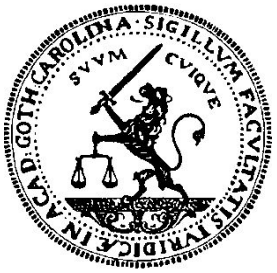

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The EU State Aid Prohibition and Taxation

– The Expanding Scope of Art. 107 TFEU

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European Business Law
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Abstract

A topic that has received a significant amount of attention within the international community is the concept of harmful tax competition. This is of particular relevance to the EU due to the additional exposure to this problem the Member States experience by virtue of the internal market. A closely related concept is that of aggressive tax planning where multinational enterprises abuse mismatches between tax systems allowing them to pay low or no tax on large parts of their profits. The Commission's recent State aid investigations into the advanced rulings handed out by Member States is an attempt to resolve a situation where Member States facilitate tax avoidance for tax competition purposes. This paper focus on the four investigations where a final decision has been reached: *Starbucks, Fiat, Apple* and *Excess Profit*.

The paper introduces the reader to the background of tax competition before explaining the current state of the law surrounding the notion of State aid in Art. 107. The focus is on the concept of the selective advantage in the area of tax law. A review of the ECJ's case law in this area show a significant degree of inconsistency in how the test of selective advantage is to be applied. The ECJ puts a major emphasis on the question of competitive advantages being granted on a discriminatory basis. This is contrary to the traditional idea of State aid which require there to be a transfer of state resources to an undertaking. But the ECJ seem to consider evidence of unequal treatment under the tax laws as enough to raise a presumption that this prerequisite is fulfilled.

Using that logic the Commission argues in the cases mentioned above that a failure to abide by the OECD's arm's length principle in the area of transfer pricing is contrary to Art. 107. As this paper illustrates this further expands the scope of Art. 107 to such a degree that the Commission can be regarded as harmonizing this area of law through the State aid process. This paper argues that this interpretation by the Commission infringes too much on the Member States' tax sovereignty and that a more restrictive approach to the State aid test is needed.

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Sammanfattning

Ett ämne som väckt stora diskussioner inom internationell skatterätt är fenomenet skadlig skattekonkurrens mellan länder. Detta är speciellt relevant för EU-samarbetet då den inre marknaden innebär ökade möjligheter för länder att delta i sådan konkurrens. Ett närliggande problem är så kallat aggressiv skatteplanering som avser när multinationella företag utnyttjar skiljaktigheter mellan jurisdiktioner för att tillägna sig skattemässiga fördelar. Kommissionen nådde nyligen fyra beslut där medlemsstater hade givit ut förhandsbeslut som hade faciliterat sådan skatteplanering; *Starbucks, Fiat, Apple* och *Excess Profits*. Detta ansågs av Kommissionen vara statligt stöd. Denna uppsats fokuserar på en rättslig analys av dessa.

Uppsatsen förklarar innebörden av skattekonkurrens i en kortare bakgrundsdel innan den sedan fortsätter med en analys av rättsläget. Fokuset ligger på frågan om hur statligt stöd ska definieras under Art. 107. Det visar sig att ECJ's praxis angående denna fråga inte är konsekvent. Domstolen använder en mycket vid definition av statligt stöd genom att fokusera på om konkurrensfördelar föreligger mellan jämförbara företag som följd av skattereglerna. I domstolens ögon är det ofta tillräckligt att bevisa att så är fallet för att rekvisiten angående statliga resurser och ekonomisk gynning ska vara presumerade uppfyllda.

Kommissionen utnyttjar denna praxis för att argumentera för att medlemsstater bryter mot reglerna angående statligt stöd om de inte applicerar armlängdsprincipen i enlighet med OECD's riktlinjer. Denna uppsats tar en kritisk syn på detta och visar att kommissionen i själva verket harmoniserar skattereglerna i EU på detta område genom dess tillämpning av Art. 107. Detta kritiseras i uppsatsen för att gå för långt i inskränkningen av medlemsstaternas kompetens inom skatteområdet. Författaren argumenterar därefter för en mer restriktiv praxis på detta rättsområde.

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Preface

This is likely (hopefully) my last assignment to hand in during the Law Programme here at Lund University. I want to take this opportunity to thank all the friends, family, teachers and classmates who has made my time in Lund so amazing. My feelings about leaving are a bit mixed but ultimately I look forward to new horizons. Considering this has been 6 years in the making I suppose it's about damn time.

I want to extend special thanks to my supervisor, Marco Claudio Corradi for his invaluable input, support and endless patience during this last semester.

May 24 2017,

Åke Häggqvist

Abbreviations

APA	Advanced Pricing Agreement/Arrangement
ATAD	Anti Tax Avoidance Directive
BEPS	Base Erosion and Profit Shifting
BPOT	Business Property Occupation Tax
Commission	European Commission
CSA	Cost Sharing Agreement
CUP	Comparable Uncontrolled Price method
ECJ	European Court of Justice, Court of Justice of the European Union
EU	European Union
IP	Intellectual Property
MEOP	Market Economic Operator Principle
MNE	Multinational Enterprise
PE	Permanent Establishment
OECD	Organisation for Economic Cooperation and Development
TNMM	Trans Net-Margin Method
TFEU	Treaty on the Functioning of the European Union
WTO	World Trade Organisation

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1: Introduction

1.1 Background

In recent years the European Commission (the Commission) has opened a number of investigations into advanced tax rulings handed down by Member States to private companies. The outcome of these cases has been subject to significant amounts of speculation and discussion. So far the Commission has reached a final decision in four such cases finding that the Netherlands, Luxembourg, Belgium and Ireland have provided illegal State aid by misapplying the arm's length principle contained in international transfer pricing law. The controversy surrounding these proceedings centers on the question of the scope of Art. 107 in the Treaty on the Functioning of the European Union (TFEU). Under the treaties the Member States of the European Union (EU) have exclusive competence in regards to their internal fiscal affairs unless such competence is explicitly assigned to the Union. This include sovereignty over their tax systems. These new developments in State aid law and in particular the Commission's use of the arm's length principle has led to concerns over the increasing power claimed by the EU authorities in the area of taxation.

This is happening against a backdrop of increasing worries within the international community and the general public over tax avoidance by transnational corporations. The appetite to take action against the legal systems that facilitate such practices has increased dramatically following the financial crisis of 2008 and its immediate aftermath. It is not only private actors who are implicated by their abuse of tax laws but also the countries that intentionally provide opportunities for this avoidance. This is a result of a more global economy where states are pitted against each other in competition over investment and other economic activity – incentivising them to offer increasingly beneficial tax treatment to multinationals. Evidence has shown that EU Member States are uniquely exposed to this kind of legislative competition by virtue of the internal market.[1] Thus the EU is under increasing pressure to enact countermeasures against the effects of this phenomenon. This is what seem to have triggered the Commission's more aggressive posture in its State aid enforcement in relation to Member States' tax systems. However as will be shown in this paper the Commission is treading on treacherous legal ground as it decides to pursue a solution by

[1] Claudio Radaelli and Ulrike Kraemer, "Governance Areas in EU Direct Tax Policy, (2008) vol 46:2, *Journal of Common Market Studies*, p. 315; Philipp Genschel, Achim Kemmerling, Eric Seils, "Accelerating Downhill: How the EU Shapes Corporate Tax Competition in the Single Market", (2011) vol 49:3, *Journal of Common Market Studies*, p. 585; Michela Redoano, "Tax Competition among European Countries. Does the EU Matter?", (2014) vol 34, *European Journal of Political Economy*, p. 353; Hanno Kube, Ekkehart Reimer, Christoph Spengel, "Tax Policy: Trends in the Allocation of Powers Between the Union and Its Member States", (2016) vol. 25:5-6, *EC Tax Review*, p. 247, 251 f

way of the State aid rules.

1.2 Purpose and Delimitation

This paper seek to answer the question of whether the Commission's interpretation of Art. 107 taken in its recent decisions regarding advanced rulings is in line with that Article. It will further endeavour to put these decisions in their proper context by providing a review of earlier case law in the field of State aid law and direct taxation. Additionally the current international developments surrounding the fight against harmful tax competition will be briefly explained in order for the reader to understand the broader context that the EU legal practice is a part of. In the end the paper focuses on the topic of the division of competence between the EU and its Member States wondering whether the Commission has gone too far in its increasingly expansive interpretation of the State aid provisions.

This paper only seek to explore these topics from the perspective of the EU State aid law, specifically Art. 107(1) in the field of direct taxation. A discussion regarding the general effects of tax competition or an in depth analysis of the arm's length principle as a legal instrument is therefore outside of the scope of this paper. Although an overview of transfer pricing and other relevant international rules of taxation will be provided the paper will not endeavour to engage in an analysis of their application to factual circumstances. Rather our interest lie in how they are used by the Commission within its reasoning around Art. 107(1). In regards to the State aid provisions themselves the paper is limited to the topic of the legal definition of material selectivity. Procedural rules and questions regarding regional selectivity are left aside as they are not at issue in the discussion regarding advanced rulings, the exception being in regards to the retroactivity of the decisions. As this latter point is but a part of a broader discussion about the Commission's powers under Art. 108 as enforcer of the rules it will only be touched upon tangentially here in order to keep the paper focused on the definition of State aid contained in Art. 107.

1.3 Methodology and Materials

This paper takes the form of a legal analysis of the case law leading up to and including the recent Commission decisions in regards to advanced tax rulings. As these are relatively recent developments and the state of the law is often not clear heavy use is made of contributions by various authors in the fields of State aid and tax law in order to facilitate a meaningful analysis. This is on top of the case law of the European Court of Justice (ECJ) as well as guidelines provided by the Commission and the Organisation for Economic Cooperation and Development (OECD) which naturally make up the basis of the analysis.

1.4 Content Outline

On the outset this paper will provide the reader with an overview of the concepts of harmful tax competition and aggressive tax planning. This is

done by explaining the theoretical underpinnings of these concepts and a brief history of the legal discussion surrounding them. This is important in order to understand the role Art. 107 plays in the area of tax law and policy. Following this the paper introduces the reader to the legal notion of State aid followed by a review of relevant case law in the field of taxation. The legal analysis of the new decisions relating to tax rulings takes place next followed by a concluding analysis. There I will aim to connect these decisions back to the two earlier parts in order to put them into the context of the overall development of State aid law. I will further seek to provide my own opinions on whether the Commission's approach is within its sphere of competence or if these decisions expand the scope of Art. 107 too greatly.

2: Harmful Tax Competition

2.1 Introduction to Tax Competition

Tax competition between countries has long been considered a major problem in the modern era of increasing transnational trade. To put it succinctly tax competition concerns practices by which countries implements tax legislation with the purpose of luring businesses to its territory or alternatively boost the competitiveness of domestic industries in the global marketplace. This stems naturally from states competing among themselves for investments and other economic activity within an increasingly globalized and mobile economy. The reasons for engaging in such competition is that it allows a country to increase its tax base and generates wealth within the state – allowing it to increase government revenue and achieve a higher standard of living for its citizens.[2]

The economic argument against this form of intergovernmental competition is that it results in governments engaging in a so called "race to the bottom". Smaller states which are generally less appealing to foreign investors are encouraged to offer lower tax rates in order to lure away economic activity from larger economies, who in turn need to follow suit in order to defend its tax base and living standards. The assumption is that this leads to less total welfare in the system as the ability of governments to provide essential public goods and services is compromised by lower tax revenue.[3] Other concerns are more political in nature such as the necessity to shift tax burdens toward less mobile sources of tax revenue and the increased difficulty of enacting social policies. Finally there is the question of fairness; more specifically in regards to the allocation of tax bases between countries and the distribution of tax burdens within them.[4]

As the wording *harmful* tax competition would suggest there is also tax competition which is regarded as benign or even beneficial. As with the free competition between goods and service providers in a free market competition between states can result in efficiency gains, for instance by incentivising the reduction of government waste, regulatory hurdles ("red

[2] See for example: Andrew P. Moriss and Lotta Moberg, "Cartelizing Taxes: Understanding the OECD's Campaign against "Harmful Tax Competition", (2012), Vol. 4:1, *Columbia Journal of Tax Law*, p. 1, 6. The authors further identifies corruption as a possible incentive for states, although this topic will not be dealt with here as it is not a primary concern for the topics discussed in this paper.
[3] Andrew P. Moriss and Lotta Moberg, "Cartelizing Taxes: Understanding the OECD's Campaign against "Harmful Tax Competition", (2012), Vol. 4:1, *Columbia Journal of Tax Law*, p. 1, 7 ff. and David Elkins,"The Merits of Tax Competition in a Globalized Economy", (2016) Vol. 91:3, *Indiana Law Journal*, p. 905, 907 f.
[4] As explained by the OECD in its report; OECD, *Harmful Tax Competition: An Emerging Global Issue*, OECD Publishing (1998), p. 14 f; For a critical discussion on these topics see; David Elkins,"The Merits of Tax Competition in a Globalized Economy", (2016) Vol. 91:3, *Indiana Law Journal*, p. 905, pp. 938-953

tape") as well as making tax regimes less susceptible to fraud.[5] Thus tax competition has been put forward as enhancing allocative efficiency of resources globally.[6] Indeed whether the overall effect of tax competition is beneficial or damaging is a subject of some dispute.[7] The debate regarding the virtues and harms of tax competition is outside the scope of this paper; however in order to examine the efforts taken to fight it we need to define what kinds of tax competition is actually considered harmful.

