EU State Aid Law and Transfer Pricing: A Critical Introduction to a New Saga

Liza Lovdahl Gormsen*

Key points

- This article argues that the European Commission's recent State aid investigations concerning tax rulings are not based on firm legal grounds.
- The author examines the Commission's opening decisions in of Apple, Starbucks, Fiat Finance and Trade, Amazon, and McDonald's and criticises the Commission's use of the arm's length principle and the prudent market operator principle.
- The overall conclusion is that in the Commission's effort to try to develop the law and to expand its remit, it takes a number of unacceptable shortcuts.

I. Introduction

It is undisputed that advance pricing arrangements ('APAs') whereby transfer pricing of related party transactions is confirmed by tax administrations can constitute state aid under Article 107 TFEU since any relief from tax is inevitably financed by the State or granted through state resources if they confer an economic advantage on a selective undertaking/group of undertakings/goods that distorts competition and effects interstate trade. The European Commission ('Commission') has recently stepped up their scrutiny of certain practices of tax administrations *vis-à-vis* APAs in various Member States.[1] It has launched investigations into transfer pricing arrangements of Apple, Starbucks, Fiat Finance and Trade, Amazon, and McDonald's agreed with tax administrations of Member States[2] and recently reached a conclusion in the Belgian 'Excess Profit' case.[3] These investigations fall under the Commission's broad priority of ensuring fairness and equality of the corporate tax system within the EU.[4] They are linked to the widely held concern that multiple Member States appear to be using APAs as a means of allowing multinational corporations to take advantage of their tax systems (by providing opportunities for such corporations to reduce their overall tax burden) and that such practices may put other undertakings at an effective competitive disadvantage. The Commission alleges that APAs could be state aid because they confer a **selective economic advantage** on the companies concerned by lowering their tax liabilities in certain jurisdictions.[5]

The Commission having no powers of its own under the Treaties to legislate on tax, but it has the discretion to investigate whether national tax administrations make rulings or issue APAs that infringe Article 107 TFEU. To that extent, the Commission's state aid investigations are aligned with the OECD/G20 Base Erosion and Profit Shifting (BEPS) project Action 5.[6] That said, AG Kokott has warned that 'too broad an understanding of the

* L.L.G. is a senior research fellow at the British Institute of International and Comparative Law, the Director for the Competition Law Forum, and a senior lecturer in Law at the University of Manchester. The research carried out for this article has not been funded by any corporation or funding body. I am grateful to my interns Joseph Tomlinson and Clement Mifsud Bonnici who have provided great research assistance on this article. I would also like to thank the following people for helpful comments and suggestions: Professor Jonathan Schwarz (King's College London and Temple Tax Chambers), Dominic Robertson (Tax Partner at Slaughter & May), and Elisabetta Righini (visiting Professor at King's College London and Latham & Watkins). The analysis and conclusions expressed herein are solely those of the author, and responsibility for any mistakes remains mine alone.

1 For recent commentary on these events, see Raymond Luja, 'Will the EU's State Aid Regime Survive BEPs?' [2015] 3 British Tax Review 379; Claire Micheau, 'Tax Selectivity in European Law of State Aid: Legal Assessment and Alternative Approaches' [2015] 40:3 European Law Review 323; Michael Lang, 'Tax Rulings and State Aid Law' [2015] 3 British Tax Review 391.

2 State aid SA.38373 (2014/C) (ex 2014/NN) (ex 2014/CP)—Ireland *Alleged aid to Apple*; State aid SA.38374 (2014/C) (ex 2014/NN) (ex 2014/CP)—The Netherlands *Alleged aid to Starbucks*; State aid SA. 38375 (2014/NN) (ex 2014/CP)—Luxembourg Alleged aid to FFT; State aid SA.38944 (2014/C)—Luxembourg *Alleged aid to Amazon by way of a tax ruling*; State aid SA. 38945 (2014/c)—Luxembourg *Alleged aid to McDonalds.* (Hereafter the 'Opening Decisions'.)

3 Belgium—excess profit tax ruling system in Belgium (3 February 2015) [SA.37667]. On 11 January 2016, the Commission issued its decision finding that the Belgian excess profit tax scheme was illegal. Commission decision of 11.1.2016 on the excess profit exemption state aid scheme SA.37667 (2015/C) (ex 2015/NN) implemented by Belgium.

4 Margrethe Vestager, 'Independence Is Non-negotiable' (Chatham House Competition Policy Conference, London, 18 June 2015) <http://ec.europa.eu/commission/2014-2019/vestager/Announcements/independence-non-negotiable_en> accessed 1 May 2016. For some further context, see Alec Burnside and Anne MacGregor, 'Enter Martha Vestager' [2015] 14:8 Competition Law Insight 10.

5 Luxembourg *Alleged aid to Amazon by way of a tax ruling* (n 2).

6 OECD/G20 Base Erosion and Profit Shifting Project, 'Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance'—ACTION 5: 2015 Final Report.

selectivity of national provisions, however, harbours the risk of adversely affecting the division of competences between the Member States and the European Union'.[7] A warning against too broad an understanding of selectivity of national provisions is warranted because the Member States have sovereignty in relation to direct taxation.

The taxation of multinational enterprises has become an increasingly political issue as reflected in a recent exchange between Europe and the United States. The arguments raised vary from the encroachment of Member States' sovereign powers in relation to direct taxation matters to alleged discriminatory treatment of US multinationals.[8] The Secretary of US Treasury, Jacob Lew, formally expressed concerns that the Commission 'appears to be adopting an entirely new legal theory and applying it retroactively in a broad and sweeping manner'.[9] Furthermore, the Commission's 'enforcement actions . . . are inconsistent with, and likely to contrary to, the BEPS project' and 'appears to be targeting U.S. companies disproportionately'.[10] This paper is not going to dwell upon the political arguments. Rather, it assess whether Commissioner Vestager is right when she argues, in her response to Lew, that the Commission's 'investigations into tax rulings is based on firm legal ground'.[11]

This paper finds that the legal ground is not as firm as argued by Commissioner Vestager.

Firstly, the cumulative criteria of 'selectivity' and 'advantage' are conflated. The Commission only focusses on 'advantage' and ignores 'selectivity'. It has been argued that '[s]ince each ruling concerns a single company there is no need to linger long on the issue of selectivity'.[12] If this is the reason for ignoring an analysis of selectivity, it not only conflicts with Article 107 TFEU, but it also ignores recent case law, which requires a separate analysis of these two conditions: 'the requirement as to selectivity under Article 107(1) TFEU must be clearly distinguished from the concomitant detection of an economic advantage'.[13] While a detection of an economic advantage could create a rebuttable presumption (in some cases) that it is selective, it does not alter the fact that economic advantage and selectivity are two separate conditions, which requires a separate analysis. This is all the more important in cases concerning tax, as AG Kokott highlighted in her Opinion in *Finanzamt Linz v Bundesfinanzgericht*:[14]

> In matters of tax law in particular, however, the decisive criterion is whether a provision is selective, because the other conditions laid down in Article 107(1) TFEU are almost always satisfied. [. . .] The criterion relating to the selectivity of a national provision therefore requires careful handling. If the provision concerns neither one or more individually identifiable sectors capable of being defined by reference to their economic activity, nor individually identifiable undertakings, as the wording of Article 107(1) TFEU requires, then the provision in question cannot in principle be assumed to be selective.

Secondly, selectivity of a specific measure such as a tax ruling has to be assessed against reference framework as identified, for example, national legislation. The OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (the 'OECD Guidelines')[15] refer to Article 9(1) of the OECD Model Convention as the authoritative statement of the arm's length principle, but that does not give it legal effect without national law that imposes an arm's length rule. If the Commission has doubts about the compatibility of the arm's length principle as applied under OECD Guidelines and incorporated in national tax laws, it ought to focus on national tax legislation rather than individual rulings. An examination of national tax rules must be undertaken as those rules are, and not as the Commission feels they ought to be.

