upon these tax rulings, the COM initiated a State aid investigation.

2. Commission's Findings concerning the Element of Selectivity

The investigation led to the decision in question. In the following section, I will present the COM's findings concerning the element of selectivity. Usually, the assessment follows three steps, which are: setting out the reference framework which would normally apply to undertakings in a legally and factually similar situation, second, identifying a deviation from this framework, and, third, assessing if this deviation is justified.[269]

a) The Reference System

The COM identified the reference system as "the ordinary rules of taxation of corporate profit under the Irish corporate tax system, which have as their intrinsic objective the taxation of profit of all companies subject to tax in Ireland".[270] The COM argues that the objective of this reference system is the taxation of all companies, integrated and non-integrated ones, as well as resident or not-resident companies, which is why there is not a separate reference system for integrated, non-resident tax subjects, such as *Apple*.[271]

b) Advantage due to Derogation of Framework

According to Irish tax law, a foreign company's Irish branch would only be taxed on the profits that arise directly or indirectly through or from the branch or agency carrying out a trade in Ireland (sec. 25 para. 2 TCA97). This wording requires a profit allocation between the foreign company and its Irish branch to be taxed, which was also acknowledged by Ireland and *Apple*.[272]

[268] European Commission (*Apple*), para. 64.
[269] *Faull; Nikpay (Hrsg.),* EU Law of Competition, para. 17.108 et seq.
[270] European Commission (*Apple*), para. 227.
[271] European Commission (*Apple*), para. 230.
[272] European Commission (*Apple*), para. 248 with reference to the confirmation of this statement as indicated by Ireland (cf. the COM's summary in para. 157) and Apple (cf. the COM's summary in para. 166).

With reference to the *Forum 187* Decision of the ECJ,[273] the COM went on and stated that Art. 107 para. 1 TFEU required the profit allocation to be based on the arm's length principle. In this decision the ECJ interpreted a tax measure that would accept an intra-group profit allocation method which does not lead to prices as they would have been reached under conditions of free competition, that is prices negotiated at arm's length between independent undertakings, as conferring a selective advantage.[274]

The COM held, that the reference system is the ordinary tax rules[275] and that the arm's length principle is applicable in the present case. This is, because since there has to be a profit allocation in order to calculate an Irish branch's taxable base, this profit allocation has to resemble a market-based outcome in line with the arm's length's principle, because otherwise it would selectively favour integrated companies over non-integrated, standalone companies.[276]

Since the Irish affiliates held substantial IP rights, the COM went on and argued that it would constitute a derogation of the ordinary rules when Irish Revenue accepted the allocation of IP related profits outside of Ireland, that is to their respective head offices, unless this resembled a market-based outcome. This is due to the fact, that intangibles cannot be physically allocated to only one part of a legal entity but are rather held by the legal person as a whole. The COM stated that this is not a question of allocating profit between two integrated companies, such as the allocation of profit between two affiliates, but an allocation of profit between different parts of the same company, which would not be legally possible. On the contrary, it is possible to allocate workforce, tangible assets and so on through their physical presence in one jurisdiction.[277]

In this context, the COM found it necessary, to apply a profit allocation method that leads to a market-based outcome in order to allocate the profits of the intangibles within the same company as if the HQ and the Irish branch were two separate and independent companies.[278]

The COM laid down that there had been no active management of the IP at the alleged HQ (not Apple Inc.) in Cupertino. In contrast to Ireland's and Apple's claim, the minutes of the board meetings do not indicate any decision-making, engagement in IP management or even

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[273] ECJ (*Forum 187*).
[274] European Commission (*Apple*), para. 249.
[275] European Commission (*Apple*), para. 228.
[276] European Commission (*Apple*), para. 253.
[277] European Commission (*Apple*), para. 265 and 268 et seq.
[278] European Commission (*Apple*), para. 272 and 280.