2.2 What Kind of Tax Competition is Harmful?

In 1997 the Council of Economics and Finance Ministers (ECOFIN) released a resolution where it adopted the Code of Conduct for business taxation which were explicitly targeting harmful tax competition.[8] The Code states that when assessing whether a measure is harmful the following should be considered:

1. "whether advantages are accorded only to non-residents or in respect of transactions carried out with non-residents, or
2. whether advantages are ring fenced from the domestic market, so they do not affect the national tax base, or
3. whether advantages are granted even without any real economic activity and substantial economic presence within the Member State offering such advantages, or
4. whether the rules for 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, or
5. whether the tax measures lack transparency, including where legal provisions are replaced at administrative level in a non-transparent way."[9]

A few months later in 1998 the OECD released its own report on the subject.[10] It identifies two kinds of harmful tax regimes; tax havens and harmful preferential tax rules.[11] For preferential regimes –the most relevant for this paper– four points of assessment for whether the regime is harmful is put forward; (a) low or zero effective tax rate on the relevant income, (b) "ring-fencing" in order to protect the domestic economy from the effects of preferential rules, (c) a lack of transparency regarding how the regime

[5] Andrew P. Moriss and Lotta Moberg, "Cartelizing Taxes: Understanding the OECD's Campaign against "Harmful Tax Competition", (2012), Vol. 4:1, *Columbia Journal of Tax Law*, p. 1, 9 f
[6] Most notably in; OECD, *Harmful Tax Competition: An Emerging Global Issue*, OECD Publishing (1998), p. 8 ff
[7] For example see generally; David Elkins,"The Merits of Tax Competition in a Globalized Economy", (2016) Vol. 91:3, *Indiana Law Journal*, p. 905
[8] Conclusions of the Council of Economics and Finance Ministers (ECOFIN) of 1 December 1997 Concerning Taxation Policy, 98/c 2/01
[9] Conclusions of the Council of Economics and Finance Ministers (ECOFIN) of 1 December 1997 Concerning Taxation Policy, 98/c 2/01, annex 1, para B
[10] OECD, *Harmful Tax Competition: An Emerging Global Issue*, OECD Publishing (1998)
[11] OECD, *Harmful Tax Competition: An Emerging Global Issue*, OECD Publishing (1998) p. 19

operates and (d) a lack of effective exchange of information with other countries.[12]

The OECD goes on to explain each of these factors. The first one is fairly self-explanatory although it is important to note that it is a question of the "effective" rate of taxation and as such also captures instances where a state apply laws which for example artificially defines a small tax base or apply overly generous deductions. Ring-fencing is a more complex topic but ultimately targets regimes that arbitrarily insulate the domestic tax base from the effects of the rules, the examples given by the OECD is when the benefits are restricted to non-residents or when beneficiaries are blocked from the domestic markets. The transparency requirement specifically refers to when the rules and practices of the regimes are not publicly available so to allow for people to rely on them in court or other countries to enact countermeasures. In particular the report points to arbitrary administrative practices and tax rulings as a way for legitimate regimes to become harmful in case these are held secret by the authorities.[13] The OECD goes on to point to a variety of other factors –often related to the four so far mentioned– to be considered in an assessment. Most notable of these are that tax regimes may be harmful if transfer pricing rules are incorrectly or not at all applied, the regime encourages purely tax driven operations or the taxpayer have access to a wide network of tax treaties with insufficient safeguards against abuse.[14]

As we can see the conclusions of the Council and the OECD is very similar. The focus when identifying harmful tax measures beyond the beneficiaries attaining a zero or low rate of taxation is whether the domestic economy is shielded from the measures' effect and a general lack of transparency.

2.3 Countering Harmful Tax Competition

The EU Code of Conduct is a political agreement and thus strictly an instrument of "soft" law. The Member States agreed to not adopt new measures that would be considered harmful and to amend or repeal those that were already in existence at the time.[15] To achieve this an independent group (the "Code of Conduct Group") was established to review member states' legislation and submit its findings to the ECOFIN Council, which would then have to decide on further action. The only such action explicitly mentioned is that the findings may be published and otherwise simply calls

[12] OECD, *Harmful Tax Competition: An Emerging Global Issue*, OECD Publishing (1998) p. 25 ff
[13] OECD, *Harmful Tax Competition: An Emerging Global Issue*, OECD Publishing (1998) p. 26 ff
[14] OECD, *Harmful Tax Competition: An Emerging Global Issue*, OECD Publishing(1998) p. 30 ff
[15] Conclusions of the Council of Economics and Finance Ministers (ECOFIN) of 1 December 1997 Concerning Taxation Policy, 98/c 2/01, annex 1, para C and D

on member states to cooperate in combating this issue.[16] The one exception is a call on the Commission to review whether some Member State tax measures may be considered State aid but without granting the Commission any new powers in this regard. However the Commission at the time released a Notice coinciding with the Code of Conduct which laid out a new approach in regards to business taxation in the area of State aid law.[17]

In a report to the ECOFIN Council delivered in 1999 the Code of Conduct Group identified 66 measures across all Member States and their dependents which contained harmful features.[18] The Commission launched State aid investigations into 15 of those measures including 4 which had been previously accepted by the Commission as not constituting illegal State aid. [19] Today the Code of Conduct Group primarily focuses on monitoring the rollbacks of those 66 measures and evaluating proposed legislation to prevent new market distortions.[20]

In similar circumstances the OECD sought to reduce the worst effects of tax competition by encouraging states to adopt less harmful rules through the Global Forum on Taxation[21]. The eventual primary focus of this work were on improving the transparency and effectiveness of information exchange of tax regimes, for instance by attacking far-going bank secrecy rules. The Forum were regarded as successful in this regard as shown in the OECD progress report of 2006.[22] The scope and ambition of this project increased after 2008 however due to the financial crisis which started that year.

2.4 BEPS and Aggressive Tax Planning

The financial crisis had a global effect with several countries facing new and significant budgetary problems. This led to a renewed appetite to challenge jurisdictions applying harmful tax regimes. Notably there was intensified focus on the phenomenon of "aggressive tax planning". This refers to when MultiNational Enterprises (MNE:s) by legal means achieve

[16] Conclusions of the Council of Economics and Finance Ministers (ECOFIN) of 1 December 1997 Concerning Taxation Policy, 98/c 2/01, annex 1, para H and K
[17] Commission Notice (98/C 384/03) on the Application of the State Aid Rules to Measures Relating to Direct Business Taxation (1998)
[18] Code of Conduct Group (Business Taxation) Report to the ECOFIN Council on 29 November 1999, SN 4901/99
[19] European Commission press Release of 11 July 2001: "Commission launches large scale state aid investigation into business taxation schemes": http://europa.eu/rapid/press-release_IP-01-982_en.htm
[20] See at the Official Website of the European Commission: http://ec.europa.eu/taxation_customs/business/company-tax/harmful-tax-competition_en#code_conduct and Wattel, Peter; Forum: Interaction of State Aid, Free Movement, Policy Competition and Abuse Control in Direct Tax Matters (2013) vol: 5:1, *World Tax Journal*, p. 128, 135
[21] A council of representatives from members and some non-members of the OECD.
[22] OECD, *The OECD's Project on Harmful Tax Practices: 2006 Update on Progress in Member Countries*, OECD Publishing, p. 2 ff

low or even zero taxation on their profits. The latter is referred to as "stateless" or "white" income and as the name suggest denotes income which is not taxable in any jurisdiction. This subject is strongly related to the concept of tax competition as a state's decision to accommodate tax planning of this nature has essentially the same effect as other forms of tax competition.[23]

This can be accomplished in a wide variety of ways. First of all an MNE may abuse the transfer pricing system. This will be detailed more in section five but as a general overview the transfer pricing rules are used to allocate profits of an MNE between nations by requiring intragroup transactions to be made at arm's length. That means that the remunerations in a transaction needs to correspond roughly to what would have been the case if the same action had been carried out between two independent undertakings subject to normal market conditions. To expedite assessments under these rules many jurisdictions allow for Advanced Pricing Agreements (APA:s) which are agreements between tax authorities and MNE:s that determines how the MNE's tax base should be established under these rules. An MNE could then secure in the knowledge what its tax liability in one country will be plan its business accordingly. One way this could be abused would for instance be if said MNE then attained a second APA from another country which applies a different method to calculate the tax base which may cause a situation of double non-taxation to arise.[24]

The example in the previous paragraph is what is called a mismatch, in that case between two different APA:s. Another common way to avoid taxation for MNE:s is to abuse mismatches implemented directly within different tax systems. For example if two jurisdictions classify an entity or a financial instrument differently. Mismatches may also occur by the way of tax treaties. For instance where the country of residence exempt income from what it considers a Permanent Establishment (PE) and the source state does not define a PE the same way and as a result does not tax that income.[25]

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[23] For a full review of the interrelationship of these two concepts see: Paolo Piantavigna, "Tax Abuse and Aggressive Tax Planning in the BEPS Era: How EU Law and the OECD are Establishing a Unifying Conceptual Framework in International Tax Law, Despite Linguistic Discrepancies", (2017) vol 9:1, *World Tax Journal*, p. 47

[24] Pierpaolo Rossi-Maccianico, Fiscal State Aids, Tax Base Erosion and Profit Shifting (2015) vol. 24:2, *EC Tax Review*, p. 63, 69; citing the European Commission Staff Working Paper, *The Internal Market : Factual Examples of Double Non-Taxation*, Consultation Document (2012), in particular p. 8 f; See further Werner Haslehner, "Double Taxation Relief, Transfer Pricing and State Aid", in editor: Isabelle Richelle, Wolfgang Schön, Edoardo Traversa, *State Aid Law and Business Taxation* (Springer-Verlag Berlin Heidelberg 2016) p. 145

[25] European Commission Staff Working Paper, *The Internal Market : Factual Examples of Double Non-Taxation*, Consultation Document (2012), p. 6 ff, I would in general recommend this document for many more examples of different kinds of mismatches

Aggressive tax planning primarily regards the exploitation of such mismatches for the purpose of lowering an MNE's overall tax burden.

Aggressive tax planning has been addressed by the OECD under the heading of "Base Erosion and Profit Shifting" (BEPS) and was the subject of a major report by the organization in 2013.[26] Base erosion refers to the reduction in a country's tax base to which profit shifting –enterprises moving their profits outside of that jurisdiction– is considered to be the main contributor. Later that same year the OECD Members adopted the highly influential *Action Plan on Base Erosion and Profit Shifting* where they outlined a number of goals to be achieved in order to curtail the perceived causes of this problem.[27] The plan broadly speaking addresses three topics; the allocation of taxation rights, procedural reform as well as the tackling of the abuse of tax treaties and other international tax rules. It calls on the OECD to develop new rules in these areas for the OECD Members to apply in an effort to curb the problems presented by BEPS, a process that is currently ongoing[28].

The Commission has also answered the call to combat BEPS and is currently pursuing an ambitious project of corporate tax reform building on its own action plan.[29] The plan called for a relaunch of the Common Consolidated Corporate Tax Base (CCCTB) which would require MNE:s to calculate one taxable base for the entirety of their EU activities to later be apportioned to Member States in accordance with a set formula[30]. This was based on a prior proposal from the Commission which were ultimately rejected by the Member States, however an important difference in the new proposal is that it requires the CCCTB system to be mandatory in order to effectively counter the effects of aggressive tax planning. Further the plan calls for measures improving allocation of taxation rights (i.e profits ought to be taxed where they are generated), effectiveness, transparency and EU-level coordination of tax regimes.

So far the Commission has proposed two "packages" of measures in the pursuit of this agenda, the Tax Transparency Package and the Anti Tax Avoidance Package. As part of the latter the EU has adopted the Anti Tax Avoidance Directive (ATAD)[31] which include rules limiting interest deductions, codifying exit taxation rules, addressing hybrid mismatches as

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[26] OECD, *Addressing Base Erosion and Profit Shifting*, OECD Publishing (2013)
[27] OECD, *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing (2013)
[28] See the OECD's Official Website for more information at http://www.oecd.org/tax/aggressive/
[29] COM(2015) 302, *Communication from the Commission to the European Parliament and the Council: A Fair and Efficient Corporate Tax System in the European Union: 5 Key Areas for Action* (2015)
[30] This global apportionment technique is an often considered alternative to current transfer pricing practices which has been rejected so far by the OECD in favour of the arm's length principle.
[31] Council Directive 2016/1164 (2016)

well as a controlled foreign company rule and a general anti-abuse rule. The ATAD is intended to enter into force on 1 January 2019.

2.5 The Role of the State Aid Rules: Negative Integration

In his opinion in the *GIL* case[32] Advocate General Geelhoed considered the State aid provisions in the treaty as *lex specialis* within the area of distortions of competition. In instances where such distortions arise from the grant of aid those rules are the governing law. He distinguishes these rules from what is now Art. 116 and 117 of the TFEU.[33] Those provisions lay down a special procedure by which the Commission –in case it finds that a rule will cause distortions and thus threaten the internal market– can recommend to a Member State to amend a proposed law. If the Member State refrain from doing so the EU legislature by way of the ordinary legislative procedure is then empowered to issue the necessary directives to force compliance. These Articles has never been used in regards to tax law which should not come as a surprise considering the Member States' reluctance to infringe on their own sovereignty to tax.

However in light of this the State aid rules can be a valuable tool for the Commission to fight harmful tax legislation. Primarily since it is the only option available to it besides the free movement provisions that is binding law. In cases where the Commission can find differential treatment under tax laws which is tantamount to a transfer by the state to an undertaking the State aid rules can thus be used against that measure.