Thirdly, the Commission adopts a rigid interpretation of the arm's length principle, which is inconsistent with that in the OECD Guidelines, which acknowledge that the arm's length principle is a method aimed at 'estimation' and 'approximation' denoting that a precise result is not possible to achieve.[16] The problem is not necessarily the Commission's scrutiny of whether transfer pricing arrangements that are approved in APAs are determined in accordance with the arm's length principle *per se*, as the principle is recognised in many tax treaties; rather, the problem is the uncertainty inherent in the arm's length principle and the way in which the Commission applies it.

Fourthly, the Commission relies upon the concept of a prudent market operator. It is not clear from the opening decisions whether this is a standalone test or whether it is to be incorporated within the arm's length

7 Case C-66/14 *Finanzamt Linz v Bundesfinanzgericht* [2015] Außenstelle Linz, Opinion of AG Kokott, para. 113.

8 Letter from Congressman Boustany to David O'Sullivan (18 December 2015).

9 Letter from Jacob J. Lew to Jean-Claude Juncker (11 February 2016).

10 Ibid.

11 Letter from Commissioner Magrethe Vestager to Jacob J. Lew (29 February 2016).

12 Richard Lyal, 'Transfer Pricing Rules and State Aid' [2015] 38 Fordham International Law Journal 1017, 1042.

13 *European Commission v MOL Magyar Olaj-és Gázipari Nyrt.* Case C-15/14 [2015], EU:C:2015:32, para. 59.

14 Case C-66/14 *Finanzamt Linz v Bundesfinanzgericht* [2015] Außenstelle Linz, Opinion of AG Kokott, paras 114 and 115.

15 *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD, 2010).

16 Ibid, paras 1.14, 3.55, and 7.23.

principle. It is, however, clear that it relates somehow to the assessment of whether there is an economic advantage. The problems with this concept in EU State aid law are threefold: firstly, it is not clear whether this concept is intended to replace the so-called market economy operator (MEO) test if at all different from the MEO in tax-related matters; secondly, it creates inconsistency between the arm's length principle applied in international tax law reflected in the OECD Guidelines, which refers to the concept of an independent enterprise, rather than a prudent one; finally, the opening decisions are ambiguous, and it is unclear whether the Commission aims the prudent market operator test at the alleged recipients or whether the Commission is implying that there is a correct 'market-based' tax outcome calculated in reference to a prudent market operator test. In this regard, it is unclear who the Commission is aiming the prudent market operator test at, ie the Member State or the beneficiary or indeed both. What is clear, however, is that the Commission should not apply any such market-based comparison test to the state acting in its public capacity.[17]

II. Concerns about APAs and the European Commission's response

APAs can be unilateral, bilateral, or multilateral. Notably, each of the APAs currently under investigation involves a unilateral APA with that respective Member State's tax authority, as opposed to multilateral APAs where more than one tax authority is a party to that agreement. The dispute in the Commission's tax investigations is not whether the national tax administrations can agree APAs with multinational enterprises as it is acknowledged that such rulings can often produce a more certain and thus better taxation environment, but rather whether the national tax administrations concluded APAs amount to illegal state aid prohibited under Article 107 TFEU.

APAs were first developed in the United States and then adopted by the OECD as one of the several administrative mechanisms to reduce the high degree of legal uncertainty that is inherent in transfer pricing arrangements. The OECD term 'Advanced Pricing Arrangement' is intended to cover a wide range of administrative instruments that aim at certainty, each with their own rules. APAs (like other rulings) play a valuable role by avoiding disputes and preventing genuine double taxation. In particular, where tax authorities enter into multilateral APAs, double taxation is more easily avoided. More generally, a tax ruling system may be set up because taxpayers require support in their own assessments, or because there exists a desire to foster a level of cooperation between taxpayers and the taxation authorities, or because authorities view a rulings system as a means of identifying important information at an earlier stage. These justifications underpin the overarching notion that rulings can often, through increased certainty and clarity, produce a better taxation environment, as acknowledged by the Commission in its *Draft Notice on the Notion of State Aid pursuant to Article 107(1)*[18] and its *Notice on the Application of the State Aid rules to measures relating to direct business taxation*.[19]

APAs have been within the Commission's glare for some time, and in recent years, there have been two major responses by the Commission to the perceived problems with APAs that go beyond the acknowledged useful role they play. One response came when the Commission published a proposal to include an automatic exchange of advance cross-border rulings and APAs in the *Council Directive on Administrative Cooperation in the field of taxation*.[20] This Directive comes into force on 1 January 2017.[21] While it does not provide for public disclosure, although the Commission is currently pressing for public disclosure of the country-by-country tax reports, which must be filed with tax authorities by large businesses,[22] the new Directive requires tax rulings to be disclosed to the Commission.

Another response by the Commission, and the focus of the discussion here, is the State aid investigations concerning APAs granted to certain multinational corporations by Member States. Developments in this respect have been rapid, and thus the following summary (see Table 1 for an overview) is correct at the time of writing but may be quickly out of date.[23]

In June 2013, the Commission sent a number of information requests to select Member States on tax rulings

17 *Ryanair v Commission*, C-196/04, EU:T:2008:585, para. 85 (states when 'the State acts as a public authority . . . the conduct of the State can never be compared to that of an operator or private investor in a market economy').

18 Commission Notice on the notion of State aid as referred to in Article 107(1) TFEU (2016), para 169.

19 Commission Notice on the application of the State aid rules to measures relating to direct business taxation [1998] *Official Journal C 384, 10/12/1998 P. 0003–0009*, para. 22. This was also reiterated by the Commission in the opening decisions under examination (n 2).

20 Council Directive 16/EU concerning administrative cooperation in the field of taxation and repealing Directive [2011] 77/799/EEC.

21 European Council Press releases and statements, 'Cross-border tax rulings: transparency rules adopted' [2015] <http://www.consilium.europa.eu/en/press/press-releases/2015/12/08-ecofin-cross-broder-tax-ruling/> accessed 1 May 2016.

22 Member States may opt to exclude APAs issued to companies with annual net turnover of less than EUR40m at a group level if they were issued, amended or renewed before 1 April 2016.

23 Research finished on 2 May 2016.

Table 1: Current stage of Commission investigations of APA under State aid rules

Case no.	Concerning	Member State	Opening decision	Final decision
SA.38374	Starbucks	The Netherlands	11 June 2014	21 October 2015 (not yet published)
SA.38375	Fiat	Luxembourg	11 June 2014	21 October 2015 (not yet published)
SA.38373	Apple	Ireland	11 June 2014	Not yet completed
SA.38944	Amazon	Luxembourg	7 June 2014	Not yet completed
SA.38945	McDonald's	Luxembourg	3 December 2015 (not yet published)	Not yet completed

issued by their respective tax authorities. The information gathered is believed to have led the Commission to open four investigations towards the last two quarters of 2014. Those investigations were in Ireland (concerning Apple), the Netherlands (concerning Starbucks), and Luxembourg (concerning Fiat and Amazon).[24] In December 2014, the information requests on tax rulings were extended to the remaining Member States,[25] although it does not appear that any new investigations were initiated as a result.[26] In October 2015, the Commission concluded that Fiat and Starbucks had each benefited from illegal state aid arising out of APAs granted to them by Luxembourg and the Netherlands, respectively.[27] The final decisions remain, at present, confidential. The Netherlands, Luxembourg, and Fiat have all appealed the Commission Decision.[28]

Subsequent to the Commission's announcement of the final findings in the investigations concerning Starbucks and Fiat, a fifth investigation was announced on 3 December 2015[29] concerned McDonald's,[30] which examines much of the same factual subject matter as the four other investigations. Commissioner Vestager reiterated the Commission's intention to ensure that APAs are not employed as a means of multinationals receiving illegal State aid:[31]

> A tax ruling that agrees to McDonald's paying no tax on their European royalties either in Luxembourg or in the US has to be looked at very carefully under EU state aid rules. The purpose of Double Taxation treaties between countries is to avoid double taxation—not to justify double non-taxation.

It is important to distinguish the McDonald's case from the other four investigations. The initial four cases all concerned APAs, whereas the ruling in McDonald's was not an APA, but a ruling on whether, under the US-Luxembourg Double Tax Treaty, Luxembourg had any right to tax the relevant income.