discussions about the IP.[279] It follows from this and from the fact, that with no employees outside of Ireland, there cannot be any form of contribution to ASI's and AOE's IP from the HQ. Consequently, the allocation of the IP (-income) to the HQ in the USA would not have been agreed on by independent companies, which is why the profit allocation of alleged royalty income from the IP to the HQ in the Cupertino does not resemble a market-based outcome.[280]

Furthermore, the COM countered *Apple*'s argument, that eventually all IP was developed by *Apple* Inc. in the US and should, therefore, not be taxed in Ireland, by pointing out that *Apple* Inc., ASI, and AOE were parties to a cost sharing agreement (CSA). In this CSA the parties had agreed upon sharing the cost of R&D by remunerating *Apple* Inc. in a ratio based on their overall sales. The COM argues that this already constitutes a remuneration for the R&D costs performed by *Apple* Inc. and ADI and AOE, therefore, had the right to exploit and profit from the IP.[281]

c) Alternative Line of Reasoning

In an alternative line of reasoning, the COM brought forward several arguments. One of which states, that Ireland had used the arm's length' principle for allocating profits of non-resident Irish branches since the 1990s. As evidence, the COM referred to and examined four tax rulings concerning other tax payers.[282] Furthermore, it observed that the Irish praxis had followed a catalogue of criteria that is essentially the same as what is laid down in Art. 7 para. 2 of the OECD Model Tax Convention for profit allocation of a non-resident company. This would be necessary in order to apply Sec. 25 TCA97 in an objective way.[283]

Even if the arm's length principle were not part of Sec. 25 TCA97, the COM said, the tax rulings would confer a selective advantage to ASI and AOE, because in such a case they would have been the result of discretion exercised by Irish Revenue without relying on objective criteria.[284]

[279] European Commission (*Apple*), para. 281 – 285.
[280] European Commission (*Apple*), para. 305.
[281] European Commission (*Apple*), para. 312.
[282] Cf. European Commission (*Apple*), para. 373 et seq.
[283] European Commission (*Apple*), para. 371.
[284] European Commission (*Apple*), para. 379.

d) No Justification for the Deviation

The burden of proof lies with the Member State when it comes to the justification of granting a selective advantage.[285] However, Ireland did not bring forward any justification, whereas *Apple*'s claim was not followed by the COM.[286] The COM's statements on this do not add any value to the purpose of this thesis, which is why they are left out for the sake of conciseness.

II. COMMISSION V LUXEMBOURG/FIAT (CASE SA.38375)

1. Factual Basis

FFT forms a part of the *Fiat* group with its parent company *Fiat* SpA (now *Fiat Chrysler Automobiles* N.V.), has its seat in Luxemburg and provides financial and treasury services to Europe based affiliates of the *Fiat* group. These financial and treasury services are either transactions between *FFT* and other treasury affiliates of the *Fiat* group or transactions between treasury companies and other group companies (bank credits, guarantees, market funding and liquidity investments).[287]

Affiliates that are funded by the *FFT* have to pay interest according to the group's weighted average cost of capital (WACC) plus a margin.[288]

In order to calculate its annual tax liability, *FFT*'s tax advisor submitted a transfer pricing analysis to the Luxembourg tax authorities in 2012, in which it was assumed that *FFT* would have an annual profit of EUR 2.542 million[289] within a range of +/-10 %. This profit should be the taxed at the standard corporation tax rate in Luxembourg of 28.8%. As most appropriate method to determine this profit in line with the OECD TP Guidelines, *FFT*'s tax advisor suggests the TNMM method and compares *FFT*'s intra-group transactions and *FFT*'s risks with transactions and the risk born by comparable companies, such as *ING Groep* N.V., *UBS* AG,

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285 ECJ on the 29.04.2004, C-159/01, Kingdom of the Netherlands v Commission, Reports of Cases 2004 I-04461, ECLI:EU:C:2004:246, para. 43; for further reading cf. *Bacon,* EU Law of State Aid (2017), para. 2.133 et seq.