One of the primary issues with applying the State aid rules in the area of tax law is the fact that Member States supposedly enjoy fiscal autonomy under the EU treaties. The EU is thus not competent to infringe on the tax sovereignty of Member States without authorisation. This was confirmed by the ECJ in the *Schumacker*[34] ruling. This freedom on the part of the Member States is not limitless however. As the ECJ has noted on multiple occasions this does not allow Member States to infringe on prohibitions laid down in the treaties. This relationship between EU and national law is referred to as negative integration. As EU primary law grow more defined through the case law handed down by the ECJ the discretion enjoyed by the Member States in their areas of exclusive competence narrows. This ability of the ECJ to enforce conformity of domestic legal systems is *de facto* only limited by the scope of the provisions of EU primary law in the treaties.[35] As we will see in the next section the State aid rules has been increasingly used in

[32] C-308/01, *GIL Insurance and Others v. the Commissioners of Customs and Excise* (2004) ECR I-04777
[33] Opinion of Advocate General Geelhoed in case C-308/01, para 65-67
[34] C-279/93, *Finanzamt Köln-Altstadt v. Roland Schumacker* (1995) ECR I-00225
[35] See for example: Hanno Kube, Ekkehart Reimer, Christoph Spengel, "Tax Policy: Trends in the Allocation of Powers Between the Union and Its Member States", (2016) vol. 25:5-6, *EC Tax Review*, p. 247, 254

tax cases in recent years. At the cost of Member State autonomy this has resulted in an increasing rate of this kind of integration side-by-side with the active steps described previously in this section.

3: The Notion of State Aid

3.1 Article 107

The EU rules on State aid are founded upon and governed by Articles 107 and 108 in the TFEU. State aid control has been a part of the EU legal body since the inception of the internal market originating in the Treaty of Rome. It is a legal doctrine unique to EU law. The intent behind the law is to remove distortions of free competition in the internal market by avoiding scenarios where Member States subsidizes domestic industries. Hence turning into a race between Member States requiring them to expend significant amount of resources on subsidies in order to protect their domestic market. Further it may limit cross-border movement, as the Member States may end up limiting their subsidies to certain "national champions". For example some industries may be subsidized in Germany while another type of industry enjoys subsidies in France, removing the incentive of firms to utilize their freedom of movement.[36]

State aid is defined in Art. 107(1) of the TFEU, which states that:

"[...] 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 shall, in so far as it affects trade between Member States, be incompatible with the internal market."

Thus in order for there to be State aid as defined in this provision the requisites are (1) that there exist an undertaking, (2) that there is a measure imputable to the state financed by state resources (3) which grants a selective advantage (4) that distorts competition and thereby affects trade between Member States. The State aid rules are an autonomous EU legal concept and are based on objective factors thus the Commission have no discretion in their interpretation. The Commission can however declare aid measures as compatible with the internal market, giving the Commission a degree of control over the enforcement of these rules.[37]

3.2 Undertaking

The requirement of there being an undertaking ought to not be in dispute for most of the issues discussed in this paper. According to the most current guidelines released by the Commission[38] the definition of undertaking is

[36] Phedon Nicolaides, "Fiscal State Aid in the EU: The Limits of Tax Authority" (2004) vol 27:3, *World Competition*, p. 365, 369, Conor Quigley, *European State Aid Law and Policy* (3rd ed. Hart Publishing, Oxford 2015) p. 255 ff
[37] Conor Quigley, *European State Aid Law and Policy* (3rd ed. Hart Publishing, Oxford 2015) p. 3
[38] Commission Notice (2016/C 262/01) on the Notion of State Aid as Referred to in Article 107(1) of the Treaty on the Functioning of the European Union (2016), see p. 3 f

independent of national legal definitions and how the undertaking is financed.[39] An undertaking does not have to generate profits nor have that as its purpose.[40] The only requirement for being considered as an undertaking is that an entity engages in economic activity, defined as "any activity consisting of offering goods or services on a market".[41]

3.3 Imputability

Contrary to what the text of Art. 107(1) may suggest the ECJ has established that the advantage granted has to be both a measure adopted by the state *and* make use of state resources. As far as imputability of the measure itself goes in instances of tax law this is uncontroversial as only the state can levy tax in the first place. It is enough for the measure to be caught by the law if it stems from any act of the state, a definition that includes local authorities as well as any other public sector entity.[42] This can be a problematic issue when the purported giver of the aid is itself a public undertaking, but ultimately the question is whether the resources used can be considered to be under the control of the public authorities.[43]

The second question is then what constitute state resources; another subject given a very wide-reaching scope in Commission and ECJ case law. The ECJ has held in *PreussenElektra*[44] that there need to be a transfer directly or indirectly of public funds with the result that measures need to burden the budget of the state in some way in order to be considered aid within Art. 107(1). In that case a requirement to buy green electricity at minimum prices set by the state and ultimately paid for by conventional energy producers (i.e competitors) were not held to be State aid despite its distortive effects on competition as state funds were not involved.

According to the Commission the term "state resources" include –beyond a direct transfer of funds– commitments to transfer or keep resources available in the future, waiving or abstaining from income that should have

[39] Defined in C-41/90, *Höfner and Elser v. Macroton* (1991) ECR I-1979, para 21
[40] C-222/04, *Ministero dell'Economia e delle Finanze v. Cassa di Risparmio di Firenze and Others* (2006) ECR I-00289 , para 122-123, see also C-49/07, *MOTOE v. Elliniko Dimosio* (2008) ECR I-04863, para 27-28
[41] C-35/96, *Italy v. Commission* (1998) ECR I-3851, para 36; Joined Cases C-180-184/98, *Pavlov and Others v. Stichting Pensionsfonds Medische Specialisten* (2000) ECR I-6451, para 75; C-205/03 P, *FENIN v. Commission* (2006) ECR I-6295, para 25
[42] Commission Notice (2016/C 262/01) on the Notion of State Aid as Referred to in Article 107(1) of the Treaty on the Functioning of the European Union (2016), 9 f; T-358/94, *Air France v Commission* (1996) ECR II-02109, para 62-68; C-248/84, *Germany v. Commission* (1987) para 17
[43] T-358/94, *Air France v Commission* (1996) ECR II-02109, para 67; C-83/98, *France v. Ladbroke Racing and Commission* (2000) ECR I-03271, para 50; C-482/99, *France v. Commission* (2002) ECR I-04397, para 38 and 50-57; Kelyn Bacon, *European Community Law of State Aid* (2nd ed. Oxford University Press, Oxford 2013) p. 64
[44] C-379/98 *PreussenElektra v. Schleswag* (2001) ECR I-02099

fallen to the state under usual circumstances as well as the state taking on the financial risk of private actors.[45] Within the area of taxation it is the question of potentially foregoing the collection of state income that is most relevant.

3.4 Selective Advantage

The advantage in this context refer to an economic one, that is an advantage where a market actor get a discernible benefit improving its economic and/or financial position as a result of a measure.[46] In order to ascertain whether there is an advantage at hand one first need to define a point of reference representing normal market conditions, the hypothetical situation that would exist in the absence of the tried measure. If the undertaking's position is worse in that scenario there is an advantage. Note that the comparison is not between the beneficiary's situation prior and after the aid has been received so it does not matter if the beneficiary has seen an actual improvement in its circumstances.[47] Other ways of assessing advantage is the so-called private investor test; a capital infusion by a member state is not illegal State aid if a private actor would have made the investment on the same terms. There is also the Market Economy Operator Principle (MEOP), a version of the arm's length principle which require a Member State acting as a supplier or buyer to charge/pay market rates.[48]

The advantage also needs to be selective as in benefitting certain undertakings, economic sectors or the production of certain goods. There are three different forms of selectivity; geographical selectivity along with *de jure* and *de facto* material selectivity.[49] This paper will only go into depth in regards to material selectivity in tax matters.

The points of relevance in order to find material selectivity is to find other actors in a sufficiently similar legal and factual situation towards which by comparison certain undertakings is treated advantageously. In case of *de jure* selectivity this can be shown by some undertakings being explicitly excluded from the application of a beneficiary measure, for instance by singling out a certain sector in the text of the law. A *de facto* selective measure accomplishes this implicitly by for instance requiring certain

[45] Commission Notice (2016/C 262/01) on the Notion of State Aid as Referred to in Article 107(1) of the Treaty on the Functioning of the European Union (2016) p. 12
[46] C-39/94, *SFEI and Others v. La Poste and Others* (1996) ECR I-03547 para 58-61; C-342/96, *Spain v. Commission* (1999) ECR I-02459 para 41; Kelyn Bacon, *European Community Law of State Aid* (2nd ed. Oxford University Press, Oxford 2013) p. 31
[47] See C-143/99, *Adria-Wien Pipeline and Wietersdorfer & Peggauer Zement-werke* (2001) ECR I-8365, para 40; Kelyn Bacon, *European Community Law of State Aid* (2nd ed. Oxford University Press, Oxford 2013) p. 33
[48] Among others described in: Kelyn Bacon, *European Community Law of State Aid* (2nd ed. Oxford University Press, Oxford 2013) p. 34 ff
[49] Commission Notice (2016/C 262/01) on the Notion of State Aid as Referred to in Article 107(1) of the Treaty on the Functioning of the European Union (2016) sections 5-5.2.3

financial thresholds to be achieved in order to apply; limiting the measure's scope to businesses of a certain size. If a public authority have a level of discretion in regards to when an undertaking will be entitled to a benefit not rooted in clear and objective criteria this will also render a measure selective.[50]

3.5 Distortion of Competition and Trade

These final prerequisites are usually considered together but one ought to be mindful of the fact that they are still mutually distinct and separate. There is no need to prove that a measure has had an actual effect on either of these points, merely that it has the potential to have one. For now it is sufficient to say that an undertaking which sees its economic position overall improved means that a measure will have distortive effects on competition. If the particular market is open to potential competition from those residing in other Member States or the beneficiary itself carries out cross-border activities trade will be considered to be affected.[51]

3.6 State Aid and Taxation: The Three-Step Selectivity test

Over time the influence of the EU over member states' domestic law in general has been steadily increasing and the area of taxation are no exception to this development.[52] That State aid could take the form of tax measures has long been accepted in EU law.[53] Tax breaks in the form of for instance a lower calculated tax base, reduced rates of taxation or deferments on tax debts is tantamount to a Member State foregoing revenue and transferring that income to the tax liable person.[54] The primary issue when it

[50] Commission Notice (2016/C 262/01) on the Notion of State Aid as Referred to in Article 107(1) of the Treaty on the Functioning of the European Union (2016) p. 27 f
[51] Kelyn Bacon, *European Community Law of State Aid* (2nd ed. Oxford University Press, Oxford 2013) p. 82
[52] For general reviews of this see: Hanno Kube, Ekkehart Reimer, Christoph Spengel, "Tax Policy: Trends in the Allocation of Powers Between the Union and Its Member States", (2016) vol. 25:5-6, *EC Tax Review*, p. 247; and Raymond Luja, "Do State Aid Rules Still Allow European Union Member States to Claim Fiscal Sovereignty?", (2016) vol 25:5-6, *EC Tax Review*, p. 312
[53] See C-70/72, *Commission v. Germany* (1973); C-173/73, *Italy v. Commission* (1974); Phedon Nicolaides, "Fiscal Aid in the EC; A Critical Review of Current Practice", (2001), Vol. 24:3, *World Competition*, p. 319, 324; Michael Lang, "State Aid and Taxation: Recent Trends in the Care Law of the ECJ", (2012), Issue 2, *European State Aid Law Quarterly*, p. 411; Pierpaolo Rossi-Maccanico, "The Gibraltar Judgment and the Point on Selectivity in Fiscal Aids", (2009) Vol. 18:2, *EC Tax Review*, p. 67, 68
[54] As enunciated by the ECJ in C-169/08, *Presidente del Consiglio dei Ministri v. Regione Sardegna* ECR I-10821, para 56-58; see also Conor Quigley, European State Aid Law and Policy (3rd ed. Hart Publishing, Oxford 2015) p. 99 and in particular for an explanation of how the latter correspond to the private creditor test see Wolfgang Schön, "Tax Legislation and the Notion of Fiscal Aid: A Review of 5 Years of European Jurisprudence", in editor: Isabelle Richelle, Wolfgang Schön, Edoardo Traversa, *State Aid Law and Business Taxation* (Springer-Verlag Berlin Heidelberg 2016) p. 4 f

comes to identifying this type of aid is the question of selectivity owing to the fact that tax measures is often constructed and worded in a general way.

For the purpose of establishing material selectivity generally a three stage approach has been developed; (1) a reference system (also referred to as the "benchmark") needs to be identified, (2) there has to be a determination whether the measure is *prima facie* selective in light of that system and (3) whether there is a justification.

The original selectivity test in the area of taxation were explicated by Advocate General Darmon in the *Sloman Neptun* case[55] where he put forth that a tax measure is selective when it constitutes a derogation from the scheme of the general system.[56] The latter refers to the reference system which is the general rules the undertaking would normally be governed by. By comparing the contested measure to that system it can be determined whether the measure represents a derogation from it, in which case there is State aid if it involves beneficial treatment. It is thus necessary to establish that the undertaking is relieved of a financial burden that it usually has to carry in its budget and that this corresponds to a loss of government revenue.[57] This point of assessment present difficulty when certain undertakings *de facto* benefits from systems ostensibly written and applied in a general manner.[58]

In 2016 the Commission released a notice on the notion of State aid where it offers a very general overview of how the reference system may be identified:

> "The reference system is composed of a consistent set of rules that generally apply — on the basis of objective criteria — to all undertakings falling within its scope as defined by its objective. Typically, those rules define not only the scope of the system, but also the conditions under which the system applies, the rights and obligations of undertakings subject to it and the technicalities of the functioning of the system."[59]

In the following paragraph to the one quoted above the Commission differentiates between two kinds of systems. Generally applicable rules such as corporate income taxes and special levies singling out certain activities

[55] Joined cases C-72/91 and C.73/91, *Firma Sloman Neptun v. Seebetriesrat Bodo Ziesemer der Sloman Neptun Schiffarts* (1993) ECR I-00887
[56] Opinion of Advocate General Darmon in Case C-72/91. para 50
[57] See C-143/99, *Adria-Wien Pipeline and Wietersdorfer & Peggauer Zement-werke* (2001) ECR I-8365, para 38-39, Joined cases C-78-80/08, *Ministero dell'Economica e delle Finanze and Agenzia delle Entrate v. Paint Graphos* (2011) ECR I-07611, para 45-46
[58] Kelyn Bacon, *European Community Law of State Aid* (2nd ed. Oxford University Press, Oxford 2013) p. 73, and Phedon Nicolaides, "Fiscal Aid in the EC; A Critical Review of Current Practice", (2001), Vol. 24:3, *World Competition*, p. 319, 331
[59] Commission Notice (2016/C 262/01) on the Notion of State Aid as Referred to in Article 107(1) of the Treaty on the Functioning of the European Union (2016), para 133

for taxation such as excise duties on products detrimental to public health.[60] In the latter case the special tax itself is the system of reference. The notice also include examples on when a reference system cannot be identified. Thus if a coherent system of reference cannot be found to exist or that reference system is found to be designed in a way that is "arbitrary or biased" this does not preclude the finding of an advantage.[61] This last point as we will see is extremely relevant to current developments in State aid jurisprudence.