The McDonald's investigation focusses upon two rulings provided by the Luxembourgish authorities to McDonald's Europe Franchising in 2009. The ruling concerned the corporate tax that was to be imposed on profits received by McDonald's Europe Franchising and transferred intra-group to the US branch of the company. The source of the material profits was intra-group transactions and, in particular, profits made from restaurants in Russia and Europe paying McDonald's Europe Franchising in order to use the McDonald's branding and certain other services. The first ruling, in March 2009, essentially stated that McDonald's Europe Franchising did not have to pay corporate tax in Luxembourg. That ruling was based on the premise that the profits were taxable under US law, and the ruling was justified on the basis of the Luxembourg-US Double Taxation Treaty. McDonald's Europe Franchising was simply required to prove each year that the profits transferred to the United States were declared and taxed. However, US

24 Opening Decisions (n 2). See Commission Press Release, 'Commission investigates transfer pricing arrangements on corporate taxation of Apple (Ireland) Starbucks (Netherlands) and Fiat Finance and Trade (Luxembourg)' (2014) <http://europa.eu/rapid/press-release_IP-14-663_en.htm> accessed 1 May 2016; Commission Press Release, 'State aid: Commission investigates transfer pricing arrangements on corporate taxation of Amazon in Luxembourg' (2014) <http://europa.eu/rapid/press-release_IP-14-1105_en.htm> accessed 1 May 2016.

25 Commission Press Release, 'State aid: Commission extends information enquiry on tax rulings practice to all Member States' (2014) <http://europa.eu/rapid/press-release_IP-14-2742_en.htm> accessed 1 May 2016.

26 Concurrently, it must be noted that the International Consortium of Investigative Journalists published LuxLeaks during this time on 5 November and 9 December 2014. For further information, see <http://www.icij.org/project/luxembourg-leaks> accessed 1 May 2016.

27 Commission Press Release, 'Commission decides selective tax advantages for Fiat in Luxembourg and Starbucks in the Netherlands are illegal under EU state aid rules' (21 October 2015) <http://europa.eu/rapid/press-release_IP-15-5880_en.htm> accessed 1 May 2016.

28 Action brought on 23 December 2015—*Netherlands v Commission* [T-760/15], Action brought on 29 December 2015—*Fiat Chrysler Finance Europe v Commission* [T-759/15], and Action brought on 30 December 2015—*Luxembourg v Commission* [T-755/15].

29 Commission Press Release, 'Commission opens formal investigation into Luxembourg's tax treatment of McDonald's' (2015) <http://europa.eu/rapid/press-release_IP-15-6221_en.htm> accessed 2 May 2016.

30 Commission Decision SA.38945—Luxembourg Alleged aid to FF (n 2).

31 Commission Press Release (n 29).

law did not, counter to the premise of the first ruling, impose any tax on the profits. McDonald's sought a second ruling and the Luxembourgish authorities permitted the same taxation arrangement as was permitted by the first ruling but did not impose any requirement to prove that the profits were being taxed in the United States. Thus, the alleged effect of those rulings is that, since that time, McDonald's Europe Franchising was under an effective corporate tax rate of 0% in Luxembourg, despite having enormous profits (more than EUR 250 m in 2013). The key points in the decision are what the benchmark is to judge this ruling by and whether double non-taxation is itself can be considered state aid. However, that would raise very wide questions about the relationship between member state tax law, tax treaties, and EU law.

III. EU State aid law and the tax context

The EU State aid rules can be found in Articles 107–109 TFEU.[32] They form part of the same chapter on the Rules of Competition in the Treaty as Articles 101 and 102 TFEU, which are concerned with fair and equal competition. The State aid regime is designed to protect competition between undertakings from distortions of competition or intra-state trade that are generated by the Member States through the grant of measures favouring certain undertakings or goods at the expense of others. The rules are also intended to protect the internal market against segmentation through State aid while, at the same time, ensuring that there is no unjustified discrimination against foreign nationals or non-residents or forms of protectionism favouring domestic undertakings or capital.

A measure will be considered to be State aid if the measure under examination satisfies the following cumulative criteria:

(a) it must confer an economic advantage on the beneficiary;[33]
(b) it must be granted by a Member State or through State resources;[34]
(c) it must be a selective advantage (it must favour certain undertakings, the production of certain goods, or the provision of certain services);[35]
(d) there must be a (potential for) distortion of competition;
(e) there must be an effect (or potential effect) on trade between Member States.[36]

The definition of State aid is wide and has been expanded further by a number of Commission's decisions and judgments delivered by the Court of Justice (CJEU). It is important to distinguish unlawful aid from incompatible aid. Subject to two exceptions,[37] Member States are required to notify the Commission before any planned aid (irrespective of whether it is non-aid or compatible aid) is implemented—failure to notify the Commission *a priori* or to hold off the implementation of the aid until the Commission's clearance will render the aid illegal. The illegality of the aid is attached to the failure to observe procedural formalities which differs from the concept of incompatibility. Aid is incompatible with the internal market, firstly, if the requisites of Article 107(1) TFEU are

32 See Conor Quigley, *European State Aid Law and Policy* (3rd edn Hart Publishing, Oxford 2015); Erika Szyszczak, *Research Handbook of State Aid Law* (1st edn Edward Elgar, Cheltenham 2011); Leigh Hancher, Tom Ottervanger, and Piet Jan Slot (eds.), *EU State Aids* (4th edn Sweet & Maxwell, London 2012); John Temple Lang, 'EU State Aid Rules—The Need for Substantive Reform' (2014) 13 European State Aid Law Quarterly 440.

33 For example, *Déménagements—Manutention Transport SA (DM)* C-256/97, EU:C:1999 ECR I-3913 and Opinion of AG Jacobs, para. 31; *Syndicat français de l'Express international (SFEI) and others v La Poste and Others* C-39/94, EU:C:1996 ECR I-3547 and Opinion of AG Jacobs, para. 60; *Italy v Commission* C-173/73, EU:C:1974:71 ECR 709, para. 26; *Banco de Crédito Industrial SA, now Banco Exterior de España SA v Ayuntamiento de Valencia* C-387/92 EU:C:1994 ECR I-877, paras 12 and 13; *Altmark Trans GmbH and Regierungspräsidium Magdeburg v Nahverkehrsgesellschaft Altmark GmbH* and *Oberbundesanwaltbeim Bundesverwaltungsgericht* C-280/00, EU:C:2003: ECR I-7747; and *Danske Busvognmænd v Commission of the European Communities (Combus)* T-157/01, EU:T:2004 ECR II 917, para. 57.

34 For example, *Het Vlaamse Gewest (Flemish Region) v Commission of the European Communities* T-214/95 EU:T:1998 ECR II-717; *SA Intermills v Commission of the European Communities* 323/82, EU:C:1984:345 ECR 3809; Joined Cases *Netherlands and Leeuwarder Papierwarenfabriek BV v Commission of the European Communities* C-296 and 318/82, EU:C:1985 ECR I-809; *Belgium v Commission of the European Communities (Tubemeuse)* C-142/87, EU:C:1990 ECR I-959; *Italy v Commission of the European Communities* C-303/88 [1991] ECR I-1433; *Italy v Commission of the European Communities* C-305/89, EU:C:1991 ECR I-1603; *Commission of the European Communities v Greece* C-63/87 [1988] ECR I-2875; *France v Commission of the European Communities (Fonds industriel de modernisation)* C-102/87, EU:C:1988 ECR I-4067; and *Italy and Sardegna Lines Servizi Marittimi della Sardegna SpA v Commission of the European Communities* Joined Cases C-15/98 and C-105/99, EU:C:2000 ECR I-8855.

35 For example, *Adria-Wien Pipeline GmbH and Wietersdorfer & Peggauer Zementwerke GmbH v Finanzlandesdirektion für Kärnten* C-143/99, EU:C:2001 ECR I-8365; *Confederación Española de Transporte de Mercancías (CETM) v Commission of the European Communities* T-55/99, EU:T:2000 ECR II-3207; *Ecotrade Srl v Altiforni e Ferriere di Servola SpA (AFS)* C-200/97, EU:C:1998 ECR I-7907, para. 36; *Netherlands v Commission of the European Communities (Fisheries quotas)* C-290/87, EU:C:1989 ECR I-3083, paras 22 and 23; *Amministrazione delle finanze dello Stato v Denkavit italiana Srl* C-61/79, EU:C:1980 ECR I-1205, para. 31; and *R Camar v Commission of the European Communities and Council* T-260/97, EU:T:1997 ECR II-2357, para. 62.