286 European Commission (*Apple*), para. 405 – 406.

287 European Commission on the 11.06.2014, SA.38375 (2014/NN)(ex 2017/CP), Opening Decision to FFT, OJ 2014/C 369/37, para. 20, 21, 26 and European Commission (*Fiat*), para. 42 and 43.

288 European Commission (*Fiat*), para. 48.

289 Note that in European Commission (*Fiat*), para. 54 the figure is "EUR 2,542 million", which would be EUR 2.542 billion since in English writing a coma indicates thousand, not decimals. However, this must be a mistake of translation, since the Opening decision mentions an annual revenue of EUR 2 334 301 for 2013 (European Commission (*Opening Decision Fiat*), para. 21.) and the binding French version also uses a comma (as this indicates decimals in French).

Deutsche Börse AG etc. using the capital asset pricing model (CAPM), which finally leads to the estimated annual remuneration of EUR 2.542 million.[290]

FFT's tax advisor split *FFT*'s equity, which amounted to EUR 287.5 million in 2011, into three parts: first, in analogy to the requirements for banks by Basel II[291] a minimum equity of EUR 28.5 million; second, EUR 165.2 million separated as offsets for *FFT*'s participations interests in affiliates; and EUR 93.7 million of capital in order to perform *FFT*'s functions.[292] The annual return of *FFT* consists of two components; first, a remuneration for the risk born by *FFT* and, second, a so called "functions remuneration".[293]

The Luxembourg tax authorities accepted this proposal in the form of a unilateral tax ruling confirming that it was according to Luxembourg tax law, which required intra-group transactions to be in line with the OECD TP Guidelines (Art. 164 para 3 LIR[294] in conjunction with Administrative Circular 164/2 from 28.02.2011[295]). Thus, they acknowledged that it complied with the OECD TP Guidelines.[296]

The COM opened the investigation, because it came to the preliminary conclusion, that this constituted unlawful State aid. The COM became suspicious about a mechanism used by *FFT* to reach "a net result equal to a stable proportion of equity over 2009, 2010 and 2011 […], despite important variation in assets, liabilities and financial charges and revenues"[297] had accrued by setting the transfer prices "in such a way so as to achieve a pre-determined return for the treasury companies".[298] Also, among other reasons to open the investigation, the COM was of the opinion that the transfer pricing method chosen by *FFT* was not reliable enough and that the transfer prices should have been calculated with the CUP method instead.[299]

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290 European Commission (*Fiat*), para. 55 and 66 et seq.

291 *Basel Committee on Banking Supervision*, International Convergence of Capital Measurement and Capital Standards – A Revised Framework, June 2004, hereinafter "Basel II", full text available at https://www.bis.org/publ/bcbs107.pdf; Basel II requires from banks and financial institutions a minimum capital for credit, market and operational risk. Cf. Basel II, para. 40.

292 European Commission (*Fiat*), para. 61.

293 European Commission (*Fiat*), para. 70.

294 *Loi modifiée du 4 décembre 1967 concernant l'impôt sur le revenue - text coordinné au 31 décembre 2010*, JO du Grand-Duché de Luxembourg A - N°191, p. 3316 et seq. Original text reads: "Les distributions cachées de bénéfices sont à comprendre dans le revenu imposable. Il y a distribution cachée de bénéfices notamment si un associé, sociétaire ou intéressé reçoit directement ou indirectement des avantages d'une société ou d'une association dont normalement il n'aurait pas bénéficié s'il n'avait pas eu cette qualité.".

295 Available at: http://www.impotsdirects.public.lu/content/dam/acd/fr/legislation/legi11/Circulaire_L_I_R__n___164-2_du_28_janvier_2011.pdf.