After this comes the question of *prima facie* selectivity. Under this part it needs to be shown that a sector or undertaking is indeed benefitting from the measure. A measure may be selective directly or indirectly[62] but some basis of selectivity needs to be shown; as in a specific sector being favoured (tax rebates for energy producers for example[63]) or companies which shares specific features (such as in the case of tax rebates for women employees favouring sectors where women make up the predominant share of the workforce[64]).

In order for a system to be justified under the last point it must be established that the contested measure derives from the inherent guiding principles of or is necessary for the functioning of the system (expressed as "the nature or general scheme of the system").[65] This definition does not include external policy objectives such as for instance national security needs or environmental policy. The primary example given of a justified measure in the notice is progressive tax rates or measures to counter tax fraud.[66] The interplay between Member State autonomy in the area of taxation and state aid law makes itself felt here. At least in theory the Member State is free to decide on the internal goals of its tax system as they are entitled to set their own economic policy, at least in the absence of EU harmonization measures. In other words how its policy goals are to be achieved and what principles are to guide the application of the tax system is up to the Member States.[67]The need for a measure to be proportionate to

[60] Commission Notice (2016/C 262/01) on the Notion of State Aid as Referred to in Article 107(1) of the Treaty on the Functioning of the European Union (2016), para 134
[61] Commission Notice (2016/C 262/01) on the Notion of State Aid as Referred to in Article 107(1) of the Treaty on the Functioning of the European Union (2016) para 129
[62] See Kelyn Bacon, *European Community Law of State Aid* (2nd ed. Oxford University Press, Oxford 2013) p. 73 ff for examples
[63] See C-143/99, *Adria-Wien Pipeline and Wietersdorfer & Peggauer Zement-werke* (2001) ECR I-8365
[64] See C-173/73, *Italy v. Commission* (1974)
[65] Commission Notice (2016/C 262/01) on the Notion of State Aid as Referred to in Article 107(1) of the Treaty on the Functioning of the European Union (2016) p. 31
[66] Kelyn Bacon, *European Community Law of State Aid* (2nd ed. Oxford University Press, Oxford 2013) p. 80
[67] Joined Cases C-106-107/09 P, *Commission and Spain v. Gibraltar and UK* (2011) ECR I-11113 para 97; Commission Notice (98/C 384/03) on the Application

the objective is present as well.[68]

To connect back to the overarching logic of State aid law; the reason the test need to start by finding a general system is to determine what the "normal" situation is. In other words the result that would prevail in the absence of the tested measure. Only by doing this can we determine that there is an advantage, i.e that the undertaking is relieved of a financial burden it would normally have to bear. Through assessing whether the measure is a derogation from that system –as opposed to a general system itself– it can be determined that the measure is selective. This can be demonstrated by the fact that comparable undertakings to the beneficiaries does not have access to the preferential treatment. The justification criterion is more elusive. But preliminarily it can be stated that if the measure is in line with the logic of the reference system it would not be a derogation –rather it could be viewed as an extension– of that system. As I will demonstrate in the next part the ECJ has been nebulous as to the correct application of this test. In particular where it comes to deciding on what the reference system should be in a given case. But also in regards to how to reconcile the open-ended effect-based assessment of State aid law with this relatively technical test.

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of the State Aid Rules to Measures Relating to Direct Business Taxation (1998) para 23-27; Commission Notice (2016/C 262/01) on the Notion of State Aid as Referred to in Article 107(1) of the Treaty on the Functioning of the European Union (2016) para. 156 and Marie-Ann Kronthaler and Yinon Tzubery, "The State Aid Provisions of the TFEU in Tax Matters", in editor: Michael Lang, Pasquale Pistone, Josef Staringer, Claus Schuch, *Introduction to European Tax Law: Direct Taxation* (4th ed. Linde Verlag, Wien 2016) p. 113

[68] Joined cases C-78-80/08, *Ministero dell'Economica e delle Finanze and Agenzia delle Entrate v. Paint Graphos* (2011) ECR I-07611 para 75; Kelyn Bacon, *European Community Law of State Aid* (2nd ed. Oxford University Press, Oxford 2013) p. 80

4: Taxation and State Aid in Case Law

4.1 Paint Graphos

The ECJ best outlined the test of selectivity in the *Paint Graphos*[69] case. That case concerned a request for an advanced ruling forwarded by an Italian court regarding Italian exemptions from corporation tax which were reserved for cooperative societies. The ECJ's explanation given to the referring court deserves to be quoted in full:

> "In order to classify a domestic tax measure as 'selective', it is necessary to begin by identifying and examining the common or 'normal' regime applicable in the Member State concerned. It is in relation to this common or 'normal' tax regime that it is necessary, secondly, to 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 it 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."[70]

As the cooperative societies in *Paint Graphos* were liable and subsequently excepted from the general corporation tax the ECJ established that as the system of reference. The ECJ then states that exempting certain legal persons depending on their legal form from that tax constitute a derogation from that system. Interestingly the actual analysis carried out after that statement regards the unique characteristics of cooperative societies. The primary points being that they are non-profits, that they exist for the benefit of its members as opposed to outside investors and tend to have smaller profit margins than other economic actors. There is no mention of the internal characteristics of the Italian tax system in this part.[71] The main point of the judgement seem to be to specify that cooperatives which do not fulfill the above mentioned criteria and operate similar to other (profit-making) undertakings is to be excluded from the beneficial regime. Those that do fulfill the criteria are held to not be in a comparable factual and legal situation to other undertakings.

As discussed by Michael Lang the decisive impact of the comparability test is noteworthy.[72] It would seem that under the reference system chosen there

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[69] Joined Cases C-78-80/08, *Ministero dell'Economica e delle Finanze and Agenzia delle Entrate v. Paint Graphos* (2010) ECR I-07611

[70] Joined Cases C-78-80/08, *Ministero dell'Economica e delle Finanze and Agenzia delle Entrate v. Paint Graphos (2010) ECR I-07611* para 49, the court refers to the 2006 case of C-88/03 *Portugal v. Commission* ECR I-07115, a leading case on the area of regional selectivity

[71] Joined Cases C-78-80/08, *Ministero dell'Economica e delle Finanze and Agenzia delle Entrate v. Paint Graphos (2010)* ECR I-07611, para 50-62

[72] Michael Lang, State Aid and Taxation: Recent Trends in the Case Law of the

actually is no distinction between a cooperative society and other undertakings as the general corporate tax seeks to tax all businesses equally. Thus it would seem appropriate to instead consider whether a separate derogating system applying to cooperatives is justified. However the court evidently only consider the justifiability criterion relevant if the measure is considered selective under the comparability test.

4.2 Adria-Wien and British Aggregates: Special Levies

Different tax treatment of various activities is not uncommon in tax legislations but the ECJ has nonetheless persisted in limiting the possibilities of member states doing so. This was demonstrated in the *Adria-Wien*[73] and *British Aggregates*[74] cases, where the court were asked about treating manufacturers differently from service providers and whether there is such a thing as a "negative" derogation from a general scheme respectively.

Adria-Wien regarded a request for an advanced ruling concerning a consumption tax on electricity in Austria which included rebates for consumers engaged in the manufacture of goods. The central question regarded whether the rebate was selective as it excluded certain identifiable undertakings, notably providers of services. The ECJ stated that the amount of undertakings enjoying an advantage did not matter when assessing a measure's selective versus general nature. Nor does it matter in the context of finding a justification within the general scheme if the selectivity is the result of objective criteria or not. Further the ECJ maintained that since the basis for the measure were to encourage the efficient use of energy there were no justification for giving preferential treatment to certain consumers since the energy used regardless of purpose were equally damaging to the environment. The scheme therefore were capable of constituting State aid.[75]

British Aggregates were about a scheme in the UK which imposed punitive taxes on the exploitation of certain materials used in construction known as aggregates. The contested measure implemented environmental policy and aimed at increasing effective use of resources by encouraging the use of recycled material and aggregates produced as a byproduct of other processes rather than virgin aggregates (which are directly extracted from quarries). The UK therefore intended to exempt the former from the tax as well as raw virgin aggregates intended for export. The UK further exempted aggregates intended for certain specified manufacturing processes. The Commission found no issue with the proposed scheme claiming that the exemptions were compatible with the internal objectives of the tax measure. This decision by

ECJ (2012) Issue 2, *European State Aid Law Quarterly*; p. 411, 418 ff

[73] Case C-143/99, *Adria-Wien Pipeline and Wietersdorfer & Peggauer Zementwerke* (2001) ECR I-08365

[74] C-487/06, *British Aggregates v. Commission* (2008) ECR I-10515

[75] C-143/99, *Adria-Wien Pipeline and Wietersdorfer & Peggauer Zementwerke* (2001) ECR I-08365 para 48-53

the Commission was appealed.

The appealing party argued that the narrow construance of the tax resulted in aid being granted to activities which had a similar environmental impact to the mining of aggregates but was not covered by the measure. The reason the tax had been constructed in such a way was to guard certain industries against international competition it was argued. The Commission's and the UK's rebuttal to this was that the levy was a "negative" form of State aid, i.e it was selective in singling out industries to be disadvantaged as opposed to being given an advantage. Since Member States are free to set its own environmental goals they have a sole right to decide which industries to subject to these kinds of charges.[76]

The ECJ rejected the reasoning of the Commission. Relying on the argument that the assessment of State aid concerns the effect of a measure as opposed to its goals the ECJ rather simply concluded that the narrow delineation of the scheme –which excluded from its application activities with similar effect to those to which were subject to the levy– was capable of having the effect of granting the exempted undertakings an advantage. Hence the focus of the assessment under Art. 107 is not on what regulatory technique is used (a narrowly applied rule versus an exemption from a more broadly construed tax) but purely on the actual outcome of a measure.[77]

These cases demonstrates the ECJ's approach to regulatory taxes focused on achieving a specific objective through the taxation of certain activities. Unlike the approach taken in *Paint Graphos* the comparability analysis is strictly focused within the confines of the goal of the tax measure. If a special levy or exemption does not apply to a situation where we would expect it to based on the objective it constitutes a derogation that subsequently require justification.

4.3 Sardinian Stopover Tax: Parallel with the Fundamental Freedoms

This case[78] concerned a tax levied by the Italian Autonomous Region of Sardinia on stopovers by aircraft. The tax only applied to aircraft not resident in the region as it was conceptualized as an environmental tax on tourism. The tax was ultimately held to infringe both the prohibition on State aid and the freedom to provide services.[79] Our interest in this case is in how the ECJ ultimately decide to apply the selectivity test to establish the former. In a quite remarkable statement Advocate General Kokott claimed that the test of State aid should be the same as for the fundamental freedoms

[76] C-487/06, *British Aggregates v. Commission* (2008) ECR I-10515 para 63-75
[77] C-487/06, *British Aggregates v. Commission* (2008) ECR I-10515 para 86-88
[78] C-169/08, *Presidente del Consiglio dei Ministri v. Regione Sardegna* ECR I-10821
[79] C-169/08, *Presidente del Consiglio dei Ministri v. Regione Sardegna* ECR I-10821, see the conclusions of the ECJ

in order to avoid a discrepancy between the two assessments. She goes on to make an analysis very similar to the one carried out in the *British Aggregates* case, stating that both resident and non-resident aircraft operators pollute the environment equally necessitating that the tax be applied to both without regard to determining a specific reference system.[80] Another noticeable part of her opinion relates to the fact that she argues that simply by fulfilling the selectivity criterion the use of state resources and the existence of an advantage can be presumed. She argues –without any closer analysis– that by imposing the tax only on non-residents the resident undertakings has been granted an indirect advantage and had Sardinia taxed them as well the Region's revenue would have been increased.[81]

The ECJ seem to endorse these views in its judgement. In regards to the use of state resources the court reiterates that a tax that should be levied on all undertakings but is limited to a specific group is tantamount to a transfer of resources to those businesses which escapes the tax' application. In determining the selectivity of the measure the court goes so far to refer to its reasoning relating to the freedom to provide services and clearly says that a measure which only apply to a limited set of comparable economic actors is selective.[82] It thus seem that in cases such as this the explicit identification of a reference system is unnecessary and selectivity as well as the use of state resources can be inferred from the mere fact that comparable undertakings are not taxed equally.[83]