36 For example, *Alzetta Mauro and Others v Commission of the European Communities* Joined Cases: T-298/97, T-312/97, T-313/97, T-315/97, T-600/97 to T-607/97, T-1/98, T-3/98 to T-6/98, and T-23/98 EU:T:2000 ECR II-2319, para. 81 and *Regione Friuli Venezia Giulia v Commission of the European Communities* T-288/97, EU:T:2001 ECR II-1169, para. 41.

37 Prior notification to the Commission is not required if the aid is *de minimis* or falls within a general block exemption. There are also sector-specific exceptions.

satisfied, and secondly, if the scenarios envisaged in Articles 107(2) and (3) TFEU are not applicable. As explained by the Commission, State aid that is compatible with the rules is 'well-designed, targeted at identified market failures and objectives of common interest and least distortive'.[38] Specific examples include aid that promotes innovation or green energy technologies, avoids environmental harm, or promotes general growth within the EU.

Though the State aid rules have always been applied to tax rulings,[39] in recent years, State aid law has taken on ever-increasing significance in the tax sphere.[40] It is well established that taxation activities (including reductions and exemptions) may constitute State aid.[41] According to the Commission, any tax ruling that departs from general tax rules, and benefits individual undertakings as a result, can be presumed to be state aid.[42]

In essence, it is the substance of the tax measure and not its form that is relevant. According to settled CJEU jurisprudence, a measure is to be considered as falling within the prohibition if the cumulative requirements mentioned above are met.[43] In the tax context, it is the questions of selectivity, advantage, and anticompetitive effects that are most crucial.

The general approach of the Commission in each of the first four investigations is substantively similar and follows the same pattern: (i) identification of the main question being the selectivity of any advantage granted, (ii) identification of the prudent market operator principle and at arm's length principle as the relevant standards underpinning the assessment which flows from that question, and (iii) a finding of selective advantage.

IV. A selective advantage: two sides of the same coin?

The selectivity issue lies at the heart of tax state aid cases. Selectivity is a contested concept, and the Court of Justice frequently overrules the General Court.[44] It appears that the public non-confidential versions of the opening decisions in the Apple, Starbucks, Fiat, and Amazon cases fail to distinguish selectivity from advantage. AG Wahl's Opinion in *MOL Magyar* highlights this distinction:[45]

> [t]hat requirement as to selectivity or—to use another term frequently employed—'specificity' of the measure must be clearly distinguished from the detection of an economic advantage. In other words, once an advantage, understood in a broad sense, has been identified as arising directly or indirectly from a particular measure, it is then for the Commission to establish that that advantage is specifically directed at one or more undertakings. It falls to the Commission to show that the measure, in particular, creates differences between undertakings which, with regard to the objective of the measure, are in a comparable situation. What is prohibited is not the granting of an advantage as such, but the fact that, if carried out in a discriminatory and selective manner, such granting is liable to place certain undertakings in a more favourable situation than others.

AG Wahl's Opinion on this point was accepted by the CJEU, which stated: 'the requirement as to selectivity under Article 107(1) TFEU must be clearly distinguished from the concomitant detection of an economic advantage, in that, where the Commission has identified an advantage, understood in a broad sense, as arising directly or indirectly from a particular measure, it is also required to establish that that advantage specifically benefits one or more undertakings'.[46] Despite having just accepted AG Wahl's Opinion on the importance of clearly distinguishing selectivity from economic advantage, the Court acknowledges 'the identification of the economic advantage is, in principle, sufficient to support the presumption that it is selective'.[47] While it is recognised that in *some cases* a detection of an economic advantage could create a rebuttable presumption of selectivity, this presumption should not apply in cases of

38 European Commission 2012: Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions on EU State Aid Modernisation COM(2012) 12 final, Brussels, 8 May 2012 <http://ec.europa.eu/competition/state_aid/modernisation/index_en.html> accessed 1 May 2016.

39 For example, *De Gezamenlijke Steenkolenmijnen in Limburg* v *High Authority of the European Coal and Steel Community* C-30/59, EU:C:1961:2; *Italian v Commission* (n 33).

40 See Pierpaolo Rossi-Maccanico, 'Commentary of State Aid Review of Multinational Tax Regimes' [2007] 1 European State Aid Law Quarterly 25; Christian HJI Panayi, 'State Aid and Tax: The Third Way?' [2004] 32:6/7 Intertax 287, 311; Michael Rydelski, 'Distinction Between State Aid and General Tax Measures' [2010] 19:4 EC Tax Review 149; Melanie Staes, 'The Combined Application of the Fundamental Freedoms and the EU State aid Rule: In Search of a Way Out of the Maze' [2014] 42:2 Intertax 106; Conor Quigley, 'Direct Taxation and State Aid: Recent Developments Concerning the Notion of Selectivity' [2012] 40:2 Intertax 112.

41 *De Gezamenlijke Steenkolenmijnen* (n 39).

42 Commission Notice (n 19). This was also more recently acknowledged by Commission Notice (n 18).

43 *Ministero dell'Economia e delle Finanze v Paint Graphos (Italian Cooperatives)* Joined Cases C-78/08 to C-80/08, EU:C:2011 ECR I-07611, para. 43.

44 Commission Decision 2005/261/EC of 30 March 2004 on the aid scheme which the United Kingdom is planning to implement as regards the Government of Gibraltar Corporation Tax Reform OJ 2005 L 85/1, found selectivity and therefore incompatible aid. On appeal the General Court, the court found no selectivity, *Government of Gibraltar and United Kingdom of Great Britain and Northern Ireland v Commission* T-211/04 and T-215/04, ECLI:EU:T:2008:595. On appeal to the Court of Justice, the court reinstated the Commission's decision as selectivity present in general tax regime if benefit limited to identifiable group of undertakings, *Commission and Kingdom of Spain v Government of Gibraltar and United Kingdom of Great Britain and Northern Ireland* C-106/09P and C-107/09P, ECLI:EU:C:2011:732.

45 *Commission v MOL* (n 13) Opinion of AG Wahl, para. 47.

46 *Commission v MOL* (n 13), para. 59.

47 Ibid, para. 60.

direct taxation. The reason for rejecting the presumption is threefold. Firstly, as recognised by the Court, economic advantage and selectivity are two separate conditions, which require a separate analysis.[48] Secondly, Member States have explicit sovereignty in relation to direct taxation. Thirdly, in matters of tax law in particular, the decisive criterion is whether a provision is selective because the other conditions laid down in Article 107(1) TFEU are almost always satisfied. Thus, by presuming in tax cases that an advantage leads to selectivity effectively reduces the first two steps of the analysis to assess whether the arm's length principle has been applied correctly.