296 Cf. European Commission (*Fiat*), para. 54.

297 European Commission (*Fiat*), para. 121.

298 European Commission (*Fiat*), para. 122.

299 European Commission (*Fiat*), para. 132.

2. Commission's Findings concerning the Element of Selectivity

The COM opened its reasoning with a general statement that all conditions of Art. 107 para. 1 TFEU must be fulfilled and then went on with assessing the involvement of State resources, the affectation of intra-Union trade and the distortion of competition.[300]

This is followed by the assessment of the existence of a "selective advantage" in line with the three-step-analysis, according to which the existence of a selective advantage is tested by identifying the reference framework, elaborating if the contested tax ruling deviates from this reference framework and cross-checking if there is a justification therefor.

a) The Reference Framework

The COM considered the ordinary Luxembourg corporate income tax rules as reference framework, since its aim is to tax the profits of standalone as well as incorporated companies resident in Luxembourg. Furthermore, the intrinsic objective of the contested tax ruling would be the determination of the taxable profit "for the purpose of levying corporate income tax under the general Luxembourg corporate income tax system".[301]

It went on with arguing that standalone and integrated companies are in a factually and legally comparable situation. This would be due to the fact that not only is it the law's objective to tax all companies, but also because even the official Circular compared the functions of an intra-group financing company, like *FFT*, to the functions of an independent financial institution (banks) and, hence, the Circular states that the profit from the intra-group financing should be based either on the amount of credit or on the market value of the managed assets.[302]

b) Advantage due to Derogation from Framework

Luxembourg managed to adequately resolve the first of the COM's doubts concerning the fact that it seemed as if the contested tax ruling had established a fixed range of taxable income. It was able to show that the contested tax ruling set a methodology and not a pre-determined return.[303]

In the assessment whether the tax ruling allowed a deviation from the reference framework, the COM laid down how a deviation from tax rules and how a deviation from the arm's length

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[300] European Commission (*Fiat*), para. 187 – 189.

[301] European Commission (*Fiat*), para. 194, 198 and 199.

[302] European Commission (*Fiat*), para. 206.

[303] European Commission (*Fiat*), para. 223. This must be born in mind when studying literature that examines the opening decision and not the final decision, since the COM's doubt that the tax ruling rather agreed upon an annual result than on a calculation method was one of the COM's main reasons to open the investigation in the first place.

principle confer a selective advantage on a beneficiary. The COM assessed the element of selectivity and the element of advantage together arguing that a deviation from the ordinary rules would coincide with the identification of an advantage.[304]

Concerning the method of calculating the taxable basis, the COM observed that this was done according to a transfer pricing analysis including methodological choices of parameter, such as the TNMM method, the choice of profit level indicator and so on. Some of these choices would be covered by the OECD TP Guidelines and some would not be in line with it.[305]

While the COM emphasized the fact that the method and parameters need to be chosen in such a way that a market-based outcome is reached, it also acknowledged that the use of a second-best method does not automatically raise concerns about a potential conferral of an advantage, if it is combined with respectively conservative parameters. On the other hand, even the most appropriate method could lead to an unsatisfying outcome, if combined with overly favourable parameters.[306]

In any event, given the specific circumstances of *FFT* and the disproportionate effort that a more direct transfer pricing method like the CUP would have caused, the COM held that the method chosen by *FFT*'s tax advisor transfer pricing analysis would be appropriate.[307]

However, while the chosen method might have been appropriate, the COM disagreed on the use of several parameters. In short, *FFT*'s tax adviser had calculated a remuneration rate for the intra-group transactions using the CAPM as it is suggested by the OECD for financial institutions. The CAPM leads to a percentage figure representing a return, which was then applied to the hypothetical regulatory capital as a profit level indicator. The COM criticized that the hypothetical regulatory capital is not an adequate profit level indicator, rather it should have been applied to the accounting equity.[308]