4.4 The P Case: Discretion of Tax Authorities

The ECJ had the chance to address this topic further in its advance ruling in *P*[84]. That case regarded a Finnish rule which limited the carry forward of losses in the case of a takeover. This could be set aside by the Finnish tax authority and it enjoyed significant discretion in this regard. In other words this was an exception to an exception. The question the referring court asked were then how to determine the reference system, was it the general tax system which allowed for a carry forward of losses or the exception to that rule in the case of a change of ownership.[85] In this instance the ECJ found that the case concerned existing aid and as such did not need to grapple with this question. However it did note that where the tax authority enjoys

[80] Opinion of Advocate General Kokott in case C-169/08, para 134-139
[81] Opinion of Advocate General Kokott in case C-169/08, para 126-127 and 144-145
[82] C-169/08, *Presidente del Consiglio dei Ministri v. Regione Sardegna* ECR I-10821, para 55-63 and 35-36
[83] for another analysis of this case which reaches similar conclusions see: Michael Lang, "Tax Legislation and the Notion of Fiscal Aid: A Review of 5 Years of European Jurisprudence, in editor: in editor: Isabelle Richelle, Wolfgang Schön, Edoardo Traversa, *State Aid Law and Business Taxation* (Springer-Verlag Berlin Heidelberg 2016) p. 28 ff; Compare to: T-500/12, *Ryanair v. Commission* (2015) para 90 and T-473/12, *Aer Lingus v Commission* (2015) para 76
[84] C-6/12, *P Oy* (2013)
[85] C-6/12 *P Oy* (2013) para 13

discretion and bases its decisions on conditions not stemming from the internal objectives of the tax system that is considered a selective advantage. Thus the ECJ heavily imply that the fact that the tax authority in a circular gave the maintainment of employment as a reason to grant a request to be excepted from the rule entails State aid on its own merit.[86]

4.5 Gibraltar: An Inherently Discriminatory System?

One of the most important developments in this field took place in the *Gibraltar* case[87]. That case concerned a proposed new corporate tax system to be implemented in the Autonomous Region of Gibraltar. The system consisted of a payroll tax, Business Property Occupation Tax (BPOT) and a registration fee. The payroll tax required the payment of a set amount per employee the taxpayer had in Gibraltar, the BPOT were charged on the property occupied by the taxpayer and the registration fee were an annual fee for companies registered in Gibraltar with companies that did not intend to generate income being charged half the amount of a company that did. The first two rates were limited to 15% of the corporation's profit with no tax at all levelled on a business not making a profit. There were special rules applied to specific kinds of companies, a separate tax on profits from financial services that were also limited by the 15% cap while utility companies were taxed on 35% of profits with the payroll tax and BPOT being deductible.

The Commission considered the scheme to be geographically and materially selective. In the Commission's view the material selectivity stemmed from the facts that companies not making a profit escapes tax, that companies making a low profit relative to their number of workers and extent of occupied property benefits from the cap, and that offshore companies having neither workers nor property in Gibraltar completely escapes taxation. Thus these three groups of businesses would gain a selective advantage.[88]

Gibraltar and the UK disputed these findings arguing that the proposed measures constituted a general tax system in its own right and that the Commission failed to identify a reference system from which the proposals could derogate. It follows from this line of argumentation that none of the supposedly materially selective rules exempted undertakings from any tax that would have normally been levied. Gibraltar further argued that the constituent parts were justified by the internal logic of the system as Gibraltar taxed two factors of production in short supply in the region and that the cap were an expression of the ability-to-pay principle. Secondly the argument were forwarded that the Commission failed to identify the

[86] C-6/12 *P Oy* (2013) para 26-31
[87] Joined Cases C-106-107/09 P, *Commission and Spain v Government of Gibraltar and the United Kingdom* (2011) ECR I-11113
[88] Joined Cases C-106-107/09 P, *Commission and Spain v Government of Gibraltar and the United Kingdom* (2011) ECR I-11113 para 21

beneficiaries since profits are naturally variable and thus it cannot be said that the groups the Commission argued were targeted to benefit from the scheme were sufficiently specific.[89]

The Commission argued that the scheme were a "hybrid" system and that the rules in question were exceptions from each other. Apparently this hybrid nature rendered the proposal as a whole indiscernible as a general system and the Commission argued that the internal logic of the system itself were flawed. This was based on the argument that the logic of a payroll tax and BPOT required that a company paid more tax the more workers or property it had, in other words the cap were a derogation from that system (as opposed to Gibraltar's argument that the cap formed a part of the general system along with the taxes). Due to this the scheme did not qualify as a general tax system and was inherently selective. As for the third point regarding offshore companies the Commission identified the unusually large amount of these in Gibraltar as a clearly discernable group of undertakings that was favored by a regime consisting of payroll and property taxes, making these parts of Gibraltar's proposal inherently selective as well.[90]

The Court of First Instance ruled in favor of Gibraltar and the UK.[91] In essence that court held that the Commission had failed to correctly apply the selectivity test by failing to identify a reference system and failing to prove that the constituent parts (the kinds of taxes chosen and the cap) could not flow from the internal logic of the tax system. The Judgement of the Court of First Instance was highly critical of the Commission's argument that the two goals pursued by these measures were incompatible, observing that it was based on hypotheticals and that the Commission imposed its own logic in the place of a valid reference system. In so doing the Commission overstepped the boundaries of its competence.

The Advocate General overall seem to agree with the assessment of the Court of First Instance[92] and offers a thorough overview of the derogation procedure along with the justifications for it.[93] It is in this part that the Advocate General criticizes the Commission as in his view they conflate the concepts of selectivity and advantage. This as without defining a point of reference to determine whether a derogation was at hand it was not possible to identify a charge that would normally have been borne in the budget of

[89] Joined cases T-211/04 and T-215/04, *Commission and Spain v Government of Gibraltar and the United Kingdom* (2008) ECR II-03745 para 118-140 for the full argumentation
[90] Joined cases T-211/04 and T-215/04, *Commission and Spain v Government of Gibraltar and the United Kingdom* (2008) ECR II-03745 para 129-138
[91] Joined cases T-211/04 and T-215/04, *Commission and Spain v Government of Gibraltar and the United Kingdom* (2008) ECR II-03745
[92] Opinion of Advocate General Jääskinen in joined cases C-106-107/09, para 147
[93] Opinion of Advocate General Jääskinen in joined cases C-106-107/09, para 155-156

the offshore companies, resulting in the measure being compared to a hypothetical regime conjured by the Commission.[94] Without a point of reference the Commission cannot demonstrate that Gibraltar loses tax revenue as there is no rule which would apply in the absence of the contested measure that would result in tax being levied.[95] The Advocate General goes on to scrutinize the Commission's argument that the system is inherently selective and finds it wanting. Once again the Commission's failure to apply the three-step test in this case makes it impossible for Gibraltar to justify the measures as being in accordance with the internal logic of its tax system. This results in the Commission acting outside its competence by removing Gibraltar's ability to decide on its own the objectives of its tax system.[96]

The ECJ affirmed that a measure applying indistinctly to all companies is not to be considered State aid.[97] The ECJ went on to confirm the Court of First Instance's reasoning in regard to the Payroll tax and BPOT vis à vis the cap.[98] It did however overturn the ruling in regards to offshore companies. Citing the *British Aggregates* case law[99] the ECJ argued that the payroll tax and BPOT were the correct reference system and that due to the fact that offshore companies by their very nature would not be liable to pay such taxes they were singled out as a group for an advantage. This was based on the logic that State aid is defined by its effect, meaning that regardless that no other tax rule would have required offshore companies to pay any tax –i.e there were no derogation from any rule– the effect was still that offshore companies were favored. To argue otherwise in the eyes of the ECJ were to interpret the selectivity test too strictly with the result that the State aid prohibition could be circumvented by the employment of a particular regulatory technique, rendering Art. 107 ineffective.[100] Later in the judgement –in a segment regarding the non-binding nature of the Commission's notices– the court goes further and proclaim that the identification of a reference system is not required at all to establish an advantage.[101]

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[94] Opinion of Advocate General Jääskinen in joined cases C-106-107/09, para 202
[95] Opinion of Advocate General Jääskinen in joined cases C-106-107/09, para 162-166
[96] Opinion of Advocate General Jääskinen in joined cases C-106-107/09, para 217-221
[97] Joined Cases C-106-107/09 P, *Commission and Spain v Government of Gibraltar and the United Kingdom* (2011) ECR I-11113 para 73
[98] Joined Cases C-106-107/09 P, *Commission and Spain v Government of Gibraltar and the United Kingdom* (2011) ECR I-11113 para 83-84
[99] Joined Cases C-106-107/09 P, *Commission and Spain v Government of Gibraltar and the United Kingdom* (2011) ECR I-11113 para 87; Citing Case C-487/06, *British Aggregates v. Commission* (2008) ECR I-10515 para 85-89 and C-279/08 P, *Netherlands v. Commission* (2011) ECR I-07671 para 51
[100] Joined Cases C-106-107/09 P, *Commission and Spain v Government of Gibraltar and the United Kingdom* (2011) ECR I-11113 para 92-95
[101] Joined Cases C-106-107/09 P, *Commission and Spain v Government of Gibraltar and the United Kingdom* (2011) ECR I-11113 para 131-132

The *Gibraltar* judgement has been widely discussed and criticized. Already in the opinion of Advocate General Jääskinen he warned that to follow along with the Commission's argument of inherent discrimination would be to endorse a "methodological revolution" in the area of State aid.[102] Similar concern was voiced by John Temple Lang who noted that had the case involved the prospect of recovery it would have been impossible to establish how much the benefiting companies were to pay. Even further it would not be possible to identify which companies were to do so unless the ECJ intended to suggest with the judgement that all companies established in Gibraltar is in a comparable position. This leads to the point that the court never carried out a proper comparability test. It is unclear how offshore companies as a group can be in a similar position to every other company. Lang argues that a correct reading of the decision is that this is only true for some companies and subsequently criticizes the ECJ for not specifying in what instances this is the case.[103]

This leads to the larger point made in the literature that the concepts of advantage and selectivity is not kept distinct by the ECJ in its case law. Determining a measure as selective will usually be enough in the eyes of the court to also presume that an advantage is at hand.[104] This gives the impression that the actual test conducted is a discrimination test similar to what the ECJ apply in other areas of law rather than the one described in the Commission's notice on State aid. Under such a system it would not be necessary to identify a "normal" state of affairs where an undertaking would be required to pay a tax that it has subsequently under a preferential regime been exempted from. Instead establishing that there is a difference of treatment resulting in a distortion of competition between comparable companies would be enough. When one adds the broad comparability test used in *Gibraltar* where seemingly every company may be considered comparable in certain instances this significantly expands the scope of measures that could be infringing on the State aid prohibition.

Michael Lang endorses this interpretation of the case law. He argues that this follows naturally from the effect based view taken by the law. It would be problematic he argues –in line with the Commission and ECJ in Gibraltar– if mere regulatory techniques could render a discriminatory regime immune from the reach of State aid law. Instead the relevant factor is if companies treated differently are in a competitive relationship, at which point the unequal treatment is liable to result in a distortion of competition.[105] Although he is more skeptical of this development, John Temple Lang

[102] Opinion of Advocate General Jääskinen in joined cases C-106-107/09, para 202
[103] John Temple Lang, "The Gibraltar State Aid and Taxation Judgment- A Methodological Revolution?" (2012) issue 4; *European State Aid Law Quarterly* p. 805, p. 807 ff
[104] Michael Lang, State Aid and Taxation: Recent Trends in the Case Law of the ECJ (2012) Issue 2, *European State Aid Law Quarterly*; p. 411, 418 ff
[105] Michael Lang, State Aid and Taxation: Recent Trends in the Case Law of the

comes to a similar conclusion.[106] Peter Wattel on the other hand regards the *Gibraltar* case as a potentially more restricted derogation from previous case law. Mirroring the Commission's opinion he argues that Gibraltar had specifically constructed the legislation so that it excluded offshore companies in order to escape the scope of the State aid prohibition and that this technicality cannot exclude a finding of State aid.[107] He further notes that this would be in line with the case law of the World Trade Organisation (WTO) where the fact that no actual failure to collect a tax otherwise due has taken place does not by itself preclude the finding of a subsidy. Citing the case *US-FSC* he notes that the WTO appellate body determined there was a need to –in the absence of a normative benchmark– to compare "legitimately comparable income".[108] In general there seem to be agreement in the literature with the notion that *Gibraltar* were trying to circumvent the State aid rules and that this justify the finding of State aid even if the test applied is not in line with the three-step test. There is however a lack of clarity as to what degree this doctrine can be used in other cases.