Different tests have been developed by the CJEU and further elaborated upon by the Commission to verify whether 'selectivity' and 'advantage' are present in an alleged measure of aid. The Commission puts forward two key tests to assess the 'advantage' aspect of the alleged aid: firstly, the prudent market operator principle, and secondly, the arm's length principle. These two principles will be analysed further below. The Commission does not engage in an assessment of whether the relevant APAs were 'selective' in nature. On the contrary, the Commission states, without reference to specific facts of the case, that a tax ruling which deviates from the practice of the issuing rulings 'have the effect of lowering the tax burden of the undertakings concerned as compared to undertakings in a similar legal and factual situation'.[49] The Commission seems to rely on the assumption that if there is a derogation from a general measure there is *prima facie* aid.[50] In these transfer pricing cases, the Commission fails to clearly identify what the general measure is. Rather, it goes on to state that 'to the extent the [relevant Member State's] authorities have deviated from the arm's length principle as regards [the undertaking], the contested rulings should also be considered *selective* [emphasis added]'.[51] This contrasts *Forum 187* where the CJEU held that the arm's length principle *might* be an appropriate test used to assess whether there is an economic advantage granted by the State.[52] The Commission seems to equate the breach of the arm's length principle with selective aid.[53]

This is a potentially dangerous development in EU State aid law. The arm's length principle is not well equipped to assess whether the measure is selective or otherwise but rather is fit to assess whether an economic advantage was granted to an undertaking as to an intra-group arrangement, which would not have been obtainable on the open market. The assumption that a breach of the arm's length principle equates to selective aid skips an important assessment dictated by the three-step approach developed by the CJEU. At no point does the Commission engage in this assessment. That said, it is acknowledged that these were opening decisions and one would have to wait for the final decisions.[54] Yet, a reading of the appeals filed by the Netherlands and Fiat it appears that the Commission stuck to this conflated approach of selective economic advantage.[55]

V. Selectivity in transfer pricing: choosing the right benchmark

The concept of selectivity in EU State aid law (beyond matters of taxation) has baffled many over the years.[56] This is somewhat attributable to the inconsistent terminology used by the CJEU to describe the test of selectivity. Before considering the actual *dictum* of the CJEU, it is suggested that this elusive concept should be approached with a pragmatic common-sense approach.

Selectivity implies a difference in treatment, whether you call it discrimination or lack of equal treatment. To ascertain whether there is a difference or distinction, it is important to identify those entities which are in a similar legal and factual situation and by subsequently properly defining that group of entities. The entities in this relevant group will be our benchmark to test whether there was a difference in treatment. In similar terms, a measure is not selective when it applies to all entities within that group but only if it applies to one entity or a select number.

Assuming that the identification of the benchmark is correct, then any measure that applies to all entities on

48 Ibid, para. 59.

49 Opening Decisions (n 2).

50 More recently, see *BNP Paribas v Commission* C-452/10 P, EU:C:2012:366, para. 101.

51 Opening Decisions (n 2).

52 *Belgium and Forum 187 ABSL v Commission* C-182/03 and C-217/03, EU:C:2006:416.

53 The lack of clarity in the Commission's drafting of the decisions seems to have confused the US Treasury, which seems to equate the Commission's application of the arm's length principle, under the 'advantage' umbrella, with the 'theory of selectivity'. This to a certain extant not unwarranted as explained above. See Letter from Jacob J. Lew to Jean-Claude Juncker (n 9).

54 In the *Action brought on 23 December 2015—Netherlands v Commission* (n 28), The Netherland claims in its appeal that 'the Commission erroneously took the general Netherlands corporation tax system as a reference'.

55 See also Dimitrios Kyriazis, 'Actions for Annulment in the Fiat and Starbucks Cases: A First Taster of What Will Ensue' Wolters Kluwer Competition Law Blog (2016) <http://kluwercompetitionlawblog.com/2016/02/29/actions-for-annulment-in-the-fiat-and-starbucks-cases-a-first-taste-of-what-will-ensue/> accessed 1 May 2016.

56 A recent case is *Eventech Ltd v The Parking Adjudicator* C-518/13, EU:C:2015:9 [2015], where no selectivity was found.

that benchmark is referred to as a general measure. Any measure that departs from that general measure to apply to select entities (but not all) on that benchmark is referred to as a derogation. Distinguishing a derogation from a general measure or scheme, however, is not easy. Admittedly, the labels of 'derogation' and of 'general measure or scheme' are not that important, but at the heart of this distinction lies the test of selectivity.

Jurisprudence of the CJEU has developed a three-step approach, which has been endorsed repeatedly by the Commission, to assess whether a measure is selective.[57] In *Salzgitter AG*, the General Court embodies the first two steps as developed through the passage of time:[58]

> [a] State aid, within the meaning of European Union law, thus presupposes that, within the context of a particular legal system, a State measure is such as to favour certain undertakings or the production of certain goods in comparison with others which are in a legal and factual situation that is comparable in the light of the objective pursued by the scheme in question.

The CJEU has time and time again expressed itself in nebulous terms on the question whether there is one test or two tests here.[59] Arguably, this distinction is largely unimportant so far as these two related facets are present: firstly, the identification of the general legal system or rather the reference framework, and secondly, whether there is a difference in treatment by analysing like for like (undertakings in a comparable legal and factual situation). This seems to be constructively implied by the CJEU in a number of cases, in particular *Paint Graphos*.[60]

The *Autogrill*[61] and *Banco Santander*[62] cases, however, have recently shown that the real challenge is not in the definition of test/s but rather in their application.[63] The General Court went out on a limb in those cases to disagree with the Commission and held that even though the tax scheme in question departed from the general Spanish corporation taxation system, the scheme was still available to *all* Spanish undertakings without discrimination. The General Court specifically required that the Commission identifies a 'particular category of undertakings [. . .] which could be distinguished on account of their specific characteristics', which is benefitting from the measure to satisfy the selectivity criterion.[64] These cases follow the CJEU judgment in *Gibraltar* where the CJEU held that the Commission had correctly identified the offshore companies as a 'privileged category' over domestic companies and found that there was selectivity.[65]

This was recently re-affirmed by AG Kokott in *Finanzamt Linz* where she explained that Article 107(1) TFEU requires that 'the group of taxable entities benefiting from a tax regime [must] sufficiently constitute specific undertakings or the production of certain goods' as a 'privileged category'.[66] Admittedly, these cases relate to general schemes, which were implemented in their respective Member State, and not to a derogation constituting individual aid. However, *Autogrill* and *Banco Santander* both illustrate the point that different results can be achieved if the initial questions on selectivity are answered incorrectly.

These first two steps in the selectivity assessment are absent from the opening decisions under examination. This contrasts with the opening decision of the Belgium excess profit tax ruling system which went through the three-step approach to find selectivity.[67] It may well be the case that the final decisions in Starbucks and Fiat did lay the Commission's reasoning for selectivity in line with the three-step approach, but in the absence of non-confidential public versions of those decisions, the author will put forward an assessment of what should be the correct benchmark.

Firstly, the reference framework must be identified, and it must be decided whether a wide or a narrow definition is to be adopted. In most of the CJEU cases referred to above, the framework was defined widely as the 'general law of taxation'.[68] The Commission did, however, propose a narrower definition in the *Autogrill* and *Banco Santander* decisions—'the rules on the tax treat-

57 Draft Commission Notice (n 18).

58 *Salzgitter AG and Germany v Commission* T-308/00, EU:T:2013:30, para. 116.

59 *Adria-Wien Pipeline* (n 35), para. 41; *Spain v Commission of the European Communities* C-409/00, EU:C:2003 E.C.R. I-1487, para. 47; *Portugal v Commission of the European Communities* C-88/03, EU:C:2006 E.C.R. I-7115, para. 54; *GIL Insurance Ltd v Commissioners of Customs and Excise* C-308/01, EU:C:2004 E.C.R. I-4777, para. 68; *British Aggregates Association v Commission* C-487/06 P, EU:C:2008 E.C.R. I-10515 at [82]; *Presidente del Consiglio dei Ministri v Regione Sardegna* C-169/08, EU:C:2009 E.C.R. I-10821, para. 61; and *European Commission v Kingdom of the Netherlands (NOx)* C-279/08, EU:C:2011 E.C.R. I-7671, para. 62.

60 *Paint Graphos* C-78/08, EU:C:2011, para. 49.

61 *Autogrill Espana SA v Commission* T-219/10, EU:T:2014:939.

62 *Banco Santander SA and other v Commission* T-399/11, EU:T: 2014:938.

63 It must be noted, however, that both cases are subject to appeal.

64 *Autogrill Espana SA v Commission* (n 61), para. 81; *Banco Santander SA and Other v Commission* (n 62), para. 85 and Adrien Giraud & Slyvain Petit, *Spanish Fiscal Aid Cases: the Good, the Bad and the Unclear* (EStAL 2015) 2 295.

65 *Commission v Government of Gibraltar and United Kingdom* C-106/09 P and C-107/09 P, EU:C:2011:732, para. 104.

66 Opinion of AG Kokott (n 6), para. 85. It should be noted that the CJEU declared inadmissible the claim that the measure was against EU State aid laws and therefore did not pronounce itself on the matter.