The COM provided technical reasons, why a hypothetical regulatory capital is not an adequate profit level indicator. Mainly this is the case, because *FFT* has not been a regulated financial institution, neither are several of the companies that *FFT*'s tax advisor used as comparison; the (hypothetical) regulatory capital is not a commonly used performance indicator; and lastly, applying the estimated return on the accounting equity would have made it obsolete to have a

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304 European Commission (*Fiat*), para. 216 – 218 and 219 – 231.
305 European Commission (*Fiat*), para. 235 and 236.
306 European Commission (*Fiat*), para. 243 et seq.
307 European Commission (*Fiat*), para. 246.
308 European Commission (*Fiat*), para. 256.

second "functions remuneration" component, "which itself does not appear to be based on any sound methodology".[309]

In the following paragraphs, the COM gave alternative reasons why the contested tax ruling would confer a selective advantage. Amongst others, the COM observed that, if the hypothetical regulatory capital was an appropriate profit level indicator, the *FFT*'s tax advisor had used the wrong ratio requirement (6% instead of the 8% required by Basel II). Furthermore, the contested tax ruling allowed inappropriate deductions from the capital to be remunerated.

As an additional argument, the COM referred to a tax ruling that has been submitted by Luxembourg. This tax ruling concerned a financial and treasury company with similar intra-group activities as *FFT*. However, the ruling arrived "at a substantially different conclusion as regards the companies' respective tax bases, without any apparent justification for that difference in treatment."[310] This argument was brought forward in order to show that alternative reference systems, for example the Circular, were inadequate.

c) No Justification for the Deviation

Neither Luxembourg nor *FFT* claimed any circumstances that would justify the selective advantage, even though the burden of proof lies with the Member State.[311]

III. COMMISSION V KINGDOM OF BELGIUM (CASE SA.37667)

1. Factual Basis

The Belgian tax law stipulated special provisions for companies resident in Belgium that belong to a multinational group or permanent establishments of foreign resident companies that are part of a multinational group (hereinafter 'Belgian group companies'). This provision allowed for a tax exemption of the part of the profit that exceeded the profit of a hypothetical independent stand-alone company carrying out comparable activities.[312]

In order to profit from the excess profit exemption, the group company had to apply for an advanced tax ruling, which could only be granted if the company increased its business activity

[309] European Commission (*Fiat*), para. 262 – 265.
[310] European Commission (*Fiat*), para. 335.
[311] European Commission (*Fiat*), para. 337.
[312] European Commission (*Belgian Excess Profit Exemption*), para. 13.

in Belgium, because only new activities can be subject to such a ruling.[313] Furthermore, it is worth noting, that it was not required to declare the part of the profit that was subject to the tax exemption (that is the excess) in another State's tax declaration.[314]

Belgium explained this exemption by stating that any excess to that of a comparable independent stand-alone company would accrue from synergies, economies of scale and other advantages resulting from the multinational corporate structure. Therefore, Belgium would in fact only tax the arm's length profit.[315]

Nevertheless, the Belgian Government argues that the Excess Profit exemption would be justified, because it would be a means to prevent double taxation.[316] The fact that the excess would not be taxed abroad does not lie within the responsibility of Belgium, but rather reveal a shortcoming of the arm's length principle.

2. Commission's Findings concerning the Element of Selectivity

As I outlined above, the assessment of selectivity differs depending on whether the COM assesses an individual aid or an aid scheme. In para. 94 – 110 the COM examined whether the prerequisites for an aid scheme were fulfilled, which would allow the COM to confine its examination to the general characteristics of the scheme without being required to examine each particular tax ruling based on Art. 185 para. 2 lit. b) Wetboek van de Inkomstenbelastingen 1992 (WIB 92). Eventually, the COM held that all prerequisites for the existence of aid were present.[317]

a) The Reference System

With reference to the *Belgium 187* decision of the ECJ,[318] the COM stated that it "considers the reference System to be the ordinary system of taxation of corporate profits under the general Belgian corporate income tax system,[...] which has as its objective the taxation of profit of all companies subject to tax in Belgium as well as Belgian branches of non-resident companies."[319]