4.6 Banco Santander and Autogrill España: Specificity of the Selectivity Criterion

The ECJ were confronted with a somewhat similar case recently in *Santander*[109] which concerned Spanish deductions of goodwill as amortization when an undertaking taxable in Spain acquired shares in a foreign company. The Commission held this to be illegal State aid as there was in its view no reason to restrict that practice from being applied to similar domestic acquisitions. Reminiscent to the *Gibraltar* case above the general court took a narrower view of the case law. From that court's interpretation of *Gibraltar* and *Adria Wien* among others the Commission were under an obligation to identify a specific category of businesses that were exclusively benefitting from the regime or at least a specific one that were excluded.[110] The Commission had purely relied on the fact that the Spanish measure was derogation from the normal regime favoring a certain form of transaction.[111] In conclusion the General Court ruled that as the

ECJ (2012) Issue 2, *European State Aid Law Quarterly*; p. 411, 418 ff

[106] John Temple Lang, "The Gibraltar State Aid and Taxation Judgment- A Methodological Revolution?" (2012) issue 4; *European State Aid Law Quarterly* p. 805, 812

[107] Peter Wattel, Forum: Interaction of State Aid, Free Movement, Policy Competition and Abuse Control in Direct Tax Matters (2013) vol: 5:1, *World Tax Journal*, p. 128, 133

[108] Peter Wattel, Forum: Interaction of State Aid, Free Movement, Policy Competition and Abuse Control in Direct Tax Matters (2013) vol: 5:1, *World Tax Journal*, p. 128, 139, citing WTO Dispute Settlement (DS) 108 Appellate Body Report circulated on January14 2002, para 89-91

[109] Joined cases C-20/15 P and C-21/15 P, *Commission v. Banco Santander, Santusa Holding and World Duty Free Group* (2016)

[110] T-219/10 *Autogrill España v. Commission* (2014) para 44-45 and 67; T-399/11, *Banco Santander and Santusa Holding v. Commission* (2014) para 48-49

[111] T-219/10 *Autogrill España v. Commission* (2014) para 50 and 63; T-399/11, *Banco Santander and Santusa Holding v. Commission* (2014) para 54

measure in question were open to all undertakings as long as they engaged in the kind of transaction described in the law and no group of specifiable undertakings were excluded or had exclusive access to the benefits of the law it should be regarded as a general measure as opposed to a selective one.[112]

The ECJ recently overturned this decision and in doing so clarified its case law established in *Gibraltar*. In its view it was sufficient in order to prove selectivity to show that the law derogated from the general scheme –in this case the taxation of goodwill under the general Spanish corporate tax system– and that this conferred an advantage on some market actors but not others in spite of them being in a comparable position in light of the ordinary tax system. Since the Spanish tax system applying to domestic undertakings regarded in essence the same situation as those benefitting from the exception the latter were a derogation.[113]

In *Gibraltar* the identification of a specific group of undertakings were necessary in order to show that the offshore companies were *de facto* beneficiaries of a selective advantage by virtue of an otherwise generally applicable system. But in case of a law that derogates from another a specific subset of undertakings does not have to be identified as beneficiaries.[114] The *Santander* case has now been sent back to the General Court in order for a comparability test to be carried out. If the domestic undertakings are held to be in a comparable legal and factual situation to their foreign counterparts the rule will then constitute a selective advantage unless it is justified under the third point of assessment.[115] The outcome of this will be important for the next section of this paper as it will answer the question whether cross-border transactions are comparable under Art. 107 to purely domestic ones. The ECJ touches on this question when considering the second ground of appeal and appear to be of the opinion that aid purely benefitting cross-border actors may indeed be considered selective.[116]

4.7 Discussion: Emphasizing Comparability

The reason the three-step test requires the identification of a reference system and a subsequent derogation is that this allows for a relatively straightforward finding of an economic advantage. If we recall the original quote in *Sloman Neptun* there has to be a charge for the beneficiary to be

[112] T-219/10 *Autogrill España v. Commission* (2014) para 70-71; T-399/11, *Banco Santander and Santusa Holding v. Commission* (2014) para 74-75
[113] Joined cases C-20/15 P and C-21/15 P, *Commission v. Banco Santander, Santusa Holding and World Duty Free Group* (2016) para 64-90
[114] Joined cases C-20/15 P and C-21/15 P, *Commission v. Banco Santander, Santusa Holding and World Duty Free Group* (2016) para 72-86
[115] Joined cases C-20/15 P and C-21/15 P, *Commission v. Banco Santander, Santusa Holding and World Duty Free Group* (2016) para 72-86 para 93-94
[116] Joined cases C-20/15 P and C-21/15 P, *Banco Santander and Autogrill España* (2016) para 72-86

alleviated from as otherwise an economic advantage cannot be shown to exist. The source of consternation with the ECJ's case law is that this concept appears to be supplanted by the more general concept of a competitive advantage. Rather than showing a financial charge avoided by an undertaking we would then be satisfied with simply showing that the alleged beneficiary is in a better situation than its competitors. In that latter context the *Gibraltar* case makes perfect sense as the offshore companies were undoubtedly granted an advantage in them paying less in taxes giving them a competitive edge over other undertakings. By adopting this logic the use of a benchmark beyond other comparable undertakings for establishing both selectivity and an advantage is unnecessary. This idea is corroborated by Advocate General Kokott in the *Finanzamt Linz*[117] case where she argues that in cases of unequal tax treatment no transfer of state resources needs to take place for a finding of State aid.[118] Thus the only relevant question to answer it would seem is whether comparable undertakings are treated differently due to a tax measure.

This holds true for the other cases as well. As noted in the literature when it is not clear which of two tax measure ought to be regarded as the general tax system versus the derogation it would be closest at hand to observe that there are two potential systems to be applied; one beneficial and one less so. The less beneficial system would then take the place of the reference system.[119] This is in line with *British Aggregates* as in that case it was technically the special tax that was the derogation from the general system. In the *Sardinia Stopover Tax* case no reference system were identified at all and it was enough that the special tax did not apply to certain undertakings it should have in light of its objective.

This approach thus also avoids the issue of determining what the term "general" implies and instead allow for the simple identification of differential treatment to establish a selective advantage. In *Santander* the onus of the court's decision is consequently on the fact that two equivalent transactions (in the eyes of the ECJ) are treated unequally rather than the question of what renders a measure general. The court appears to establish a rule that similar situations should be taxed equally.[120] Even if the General Court were to rule that the companies fulfilling the criteria for the beneficial regime to apply are not in a comparable position to those that do not this still means that the comparability test is the decisive factor.

This would seem to go against the wording of the law. Indeed the ECJ has

[117] C-66/14, *Finanzamt Linz v. Bundesfinanzgericht* (2015)
[118] Opinion of Advocate General Kokott in case C-66/14, para 74
[119] Marie-Ann Kronthaler and Yinon Tzubery, "The State Aid Provisions of the TFEU in Tax Matters", in editor: Michael Lang, Pasquale Pistone, Josef Staringer, Claus Schuch, *Introduction to European Tax Law: Direct Taxation* (4th ed. Linde Verlag, Wien 2016) p. 112
[120] Compare: Case C-75/97, *Belgium v. Commission* (1999) ECR I-03671, Opinion of Advocate General La Pergola, para 8

said as much in the British *Black Cabs*[121] case. In that case only licensed ("black") cabs were allowed to use bus lanes while other vehicles (including those belonging to other types of private transportation services) were fined for using them. The ECJ did not consider this to constitute State aid as it did not fulfill the criteria of the measure being financed through state resources. [122] However cases such as this is distinguishable from tax cases in that the latter by their very nature will always involve state resources and a consequent competitive advantage. The conclusion one reaches is that in any instance where a rule of tax law constitutes unequal treatment between two similar situations it is liable to infringe on the State aid prohibition.

As observed by Wattel this is very much akin to the mentality adopted in the area of the freedom of movement rules.[123] In such cases the ECJ first carries out a discrimination test; is a cross-border situation treated unfavorably relative to a comparable domestic situation. If discrimination is found to be present this is then followed by a review if any of the derogations laid down in the treaty is applicable to the measure at issue, after which the court carries out a proportionality test. Transposed to the matter of a tax measure being tried under State aid law the test would look as follows: Are two undertakings in a comparable legal and factual situation being treated differently (i.e required to pay different amounts of tax)? Is this justified? If justified is the measure proportional to that goal?

I have not talked about the final point of assessment under the three-step test much as of yet; whether a measure is justified or not. But if we accept this new understanding of the test this question of justifiability swells in importance as it would dramatically increase the scope of art. 107 from what is implied in section 3 and 4. Wattel argues this point as well.[124]

5.9 Justifiability

There is no finding of a selective advantage where it stems from the internal logic of the system. This area of State aid law is poorly developed in the ECJ's jurisprudence and it is remarkably unclear what is actually to be assessed under this point. This part of the test were explored in *Tiercé Ladbroke*[125]; a case involving differential taxation of bets placed on domestic vis à vis foreign horse races. The ECJ noted that since there were different regulatory systems and economic conditions in place for the two

[121] C-518/13, *Eventech v. The Parking Adjudicator* (2015)
[122] C-518/13, *Eventech v. The Parking Adjudicator* (2015) para 34-47
[123] Peter Wattel, Forum: Interaction of State Aid, Free Movement, Policy Competition and Abuse Control in Direct Tax Matters (2013) vol: 5:1, *World Tax Journal*, p. 128, see in particular p. 134
[124] Peter Wattel, Forum: Interaction of State Aid, Free Movement, Policy Competition and Abuse Control in Direct Tax Matters (2013) vol: 5:1, *World Tax Journal*, p. 128, p. 134
[125] C-353/95 P *Tiercé Ladbroke v. Commission* (1997) ECR I-07007; referred to in C-53/00 *Ferring v. ACOSS* (2001) ECR I-09067; see also Conor Quigley, European State Aid Law and Policy (3rd ed. Hart Publishing, Oxford 2015) p. 119

kinds of races it would be illogical to superimpose the tax system in one instance to the other. This makes no sense as what the court is really saying and what ended up being the deciding factor in the case is that the two situations are not comparable. This early case fails to distinguish between the comparability test and that of justification.

More recently the ECJ pointed to the justifiability criterion in *P*, although this only served to point out that the ground of justification must stem directly from the goals of the tax system and not extrinsic policy goals.[126] It is obvious that neither the courts nor the Commission have a firm grasp at what a justification under this rule would look like or how it differs from the comparability test. As previously mentioned the Commission gives as two of its examples progressive taxes and rules combatting fraud. This is nonsense since by definition in a system based on the ability-to-pay principle two persons falling into different tax brackets are not in a comparable position from the point of view of that system in the first place. Similarly it is unclear why a rule combatting tax fraud would ever result in different amounts of tax being levied on two comparable undertakings and not at the very least be considered disproportional.

It has been suggested in literature that the objective of a tax measure is simply to raise revenue.[127] But in that case the reasoning in *Paint Graphos* is clearly wrong as it does not make any sense at all why cooperative societies and other undertakings would be regarded as incomparable within a general tax system seeking to raise revenue by taxing all businesses. The court in that case should have held that the cooperative societies were indeed granted a selective advantage but that this was justified by the unique position granted to this kind of undertaking in Italian law (this is enshrined in the Italian constitution no less[128]). As it stands the court arbitrarily distinguishes between different undertakings in the first part of the test based on objective criteria that does not appear to have any internal basis within the Italian corporate tax system.

This confusion is not helped by the ruling in the *Gibraltar* case where the different treatment of offshore companies is perfectly justified by the scheme of that system. There is no provision in the treaties that precludes disparate treatment of different kinds of companies when that results from the internal goal of a tax system. In my view the way one can understand the term "inherently selective" is that where one can conclude that the goal of a tax system is purely to boost the competitiveness of certain companies or make certain transactions more attractive this is not justified. In other words there is an as of yet undefined limited set of grounds for justification the

[126] C-6/12 *P Oy* (2013) para 29
[127] Conor Quigley, European State Aid Law and Policy (3rd ed. Hart Publishing, Oxford 2015) p. 114
[128] *Joined Cases C-78-80/08, Ministero dell'Economica e delle Finanze and Agenzia delle Entrate v. Paint Graphos (2010) ECR I-07611*, para 5

ECJ will recognize. There seem to be no obstacle to a Member State instituting punitive taxes where that stems from environmental policy for example. Similar to assessments under the freedom of movement rules there may be legitimate and illegitimate goals a tax policy may pursue. If it is legitimate a measure will be treated as a "special" levy and as its own reference system. Otherwise it will be viewed from the broader view of the entire tax system in which every single undertaking should be treated equally.

The case of *Santander* will likely be decisive on this point as it is currently back in the General Court where this part of the test is being considered. The goal of the Spanish measure is likely to boost the competitiveness of domestic companies internationally. If a Member State is entitled to set its own internal goals for its tax system there is not anything in the treaties that precludes this. However under the *Gibraltar* case law this is likely not a legitimate basis for differential treatment.

The core issue is that there is no clear distinction between a comparability test carried out "in light of the objectives of the system" and a justification deriving from "the general scheme of the system". However if the ECJ continue to take a broad view as to what constitutes comparable undertakings this distinction is important. It is not satisfactory that the legitimacy of the underlying measure in *British Aggregates* or *Adria-Wien* is taken as a given while a completely different test is used in *Gibraltar* because that system happen to look like a general income tax. It seems to me that the proper approach is to establish on the outset that all undertakings should be treated equally under tax law and then consider whether a given measure reflect a goal that is legitimate as a reason for differential treatment. This question as to how selectivity is actually to be determined is highly relevant for the cases analysed in the next section.

5: A New Frontier: Transfer Pricing and Article 107

5.1 Introduction to Transfer Pricing

As stated previously a problematic question in the tax area is the question of intragroup transactions. MNE:s can move assets across multiple jurisdictions within the group which presents a multitude of problems in regards to calculating their tax. An MNE can shift profits between jurisdictions by under- or overcharging for services or goods allowing them to shop for low tax jurisdictions. On the other hand taxable income needs to be allocated in a way which ensures that such transactions does not face double taxation. Transfer pricing rules are the tools which seek to address these problems by allowing tax authorities to allocate an MNE:s tax base in a way which reflects the actual value creation chain in a group. The key basis of these rules is the arm's length principle agreed upon by the OECD.[129]

The leading guidance on the rules of transfer pricing is laid down by the OECD in its transfer pricing guidelines.[130] The arm's length principle is meant to ensure that transactions between related enterprises reflect equivalent transactions made by undertakings subject to normal market conditions. As the name implies the payments exchanged in such transactions should be within "arm's length" of what would be expected if the companies involved abided by normal market forces i.e if the transactions were carried out by independent undertakings. If this rule is not followed the tax authority may adjust the company's tax base upwards or downwards accordingly. The rule stems from Article 9 of the OECD Model Tax Convention[131]:

> "Where a Contracting State includes in the profits of an enterprise of that State — and taxes accordingly — profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the firstmentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits"[132]

[129] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD Publishing (2015) p. 31 ff, for a full evaluation of the goals of transfer pricing see Schoueri, Luis; "Arm's Length: Beyond the Guidelines of the OECD", (Dec 2010) *Bulletin for International Taxation*, p. 690
[130] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD Publishing (2015)
[131] Full name: OECD Model Tax Convention on Income and Capital (2014)
[132] See also Art. 7(2) in relation to PE:s

There are two kinds of analysis to be made under the arm's length principle. A functionality analysis where the functions of, risks assumed and assets used by the involved parties are taken under consideration and using that information a comparability analysis is performed. The former is used to determine the role of the respective undertakings which are then utilised to find an appropriate comparable situation. Generally one of the involved parties is tested ("the tested party"), which party is tested depends on the functional analysis as it is preferable to test the party with the least complex role in the transaction. There are two kinds of comparables ("uncontrolled transactions") that can be made, an internal comparability analysis is conducted by comparing the tested transaction with another transaction between the tested party and an independent one. An external comparable is when a similar party engaged in an equivalent transaction is compared to the tested party.[133] In the OECD guidelines 5 different ways of carrying out the comparability test is described. It does not establish a hierarchy between these methods but offer guidance as to when specific methods are more accurate.