67 Belgium—Excess profit tax ruling (n 3).

68 *Portugal v Commission* (n 59), para. 56.

ment of financial goodwill in the Spanish tax system' as opposed to 'the general Spanish corporate tax system'.[69] It is submitted that in the Apple, Starbucks, Fiat, and Amazon cases the reference framework should be the rules on cross-border transfer pricing in the tax system (and the legal principles therein) of the Member States in question that are relevant and not those of other Member States. The Commission cannot impose legal standards or principles not present in the domestic tax system of the Member States in question. This is particularly important in light of the lack of harmonisation of direct taxation.[70]

Secondly, one must identify which undertakings are in a comparable factual and legal situation within the application of that reference framework of rules. It is submitted that cross-border transfer pricing rules can only apply to a multinational, which have internal commercial agreements among its subsidiaries. If that factual and legal relationship does not exist, there is no scope to apply those rules. On that basis, one must assess whether a multinational like Starbucks was treated differently than other multinational companies to which the Dutch transfer pricing rules applied. This boils down to whether the arm's length principle, which shall be discussed below, was applied consistently to all multinational companies.

This contrasts to a certain extent with opening decision in the Belgium excess profit tax ruling case.[71] The Commission rejected Belgium's argument that multinationals are in a similar legal and factual situation in respect of their revenues from cross-border activities. This was predicated on two facts. Firstly, the Commission adopted a wide definition of the reference framework, that is, the 'Belgian corporate income tax'.[72] Secondly, the Commission argued that categorising multinationals in the same legal and factual situation runs counter to the objective of this reference framework.[73] The Commission stated that the fact that multinationals are the only 'ones whose revenues can originate in cross-border activities and be subject to international double taxation rules' is irrelevant for that objective.[74] The Commission itself has recognised that transactions between related companies are not comparable with transactions between unrelated companies.[75]

Without entering too much in detail in the merits of this case, it appears evident that asking the right questions is crucial in Commission investigations to get at the right benchmark. The identification of the appropriate reference framework, however, is not that important. Even if one were to go for a wider or a narrower definition of the reference framework, the result should be the same. 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.

The final step of the selectivity test consists of assessing whether the selectivity of the measure can be justified on the basis of the logic of the system. This notion of justification has been introduced by the Court as an *obiter dictum* in the Italian Textile case.[76] In this landmark case, the Court endorsed the view that a measure may be justified 'on the basis of the nature or general scheme of the system'.[77] It was not until the 1990s that this justification by the logic of the system emerged again. It is now formally recognised as a legal element by the Commission State aid Notice,[78] the Commission notice on the notion of State aid[79] and case law.[80] Interestingly, two major terminologies are used: justification by the nature or general scheme of the system,[81] and justification by the logic of the system.[82] It is questionable whether or not a distinction should be made between these two terminologies. However, neither administrative practice nor case law seems to draw such a distinction. One can therefore state that EU law refers to the same justification described in different manners.[83]

The justification by the nature or general scheme of the system is important in tax matters because it takes

69 *Autogrill Espana SA v Commission (*n 61), para. 50; see *Banco Santander SA and other v Commission* (n 62), para. 54.

70 *Salzgitter AG* (n 58), para. 81.

71 Belgium—Excess profit tax ruling (n 3), Recital 67.

72 Ibid, Recital 58.

73 Ibid, Recital 67.

74 Ibid.

75 *Groepsrentebox* decision, OJ L288/26 (4 November 2009).

76 *Italy v Commission* (n 33), para. 33.

77 Ibid, para. 15.

78 Commission Notice (n 19), paras 23–27.

79 Commission Notice (n 18), para 128.

80 *Italian Republic v Commission of the European Communities* T-211/05, EU:T:2009 E.C.R. II-2777, para. 117; see *British Aggregates* (n 60), para. 76; *Unicredito Italiano SpA v Agenzia delle Entrate, Ufficio Genova 1* C-148/04, EU:C: 2005 E.C.R. I-11137, para. 51.

81 *Belgium v Commission of the European Communities* C-75/97, EU:C:1999 E.C.R. I-3671, para. 33.

82 *Ferring SA v ACOSS* C-53/00, EU:C: 2001 E.C.R. I-9067, para. 17.

83 The CJEU even combines the two wordings by referring to a justification 'by the nature or logic of the system', in *Italian Republic v Commission of the European Communities* C-6/97, EU:C:1999 E.C.R I-2981; [2000] *2* C.M.L.R. 919, para. 20.

into account the fiscal logic and the internal consistency of the tax regime. According to the Commission, one can justify 'measures whose economic rationale makes them necessary to the functioning and effectiveness of the tax system'.[84] That said, one can observe that EU law adopts a narrow interpretation of the justification by the nature or general scheme of the system. Only certain justifications have been accepted in a limited number of cases (eg principle of tax neutrality,[85] the fight against tax avoidance,[86] the progressive nature of income tax,[87] specific accounting requirements,[88] or the peculiar nature of the sector at issue).[89] The narrow application of this exception to the selectivity assessment would seem to exclude justifying a situation where multinationals benefit from specific rules on taxation.

VI. The prudent market operator test

In the opening decisions, the Commission is relying on the test of the 'prudent market operator' for identifying whether there is a breach of Article 107(1) TFEU. A prudent market economy investor is expected to make an *ex ante* assessment of whether an investment is worthwhile prior to injecting any funds in a venture. There is a certain resemblance in the OECD Guidelines.[90]

The test of 'prudent market operator' has been used before,[91] but it was always used in cases where the State was not merely carrying out a public function but was an investor. It is the conduct of the State, which is usually scrutinised through a number of permutations of the MEO principle. The prudent market operator test and the MEO test appear to be identical, albeit they apply to different subjects. Indeed, the term 'prudent' was also mentioned in relation to the MEO test, from which the Commission's Draft on the notion of State aid explicitly excludes the public functions of a public authority.[92]

It is widely acknowledged that the MEO cannot be used to assess public authorities acting in their public function, ie in the context of taxation matters as there is no other MEO engaged in the public activity of tax collection.[93] Thus, the prudent market operator principle should also only be used where the State acts as an investor and not when it is carrying out a public function.

One does start to wonder what the Commission is trying to achieve here and why the Commission came up with the prudent market operator test as a benchmark for assessing whether there is an advantage. It is not hard to see the great advantage for the Commission in having an objective, abstract criterion to measure advantage by directly comparing the tax treatment of related companies (group companies) with that of independent companies. The latter is supposed to deal at arm's length, and it automatically introduces this generally accepted principle into the assessment of the advantage, while at the same time giving substance to the very abstract prudent market operator principle. However, by applying such an abstract principle directly under the state aid rules, it is presupposed that (i) the reference framework is the general corporate tax system, and (ii) that group companies and independent companies are by definition in the same legal and factual situation. Since the Commission argues that in tax cases an advantage more or less automatically leads to selectivity,[94] the first two steps in the three-step analysis are effectively reduced to assess whether the arm's length principle has been correctly applied meaning in line with what a prudent market operator would have done. This is a stricter test than required by the OECD Guidelines or the national legislation. The use of an independent criterion, directly derived from case law, would also allow the Commission

84 Commission Notice (n 19), para. 23.

85 Commission Decision of 5 June 2002 on State aid granted by Italy in the form of tax exemptions and subsidised loans to public utilities with a majority public capital holding, 2003/193 [2003] OJ L77, para. 81.

86 *GIL Insurance* (n 59), paras 72–79; Commission Decision of 20 December 2006 on the aid scheme implemented by France under Article 39 CA of the General Tax Code, 2007/256 [2007] OJ L112.