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313 European Commission (*Belgian Excess Profit Exemption*), para. 20 and 21.
314 Cf. European Commission (*Belgian Excess Profit Exemption*), para. 86.
315 European Commission (*Belgian Excess Profit Exemption*), para. 14.
316 European Commission (*Belgian Excess Profit Exemption*), para. 68 and 89.
317 European Commission (*Belgian Excess Profit Exemption*), para. 110, with reference to ECJ (*Forum 187*), para. 82.
318 ECJ (*Forum 187*), para. 95.
319 European Commission (*Belgian Excess Profit Exemption*), para. 121.

In detail, the COM argued that the Belgium corporate tax system taxes both companies resident in Belgium as well as Belgian branches of non-resident companies. "In both cases, Belgian corporate income tax is payable on the total profit, either worldwide or Belgian sourced. In general, therefore, all undertakings generating income in Belgium are considered to be in a similar legal and factual situation from the perspective of corporate income taxation."[320]

Consequently, the fact that the Excess Profit Exemption's objective is the adjustment of the company's taxable profit for determining the corporate income tax in Belgium would make it only logical to assess this measure against the corporate income tax system, which, therefore, should serve as a reference system for the assessment of a selective advantage.[321]

b) Advantage due to Derogation from Framework

First, the COM stated that the assessment of a derogation from the framework and the assessment of the conferral of an advantage would coincide.[322]

Then, the COM went on and observed that the Belgian corporate income tax system usually taxes the total profit, meaning the profit that is actually recorded. By relieving a certain part of that profit from the burden of taxation, the Excess Profit Exemption scheme would both deviate from this pattern of the ordinary tax system and grant an advantage to the companies benefitting from it, even though they are in a similar factual and legal situation to other companies that cannot benefit from this.[323]

As an indicator for the comparability of integrated and independent companies, the COM states the Belgian corporate tax system has as its objective the taxation of all corporate taxpayers on their actual profits, irrespective of their size, legal form or corporate structure (integrated or independent). Consequently, since the corporate tax system does not distinguish between companies in any way whatsoever, but the Excess Profit exemption does, it is *de jure* selective.[324]

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320 Ibid.
321 European Commission (*Belgian Excess Profit Exemption*), para. 129.
322 European Commission (*Belgian Excess Profit Exemption*), para. 131.
323 European Commission (*Belgian Excess Profit Exemption*), para. 135 – 136.
324 European Commission (*Belgian Excess Profit Exemption*), para. 138 (also cf. para. 126). The COM finds it to be selective on other reasons as well, cf. para. 139 (advantage only for new activities by multinationals in Belgium) and para. 140 (documentation of economies of scale were only profitable to multinationals of a certain size).

c) Justification by Belgium

Belgium justified the Excess Profit Exemption with the need for an arm's length adjustment. Interestingly, Belgium stated that it would only be allowed to tax the arm's length profit of multinationals, meaning the profit that other standalone companies would have made under the conditions of free competition.[325]

The COM replied to that by stating that "[t]here is no room in the application of the arm's length principle for a general separate recognition for and allocation of profit from synergies and economies of scale in a transfer pricing assessment".[326] Thus, the recorded profit should not be reduced by any kind of artificial 'adjusted arm's length profit'. Rather, such an adjustment would indeed be contrary to the arm's length principle.[327]

Since the Belgian Excess Profit Exemption leads to a lowering of the beneficiaries' tax liability as compared to companies in a similar legal and factual situation, which cannot be justified, it would confer a selective advantage.[328]

[325] European Commission (*Belgian Excess Profit Exemption*), para. 14.
[326] European Commission (*Belgian Excess Profit Exemption*), para. 151.
[327] European Commission (*Belgian Excess Profit Exemption*), para. 156.
[328] European Commission (*Belgian Excess Profit Exemption*), para. 182.

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