The simplest method for assessing an arm's length price is the Comparable Uncontrolled Price (CUP) method. In essence this form of assessment entails the identification of a comparable transaction which is compared to the one undertaken in the case being tested. This is considered the most reliable way to establish a suitable standard for comparison but runs into issues if no sufficiently similar transaction can be found. The resale price method is similar and compares the price usually charged when an item is sold to that of the controlled transaction. The cost-plus method rely on an estimation of the cost incurred by the seller of a product to which a profit margin is then added derived from the margin applied in comparable transactions. These three methods are referred to as traditional transfer pricing methods and are generally preferred due to their relative simplicity.[134]

In the Transactional Net-Margin Method (TNMM) the transfer price is estimated by analyzing the net profit relative to a profit indicator such as operating costs or total sales. A profit ratio is determined relative to the indicator chosen corresponding to what is observed in comparable transactions and then applied to the tested situation. This test has its strength in being more versatile than the traditional methods and is not affected to the same degree by the differences between different independent transactions. This as one would expect the net profit a comparable company operates under to be at a similar level.[135] The transactional profit split method is intended to be used in transactions involving parties which both

[133] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD Publishing (2015) p. 41-49
[134] Described in the OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD Publishing (2015), p. 63-76
[135] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD Publishing (2015), p. 77 ff

carry out unique and valuable functions. It estimates the total profits from a given transactions and then seek to allocate these equitably between the parties based on what portion of the return they would have expected to gain in an uncontrolled transaction.[136] These two are referred to as the transactional profit methods.

The approach taken by the OECD is not without criticism. First of all the rules as defined by the OECD are very imprecise which may lead to different versions of the arm's length rule being applied across jurisdictions. That is not to mention the difficulties facing companies and tax authorities in trying to determine how to apply the rule in the first place due to that fact. Secondly there are situations where finding reasonable comparables is not possible. This may be because of problems in accessing the relevant market information but also due to more fundamental reasons. Undertakings belonging to a single group may undertake transactions independent companies would not, stemming from the simple fact that the considerations of associated businesses acting together differ from those of independent enterprises. Finally there are instances where the conclusions reached under this principle may not reflect economic reality. This is particularly the case when one considers the boons of integrating into groups that exist, such as economies of scale. These benefits will be included in the arm's length price calculation and the group may therefore lose out on the financial benefits of these perks.[137]

5.2 Advanced Pricing Agreements

APA:s are essentially predictions agreed upon by states and undertakings on how transfer pricing or other tax rules will be applied to specific circumstances.[138] They serve an important purpose in counteracting some of the disadvantages of the arm's length test mentioned above. This is achieved by granting undertakings an ability to foresee how they will be taxed and plan accordingly. In this way they add an important level of transparency and certainty for businesses to what may otherwise be obscure laws. The use of APA:s further allows for more administrative expediency and effectiveness as tax authorities do not need to once again settle questions addressed in the original APA. Increased cooperation between tax authorities of different nations and various undertakings is another effect of this procedure that is often pointed to.[139]

This system can also be misused by both states and undertakings. A state can grant undertakings so-called "sweetheart" deals which do not reflect the

[136]OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD Publishing (2015), p. 93 ff
[137] See OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD Publishing (2015) p. 34 f
[138] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD Publishing (2015), p. 168 ff
[139] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD Publishing (2015), p. 173 f

arm's length principle resulting in an undertaking paying an artificially low tax. APA:s entered into separately by various states with a single MNE may give rise to mismatches between the jurisdictions the MNE could exploit, for instance for the purpose of creating "stateless" income if both countries expect an income to be taxed in another jurisdiction. Inconsistent applications of the law in different APA:s by a tax authority hold major implications for the internal market as more (or less) favourable rules being applied to varying MNE:s risk hampering free competition. Another problematic feature of APA:s is that they are usually confidential and thus not available for public or other forms of scrutiny. These issues has been identified by both the OECD and the Commission.[140]

The Commission released a staff working paper addressing issues related to APA:s in 2016 following concerns raised over its ongoing investigations into such arrangements.[141] After affirming the importance of this tool for tax authorities and that the practice of giving them out were itself compatible with EU law, the Commission described how they are to be assessed under State aid rules. The paper makes heavy use of references to the OECD guidelines with a few notable additions on part of the Commission. It is established that the CUP is considered by the Commission as the most appropriate method unless no suitable comparables can be found. If that is the case in the instance of the TNMM the Commission asserts that usage of operating expenses (the most commonly used) as the performance indicator of an undertaking is not always appropriate. Hence tax authorities need to carry out a proper analysis in order to assess which indicator will lead to the result best in line with the arm's length principle. The Commission concludes that in cases where an outcome is not accurate and cannot be explained by the inherent uncertainty of the test an APA will be considered in manifest breach of the arm's length principle. At this point the State aid prohibition is infringed.[142] As we can extrapolate at this point the Commission has its own interpretation of what constitutes arm's length pricing and a failure to abide by it will put a Member State in breach of Art. 107. This approach is problematic in a number of ways.

5.3 Comparability of Independent and Integrated Companies

In a number of recent decisions the Commission considered APA:s which was ultimately not considered to abide by the arm's length principle. In these cases the Commission criticizes the methodology used (in all cases the TNMM) and also substantive judgements of facts made in these rulings.

[140] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD Publishing (2015), p. 174 f and the Commission working paper on state aid and tax rulings (2016) as well as Peter Wattel, "Stateless Income, State Aid and the (which?) Arm's Length Principle", (2016) vol 44:11, *Intertax*, p. 791, 791 f

[141] Commission working paper on state aid and tax rulings (2016)

[142] Commission working paper on state aid and tax rulings (2016), summary of the full document

These cases touches on a few interesting topics. The two first cases where the Commission reached a decision was *Fiat*[143] and *Starbucks*[144]. First of all the Commission decides to define the system of reference as the general corporate income tax systems of Luxembourg and the Netherlands respectively. This is key to the Commission's reasoning on the selectivity of the measures as they argue that Fiat and Starbucks has been granted aid when compared to other *independent* undertakings.

Following this doctrine the Commission declared that the Netherlands had granted State aid to Starbucks. First of all royalties paid by a Dutch subsidiary to its parent company for know-how in coffee roasting were criticized. The Commission noted that the APA used the TNMM rather than the CUP despite the fact that there was suitable uncontrolled comparables available.[145] Based on its own assessment the Commission considered the worth of the underlying Intellectual Property(IP) to be zero as it was only the Dutch Starbucks company which paid any royalty for its usage of it.[146] The Commission continued to say that the contract were inherently unfavorable to the licensee in a way that would not have been acceptable for an independent actor.[147] In subsidiary reasonings the Commission went on to argue that the TNMM had in either case been incorrectly applied. Finally in regards to the pricing of green beans supplied within the group were considered to be outside of arm's length. Starbucks had raised the prices of the green beans supplied and while the company tried to justify the increase these arguments were rejected by the Commission.[148] Similarly, although the Commission accepted the use of TNMM in the *Fiat* case it went on to poke holes in the methodology endorsed in the APA. The company subject to the APA provided the Fiat group with internal financing services. The indicator chosen in the TNMM analysis were the company's regulatory capital instead of its accounting capital. The Commission estimated that this rendered Fiat's tax base about ten times smaller than it should have been.[149]

The first issue it is appropriate to explore is thus the assertion that undertakings that is part of a group is comparable to those who are not. Such a conclusion necessitates that the goal of any given transfer pricing regime or indeed any tax system in general is the equal treatment of these different kinds of companies. As pointed out by Raymond Luja this ideal does not necessarily correspond well to real life. A company that is part of a group has different considerations than two independent companies engaged in an individual transaction. This is the case since members of a group of undertakings have to also take into account the needs of the group as a

[143] Commission Decision SA.38375 *Fiat* (2015) O.J. L/351/2016
[144] Commission Decision SA.38374 *Starbucks* (2015) O.J. L/83/2017
[145] Commission Decision SA.38374 *Starbucks* (2015) O.J. L/83/2017, para 281-282
[146] Commission Decision SA.38374 *Starbucks* (2015) O.J. L/83/2017, para 309
[147] Commission Decision SA.38374 *Starbucks* (2015) O.J. L/83/2017, para 312-317
[148] Commission Decision SA.38374 *Starbucks* (2015) O.J. L/83/2017, para 348-349
[149] Commission Decision SA.38375 *Fiat* (2015) O.J. L/351/2016, para 256

whole. The problem inherent in following the arm's length principle is that it requires a tax authority to compare an intragroup transaction to a hypothetical action by an independent company. This is why the test is considered to be at "arm's length" as it is the result of an approximation of what an independent actor would do in the situation of an integrated undertaking. One of the main criticism of this approach is that it leads to tax authorities second guessing the business decisions of private companies.[150]

The issue from Luja's point of view appear to stem from the fact that independent actors do not have to be subject to these types of judgments where the tax authority puts an undertaking's business strategy on trial. However if the transfer pricing rules are to achieve their original intent of avoiding double taxation and countering MNE:s shopping for low tax jurisdictions it is quite simply a necessity that special rules are applied to them in some capacity. The contradiction here is thus that even if transfer pricing rules were to be applied perfectly MNE:s would still not be treated the same as independent companies strictly speaking. It therefore bears to be questioned whether the Commission can actually insist that these two very different types of companies are comparable.

The counterargument lies in the terminology of "in the light of the objectives intrinsic to the system"[151]. The argument forwarded by the Commission is that the goal of transfer pricing rules is or ought to be the equal taxation of grouped and independent companies. The criticisms in the above paragraphs concern transfer pricing rules based on the arm's length principle in general rather than these specific procedures. Indeed the Commission itself observes this, noting that the goal of transfer pricing rules is to achieve parity in the taxation of independent and integrated companies. Considering this it makes little sense to accept that the transfer pricing system of the Member States be treated as its own reference system rather than the corporate tax system. This seeing as the State has not made a decision in the first place to treat these different kinds of companies differently, if anything quite the opposite.[152] That conclusion is not changed by designating transfer pricing rules as part of the general system or taking an approach similar to the *Sardinia Stopover Tax* case. Since there is bound to be areas where integrated and non-integrated companies compete the *Gibraltar* case implies that even in that case a system which treated the two groups differently would be liable to be labelled as inherently discriminatory.

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[150] Raymond Luja, "State Aid Benchmarking and Tax Rulings: Can We Keep it Simple?", in editor: Isabelle Richelle, Wolfgang Schön, Edoardo Traversa, *State Aid Law and Business Taxation* (Springer-Verlag Berlin Heidelberg 2016) p. 114 ff

[151] Taken from Commission Notice (2016/C 262/01) on the Notion of State Aid as Referred to in Article 107(1) of the Treaty on the Functioning of the European Union (2016), para 128

[152] Commission Decision SA.38374 *Starbucks* (2015) O.J. L/83/2017, para 236-237; Commission Decision SA.38375 *Fiat* (2015) O.J. L/351/2016, para 198-199

Still the fact remains that MNE:s face separate treatment under special rules. So while it is true that these rules will apply exclusively to groups that is because they cannot be applied in practice or theory to independent enterprises. As a result there is no real difference between which of the tests suggested in the previous section you apply. No matter which the question is one of comparing the financial situation of the two kinds of companies after tax is paid without regard for the process of getting there, which is very different from one another and cannot be compared. Keep in mind that the transfer pricing rules are not technically about how much tax a company should pay but how much of its profit tax should be levied upon. This is done by deciding how an MNE:s profits should be allocated within that group. Since the determination of the profits of an independent company is –all things being equal– relatively straightforward the general corporate tax system will not provide for a general rule the transfer pricing rules can derogate from. Hence in any case the Commission cannot rely on showing unequal treatment purely as provided for in the tax rules to demonstrate that the integrated company is better off than it would have been if it was independent. This requires an autonomous concept of equality since otherwise the Commission cannot show that too much or little of the group's total tax base has been allocated to a specific member, i.e in order to prove the existence of an advantage.

Thus the Commission needs to identify what the normal taxation would have resulted in devoid of the selective advantage. Only the transfer pricing rules can provide an answer to this question. However since they themselves have resulted in the selective advantage the Commission is in the same position as in *Gibraltar* as it needs to apply a reference system where there is none available. The way the Commission has decided to address this is to use an autonomous EU concept of the arm's length principle.