87 Commission Notice (n 19), para. 24.

88 Commission Notice (n 19), point 27; Commission Notice (n 18), para 139.

89 Regarding the banking sector, see Commission Decision of 11 December 2001 on the tax measures for banks and banking foundations implemented by Italy, 2002/581 [2002] OJ L18, para. 32; as to the agricultural sector, see Commission Decision, Exemption form real estate taxation for cultivation on substrate, N 20/2000 [2000] OJ C169/5. Regarding the agricultural sector, see Commission Decision of 9 June 1999 on ceiling on local tax land implemented in Denmark, N 53/99 [1999] OJ C213; Commission Decision of 11 April 2000 on the exemption implemented in the Netherlands for real estate taxation for cultivation on substrate, N 20/200 [2000] OJ C169. Regarding the environmental sector, see Commission Decision of 3 April 2002 on the dual-use exemption, which the UK is planning to implement under the Climate Change Levy and the extended exemption for certain competing processes [2002] OJ L229/15–23.

90 OECD Guidelines (n 15), para. 1.34. ('Independent enterprises, when evaluating the terms of a potential transaction, will compare the transaction to the other options realistically available to them, and they will only enter into the transaction if they see no alternative that is clearly more attractive. For example, one enterprise is unlikely to accept a price offered for its product by an independent enterprise if it knows that other potential customers are willing to pay more under similar conditions.')

91 For example, in case State Aid N 629/2009—Grants for investment in electricity and natural gas transmission network (2010); *Budapesti Eromu Zrt v Commission* Joined Cases T-80/06 and T-182/09, EU:T:2012:65.

92 Commission Notice (n 18), para. 77.

93 Ibid para. 77 states that 'the [MEO] test is normally not applicable if the State acts as a public authority rather than as an economic operator'; See *Ryanair v Commission* (n 17), para. 85.

94 The Commission relies on para. 60 of *Commission v MOL* (n 13).

to tackle situations where the arm's length principle is or was not part of the national legislation, like in the Apple case,[95] or handle the problem that some Member States may have introduced differing interpretations and rules for the implementation of the arm's length principle into their respective legislations. Finally, it allows the Commission to directly tackle individual tax rulings without examining the question whether they form part of a scheme for (international) group companies which should otherwise be examined. This approach would greatly simplify the handling of these cases and be a very effective tool for the Commission in monitoring APAs and the ruling practice of the Member States.

Some of the cases have been appealed,[96] and it is possible that the Commission will drop the prudent market operator test as a benchmark for assessing whether there is an advantage, but the Commission is unlikely to give up on the concept of an abstract, directly applicable benchmark. Likewise, the Commission may argue that the arm's length principle is a general principle of equal fiscal treatment that falls within the scope of Article 107(1) and thereby different from the one based on Article 9 of the OECD Model Convention. This would mean that the application of the arm's length principle is directly based on the Treaty and not dependent on whether or how a Member State has implemented it in its national legislation. Although this would be a change in the Commissions argumentation, the consequences would remain the same: a distortion of the delicate balance between the Commission's State aid powers and Member States fiscal sovereignty in the area of corporate taxation.

These observations are naturally speculative at this stage, but nevertheless, it is proposed that there is no shift or inversion in the conduct assessment and that it remains focussed on the State. The yardstick for the State's conduct is not that of a MEO's behaviour in that situation, but rather a form of consistent and unbiased behaviour based on its dealings with prudent independent operators behaving under normal market conditions. This proposition seems to be strengthened by the fact that the Commission relies on a number of assumptions on the conduct of a prudent market operator, which reflect a Utopian relationship between tax authorities and tax payers.

According to the Commission, a prudent market operator will only accept 'perfect' transfer pricing arrangements between related companies within a corporate group.[97] The Commission appears to be expecting the valiant undertaking to be responsible enough to choose the most suitable technique for transfer pricing arrangements from the options listed in the OECD Guidelines[98] and apply that technique in an impeccable manner. This is a very high bar to set as the OECD Guidelines acknowledges that the arm's length principle is a method aimed at 'estimation' and 'approximation' denoting that a precise result is not possible to achieve.[99] In a very strong pronouncement, the Commission goes as far as suggesting that this undertaking will definitely refuse to take the path which achieves 'the lowest possible outcome if the facts and circumstances of the case could justify the use of other more appropriate methods'.[100] It must also be observed that the requirement of 'prudence' is not part of the transfer pricing rules of the OECD, which specifically refers to 'independent enterprises in comparable transactions under comparable circumstances'.[101]

VII. The arm's length principle: uncovering its origins and divergence in EU State aid law

The crux of the public non-confidential versions of the opening decisions in the Apple, Starbucks, Fiat, and Amazon cases[102] lies in the assessment of whether the APAs afford an economic advantage to the undertakings under review through the breach of the arm's length principle. The arm's length principle was originally examined in a couple of final decisions by the Commission in the context of the domestic tax systems of a number of Member States.[103] In those cases, the Commission describes the arm's length principle as follows:[104]

95 Ireland—Alleged aid to Apple (n 2).

96 *Netherlands v Commission*, *Fiat Chrysler Finance Europe v Commission*, and *Luxembourg v Commission* (n 27).

97 Opening Decisions (n 2).

98 OECD Guidelines (n 15), Chapter II.

99 Ibid, paras 1.14, 3.55, and 7.23.

100 Opening Decisions (n 2).

101 OECD Guidelines (n 15), para. 1.3.

102 Opening Decisions (n 2).

103 Mehdi Hocine, 'Aides fiscales: la Commission procède à l'examen approfondi du critère de la sélectivité dans le domaine de la fiscalité directe des entreprises' (2002) Issue 1 *European Commission Competition Policy Newsletter* <http://ec.europa.eu/competition/publications/cpn/2002_1_85.pdf> accessed 1 May 2016.

104 Commission Decision 2003/438/EC of 16 October 2002 on the aid scheme for Finance companies implemented by Luxembourg OJ 20 June 2003 L153/40, Recital 42; Commission Decision 2003/501/EC of 16 October 2002 on the State aid scheme for Coordination Centres implemented by Luxembourg OJ 9 July 2003 L 170/20, Recital 46. See also Commission Decision 2003/81/EC of 22 August 2002 on the aid scheme implemented by Spain in favour of coordination centres in Vizcaya OJ 6 February 2003 L31/26, Recitals 27–29; Commission Decision 2003/512/EC of 5 September 2002 on the aid scheme implemented by Germany for control and coordination centres OJ 16 July 2003 L177/17, Recitals 26 and 27; Commission Decision 2003/755/EC of 17 February 2003 on the aid scheme implemented by Belgium for coordination centres established in

> Firstly, the measure must confer on recipients an advantage which relieves them of charges that are normally borne from their budgets. The objective of using alternative methods of determining taxable income in order to prevent certain transactions from hiding undue advantages or donations with the sole purpose of avoiding taxation must normally be to achieve taxation comparable to that which could have been arrived at between independent operators on the basis of the traditional method, whereby the taxable profit is calculated on the basis of the difference between the enterprise's income and charges. This complies with the principle of full competition. In the area of transfer prices, this international principle is set out in Article 9 of the OECD Model Tax Convention (and, in more detail, in the 1995 OECD Transfer Pricing Guidelines).

Arguably, the CJEU endorsed the arm's length principle, albeit in a cryptic fashion, in *Forum 187*, which was the result of an appeal made before the CJEU in the Belgian coordination centres case.[105] The Court stated:[106]

> In order to decide whether a method of assessment of taxable income such as that laid down under the regime for coordination centres confers an advantage on them, it is necessary, as the Commission suggests at point 95 of the contested decision, to compare that regime with the ordinary tax system, based on the difference between profits and outgoings of an undertaking carrying on its activities in conditions of free competition.... In that regard, the staff costs and the financial costs incurred in cash-flow management and financing are factors which make a major contribution to enabling the coordination centres to earn revenue, inasmuch as those centres provide services, particularly of a financial nature. Accordingly, the effect of the exclusion of those costs from the expenditure which serves to determine the taxable income of the centres is that the transfer prices do not resemble those which would be charged in conditions of free competition.

The arm's length principle, relied on by the Commission, was that of the OECD Model Tax Convention, and thus not a creation of the Commission. The Commission must have found the arm's length principle to fill a specific gap in the assessment of economic advantage within cases of fiscal aid with a transfer pricing context.[107] The arm's length principle has been specifically challenged in the appeal applications filed by the Netherlands and Fiat Chrysler Finance Europe which complained that the principle is not derived from Union law and it should not be part of State aid assessment.[108]

There are a number of observations to be made on the way in which the arm's length principle was interpreted and applied in the opening decisions under examination.

Firstly, the arm's length principle, as applied by the Commission, wrongly assumes that an independent undertaking operating under normal market conditions will refuse to choose the method which achieves the least possible outcome.

Secondly, the Commission has effectively imposed the arm's length principle (as interpreted by it) as the tool to measure whether there is economic advantage in any transfer pricing scenario in the internal market. Transfer pricing tax rules are not subject of harmonisation measures at EU level,[109] and it may well be the case that some Member States either have not implemented this principle in their national laws or that there are divergences in its transposition and application from Member State to Member State. The arm's length principle is not a rule of international law (whether treaty law or customary law) and as such no Member State has a legal obligation to implement it in national law and to apply it consistently with OECD Guidelines. Most modern tax treaties contain Article 9 of the OECD Model Convention, and in some quarters, the assertion is made that there is an international body of tax rules, which contains the arm's length principle as enunciated by the OECD.[110] That said, in order to be a rule of international law, it must be binding on states. Article 9 is only law to the extent that states give effect to it under domestic law. The Commission seeks to rely on an arm's length principle derived from European State aid law different from that of the OECD Guidelines. Moreover, the Commission states that the arm's length principle is 'an internationally agreed standard' but does so without explaining why it should all of a sudden be part of the EU State aid law regime.[111] If it were true that it is a binding rule of international law, which it is not, then, as such, it may be part of EU law. The Guidelines are probably the agreed standard in applying Article 9, to relieve double taxation which results from the domestic law of

Belgium OJ 30 October 2003 L282/25, Recital 95; Commission Decision 2004/76/EC of 13 May 2003 on the aid scheme implemented by France for headquarters and logistics centres OJ 28 January 2004 L23/1, Recitals 45 and 46.

105 *Belgium and Forum 187 ABSL v Commission* (n 52).

106 Ibid, paras 95 and 96.

107 As reiterated in CJEU jurisprudence, the MEO test is not suitable to be applied in cases where public authorities, such as tax authorities, are to exercise public powers for there is no market economy operator who is in a comparable situation.

108 *Netherlands v Commission* and *Fiat Chrysler Finance Europe v Commission* (n 28).

109 Other than in the Arbitration Convention which aims to resolve disputes and double taxation that results from application of the arm's length principle differently by different Member States.

110 See for example Reuven Avi-Jonah, *International Tax as International Law* (1st edn Cambridge University Press, 2007).

111 Opening Decisions (n 2).

two states, but not to impose norms binding on states. The Commission seeks to justify its position by relying on the CJEU's judgment in *Forum 187*[112] and cites a number of decisions from 2001.[113] However, the CJEU's endorsement of the arm's length principle in *Forum 187* is vague. The CJEU does not even refer to the term 'arm's length principle' but rather focusses on the application of the 'cost-plus method',[114] and it does not clarify whether its endorsement should be read to apply only to the Belgian legal system or to all Member States. More importantly, the CJEU made specific reference to the cost-plus method 'as recommended by the OECD' seemingly indicating that its interpretation should be strictly in line with the OECD Guidelines.[115] In the absence of clear case law precedent and given the lack of harmonisation, no such EU arm's length principle can exist. Any assessment must be based on national rules as not every Member State has implemented an arm's length principle or the OECD Guidelines. If the Commission has doubts about the compatibility of the arm's length principle as applied under OECD Guidelines and incorporated in some national tax laws, it ought to focus on national tax legislation rather than individual rulings. An examination of national tax rules must be done as they are and not as the Commission feels they ought to be.

Thirdly, the Commission may be ignoring the simple truth that transfer pricing arrangements involve a hypothesis about what independent enterprises would do in the same circumstances. In its opening decisions, the Commission consistently made remarks that suggest that a mere departure from the arm's length principle will fall foul of Article 107(1) TFEU insisting that there is a 'correct' way how to apply this principle.[116] A rigid application of the arm's length principle may have the effect of distorting the relationship to achieve an outcome, which may not necessarily reflect what would have been obtainable on the market. The same OECD Guidelines emphasise a flexible approach, which attempts to approximate what would actually happen in real life in arm's length scenario, and in fact, the result is usually in the form of a range of values.[117] It is not meant to be a precise mathematical formula—the choice of the methodology and the application of that choice can lead to different results and generally in the form of a range of values. The arm's length principle is really 'an exercise that reflects economic behaviours between independent parties which manifest economic realities'.[118] Any departure from this approach would not be compatible with the OECD Guidelines but also may be the cause of disproportionate results since, as explained above, the transposition and application of the arm's length principle may well vary across the internal market.

VIII. Conclusion

This article has sought to present a number of arguments questioning Vestager's claim that the recent State aid investigations concerning tax rulings are based on firm legal grounds by placing these into the broader contexts of the State aid law and the function of tax rulings. The overall conclusion is that in the Commission's effort to try to develop the law and to expand its remit, it takes a number of unacceptable shortcuts.

Firstly, it ignores recent case law, which confirms that a detailed analytical framework is needed to establish selectivity. This is not ideal as selectivity is the analytical lynchpins in the application of State aid principles to tax rulings.

Secondly, the Commission suggests replacing rules and practices developed by sovereign Member States—on the basis of international consensus recognising ranges of 'correct results', such as the OECD arm's length principle—with a binding EU law concept. The Commission seeks to justify its application of the arm's length principle by reference to the judgment in *Forum 187*, but the judgment is vague on this point. Even if (and this is a big 'if') it is accepted that *Forum 187* is an adequate legal basis for the application of the arm's length principle, the way in which the Commission applies the principle is not correct. The Commission bypasses the identification of the reference framework and presupposes that related (group) companies and independent companies are by definition in the same legal and factual situation. In the absence of clear case law precedent and given the lack of harmonisation, no such EU arm's length principle can exist.

Thirdly, the Commission applies the prudent market operator principle in cases where the State is carrying out a public function, which runs the risk of distorting the delicate balance between the state aid powers of the

112 Ibid.

113 Hocine (n 107).

114 *Belgium and Forum 187 ABSL v Commission* (n 52), paras 93 and 94.

115 Ibid, para. 94.

116 The Commission refers to *Forum 187* (n 52) and concludes that if the 'method of taxation for intra-group transfers [. . .] leads to a taxable base inferior to the one which would result from a correct implementation of that principle, it provides a selective advantage to the company concerned'. See Opening Decisions (n 2).

117 The same OECD Guidelines acknowledge that the arm's length principle is a method aimed at 'estimation' and 'approximation' denoting that a precise result is not possible to achieve. OECD Guidelines (n 15), paras 1.14, 3.55, and 7.23.

118 Franklin Cachia, *Analysing the Fiscal State Aid Cases: Apple, Starbucks, Amazon and Fiat Finance & Trade* (ITC Leiden University, unpublished LL.M. paper 2015), 5.

Commission and the fiscal sovereignty Member States have in the area of corporate taxation.

This article suggests that any assessment must be based on national rules as not every Member State has implemented an arm's length principle or the OECD Guidelines. If the Commission has doubts about the compatibility of the arm's length principle as applied under OECD Guidelines and incorporated in national tax laws, it ought to focus on national legislation rather than individual rulings. Some of these cases have already been appealed. Even if the Commission wins on appeal, the Commission's interpretation of Article 107(1) TFEU in these cases is novel and unprecedented, and thus, the Member States should not be asked to recovery the aid based on legitimate expectations.[119] Alternatively, the recovery period should be limited from the date when the Commission's opening decision was published.

The Commission must acknowledge that this is not a straightforward matter and applying a rule rigidly could mean that all work of tax administrations in the internal market is potentially reviewable. These apparent weaknesses of interpretation and application of the arm's length principle suggest that it is not correct that the Commission has a 'firm' legal basis as has been claimed.

doi:10.1093/jeclap/lpw040

119 See Adrien Giraud, 'A Study of the Notion of Legitimate Expectations in State Aid Recovery Proceedings: "*Abandon All Hope, Ye Who Enter Here*"?' (2008) 45 Common Market Law Review 1399, 1431.