5.4 An EU Arm's Length Principle

In all the cases regarding transfer pricing the Commission has used its own interpretation of the arm's length principle. Although heavily reliant on the OECD guidelines it is not clear that this interpretation is completely in line with them in all respects.[153] This is apparent in the Commission's assertion that there is a best method to apply in a given case. Hence the Dutch authorities had erred in using the TNMM in *Starbucks* and Luxembourg in *Fiat* had to justify its use of that same method. It follows from this same logic that in the case of the TNMM there is also a most appropriate performance indicator as shown in *Fiat*. In none of these cases is the arm's

[153] This is largely due to the Commission's use of the term "prudent market operator", the meaning of which is not clear in this context. See Werner Haslehner, "Double Taxation Relief, Transfer Pricing and State Aid", in editor: Isabelle Richelle, Wolfgang Schön, Edoardo Traversa, *State Aid Law and Business Taxation* (Springer-Verlag Berlin Heidelberg 2016) p. 148 f, citing as an example Preliminary Decision SA.38944 *Amazon* (2014) O.J. C/44/2015, para 55

length principle's existence in the national laws disputed. But by imposing an EU concept of that legal doctrine the Commission demands that the Member State apply a specific form of that principle as opposed to their own interpretations of it.

The Commission's application of the arm's length principle reached its head in the *Apple* case[154]. It concerned an APA between Ireland and Apple which had a few features differentiating it from the previous two cases. First of all the two Apple companies involved were not considered resident under Irish tax law which resulted in them essentially being without a country of residence for tax purposes.[155] Secondly there were no arm's length principle incorporated within Irish law and thirdly the two relevant APA:s were entered into in 1991 and 2007; before the OECD Council had adopted transfer pricing guidelines relating to non-resident branches.[156] At the heart of these proceedings were the question of where the IP of Apple were to be located. The Irish authorities had determined that this IP were not attributable to the Irish branches of the company and left it at that. In practice this meant the IP were allocated to the companies' head offices in the US.

The Commission argued first that the Irish authorities were mistaken in not assigning Apple's IP to the Irish branch based on the lack of staff and active management by the directors at the head offices.[157] Further the Commission criticized the fact that Apple had failed to identify what part of the Irish branches' sales constituted royalties to be subtracted from the total profits.[158] It also took issue with the allocation of R&D responsibilities with the logic that the Irish branches already contributed to such efforts through a Cost Sharing Agreement (CSA) thus debunking Apple's claim that these activities should be allocated to the US parent company.[159] In a subsidiary line of reasoning the Commission familiarly argued that the choice of method (TNMM) and application of that method were incorrect.[160]

This decision clearly show that the Commission is of the opinion that Art. 107 requires the use of the arm's length principle regardless of national law. The decision clearly states that any other method for profit allocation –at least insofar it reaches a different result– is contrary to the State aid prohibition. The fact that Ireland has not officially adopted any particular method for profit allocation and does not allow for taxation based on general principles under its constitution would thus be irrelevant since the doctrine of EU law supremacy gives the EU principle precedence over any

[154] Commission Decision SA.38373 *Apple* (30.08.2016)
[155] It was a so called "Double Irish" tax planning setup
[156] Commission Decision SA.38373 *Apple* (30.08.2016), para 153-155
[157] Commission Decision SA.38373 *Apple* (30.08.2016), para 280-282, final conclusion in para 304
[158] Commission Decision SA.38373 *Apple* (30.08.2016), para 306-307
[159] Commission Decision SA.38373 *Apple* (30.08.2016), para 312-318
[160] Commission Decision SA.38373 *Apple* (30.08.2016), para 325-327

domestic rules. In spite of the fact that the Commission goes on to carry out a test using the OECD rules as the standard it keeps on insisting that it does not apply the OECD Guidelines directly but simply consider them "useful guidance".[161]

5.5 The Case of the Belgian Coordination Centres

The basis for the Commission's use of the arm's length principle can be found in the 2006 ECJ ruling on the Belgian regime for coordination centres.[162] This case reflects the Commission's toughening stance on tax competition as a regime previously authorised by it in 1984 ended up being rejected by the Commission following the renewed reviews initiated after the adoption of the Code of Conduct. The case concerned a tax regime which favored coordination centres, a kind of undertaking created by corporate groups to provide various internal services to its members. The benefits consisted of a standardized tax base based on the centre's operating costs (based on the cost-plus method) sans staff costs and financial charges along with various exemptions.

The ECJ sided with the Commission on the question whether the regime was compatible with the State aid prohibition. More specifically the court agreed that the exclusion of workforce and financial charges from the operating cost assessment did not reflect arm's length prices (the court did not explicitly mention the arm's length principle but instead referred to the "conditions of free competition").[163] Thus it was an advantage. As for selectivity the regime were explicitly a derogation from the Belgian general tax system. More interestingly the court also held that the fact that only multinational entities fulfilling the criteria laid down could benefit from the regime rendered it selective.[164] The Commission's interpretation of this case is that a failure by a member state to properly apply a rule on arm's length transfer pricing is tantamount to State aid.

The Commission's reading of this case can and has been criticized.[165] The ECJ does not interpret the arm's length principle as such but rather deals specifically with the cost-plus method. Secondly the court's decision does not specify whether the conclusions reached are attributable to the features of the Belgian tax system or if this is indeed a generally applicable rule of the EU State aid regime. Finally that case regards the explicit exclusion of certain parameters (staff and financial costs) from the transfer pricing

[161] Commission Decision SA.38373 *Apple* (30.08.2016), para 254-257
[162] Joined Cases C-182/03 and C-217/03 *Belgium and Forum 187 v. Commission* (2006) ECR I-05479
[163] Joined Cases C-182/03 and C-217/03 *Belgium and Forum 187 v. Commission* (2006) ECR I-05479, para 96
[164] Joined Cases C-182/03 and C-217/03 *Belgium and Forum 187 v. Commission* (2006) ECR I-05479, para 122-123
[165] See Liza Lovdahl Gormsen, "EU State Aid Law and Transfer Pricing: A Critical Introduction to a New Saga", (2016) vol 7:6, *Journal of European Competition Law & Practice*, p. 369, 379 ff

calculation –an obvious contradiction of what is described by the OECD– as opposed to a situation where an ostensibly OECD compliant methodology is being applied.[166] Further it is of some note that the case identifies the coordination centres "and the groups they belong to" as the beneficiaries.[167] It is difficult to parse this language but I would posit that it is not possible to safely conclude that the intent of the court is to lay down a rule of equal treatment between groups and independent undertakings in general. As outlined in the previous section this requirement of equality likely exist but it is not clear from this case that the arm's length principle is the rule through which this should be achieved. Another interpretation would be that the ruling relates to the special circumstances of the case and that coordination centres being uniquely available to groups as a form of undertaking is incidental to the court's conclusion. Actually the court later criticizes the fact that the regime were exclusively available to groups of a certain size; rather than that standalone companies are *de facto* locked out from the system.[168] Although it is worth stating that the court are never clear what companies it refers to when discussing comparables elsewhere in the ruling, making it difficult to come to any definite conclusions in this regard.[169]

This is thus not wholly solid ground for the far-reaching application the Commission is propagating for. There was some confusion when the Commission first took the decisions to start the investigations whether it was extending the MEOP to also encompass private undertakings as opposed to just the public sector.[170] It is clear from how the final decisions are written however that this is not the case. Rather the Commission thinks it has found a new arm's length principle to be applied to private operators within EU law as an expression of the general principle of equal treatment.[171] This casts Art. 107 not as a prohibition on aid but rather as an obligation for Member States to ensure competitive equality of undertakings in the market place.[172] A big difference between these cases and those previously discussed is thus the argument that there is a positive obligation for Member

[166] Joined Cases C-182/03 and C-217/03 *Belgium and Forum 187 v. Commission* (2006) ECR I-05479 para 94-96
[167] Joined Cases C-182/03 and C-217/03 *Belgium and Forum 187 v. Commission* (2006) ECR I-05479 para 102
[168] Joined Cases C-182/03 and C-217/03 *Belgium and Forum 187 v. Commission* (2006) ECR I-05479 para 125
[169] Joined Cases C-182/03 and C-217/03 *Belgium and Forum 187 v. Commission* (2006) ECR I-05479, For instance in paragraphs 104 and 107 the court refer to "every company" without ever singling out integrated companies specifically as the privileged group
[170] See for example Liza Lovdahl Gormsen, "EU State Aid Law and Transfer Pricing: A Critical Introduction to a New Saga", (2016) vol 7:6, *Journal of European Competition Law & Practice*, p. 369, 378 f
[171] Commission Decision SA.38374 *Starbucks* (2015) O.J. L/83/2017, para 264; Commission Decision SA.38375 *Fiat* (2015) O.J. L/351/2016, para 228
[172] Peter Wattel, "Stateless Income, State Aid and the (which?) Arm's Length Principle", (2016) vol 44:11, *Intertax*, p. 791, 791 f

States to apply a certain legal regime rather than a negative obligation to not institute measures resulting in unequal treatment.

5.6 Other Legal Bases for an EU Arm's Length Principle

At the start of the proceedings investigating APA:s scholars Anna Gunn and Joris Luts identified three ways the OECD rules could be applied in the cases. Firstly as a starting point for an investigation where the Commission merely uses it as an indicator of potential State aid and later moves on to using the established three-step model. With the decisions now in hand we can tell that this is evidently not the case. Secondly the guidelines could be viewed as a part of the internal system of reference i.e as part of the national legislative framework. Whether this is possible is dependent on if and in that case how the arm's length principle has been incorporated into national law. Finally these rules could be used as a reference system external to domestic law in which case these decisions heralds a departure from established practice.[173]

If discrepancies between the national transfer pricing rules and the Commission's interpretation lead to a presumption of State aid that needs to be rebutted it constitutes a reference system. Another feature of the decisions is the observation by the Commission that the OECD rules has been endorsed by the Member States by virtue of their participation in the OECD. However this fact does not support a conclusion that the guidelines are part of the national tax system. A tax treaty is generally regarded as lacking the capacity of extending taxation rights beyond what is provided for by national domestic law. This rule also apply to the OECD Model Convention.[174] Even in the cases where the Member State has incorporated an arm's length principle the application of the guidelines would therefore be limited by domestic law. Considering this the Commission cannot validly argue that its own interpretation of that principle is part of the national reference framework if that is not supported by laws and legal precedent actually applied by the domestic authorities.[175] In conclusion it would seem like the Commission rather uses the guidelines as an external reference system.

With that said the application of the arm's length principle is not necessarily without merit. It is reflective of a general international consensus on transfer pricing, adopted by the OECD of which a majority of EU Member States are part. Further besides being used in the MEOP it has also seen use in the case law of the ECJ. In the free movement case *Thin Cap GLO* it was

[173] Anna Gunn and Joris Luts, "Tax Rulings, APAs and State Aid: Legal Issues", (2015) vol. 24:2, *EC Tax Review*, p. 119, 122 f
[174] Jens Wittendorf, "The Transactional Ghost of Article 9(1) of the OECD Model", (2009) vol 63:3, *Bulletin of International Taxation*, p. 107, 110 f
[175] Anna Gunn and Joris Luts, "Tax Rulings, APAs and State Aid: Legal Issues", (2015) vol. 24:2, *EC Tax Review*, p. 119, 123

determined that a failure to show that a transaction is within arm's length of what would have been agreed between unrelated parties may be used as an indication of the artificiality of such a business arrangement.[176] The principle is further referred to in the ATAD[177] as well as adopted verbatim from the OECD Model Convention in the EU Transfer Pricing Arbitration Convention[178]. However both of these only uses the concept loosely without a standalone detailed definition and in the case of the ATAD only in relation to interpreting the rules of that directive. Thus they do not lend support to the idea of using it to counter tax competition like what is the case here.[179]

Regardless there is no legitimate case that this principle can be used to extend the scope of domestic tax rules. In further support of this –as exemplified by the limitation in the Irish Constitution– tax rules are a particularly sensitive area in regards to legal certainty and legitimacy.[180] I have already pointed out the restrictions in regards to expanding tax rules by way of the Model Convention and as Werner Haslehner points out the OECD guidelines is at the end of the day issued by unelected technocrats after which they are confirmed by representatives of the members' governments (this decision would not be subject to ratification in a legislature).[181] In terms of EU law the lack of competency for the Union in the area of taxation should limit any expansive interpretation of international or EU trends in this respect. There is no support in the jurisprudence that the ECJ or the EU legislature endorse a mandatory legal doctrine in this area of law as the Commission suggest.

As mentioned the Commission in the decisions themselves argues that the arm's length principle is an expression of the general EU principle of equal treatment. Such general principles are only relevant when applying and interpreting EU law. As a result they are not capable of expanding the scope of EU legislation or competencies.[182] I therefore seriously question the idea that it is possible to introduce a highly complex set of mandatory rules like a transfer pricing regime using this logic. Considering the all-encompassing area of application of Art. 107 this would set a dangerous precedent in my opinion. It also still does not answer why the Commission consider its version of the arm's length principle to be a suitable indicator of equal

[176] C-524/04, *Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue* (2007) ECR I-02107 para 77
[177] In the recital para. 14 and Articles 5(6) and 8(2)
[178] Convention (90/436/EEC) on the Elimination of Double Taxation in connection with the Adjustment of Profits of Associated Enterprises (1990), In Art. 4
[179] See Peter Wattel, "Stateless Income, State Aid and the (which?) Arm's Length Principle", (2016) vol 44:11, *Intertax*, p. 791, 794 ff
[180] Wars have after all been fought over "no taxation without representation"
[181] Werner Haslehner, "Double Taxation Relief, Transfer Pricing and State Aid", in editor: Isabelle Richelle, Wolfgang Schön, Edoardo Traversa, *State Aid Law and Business Taxation* (Springer-Verlag Berlin Heidelberg 2016) p. 149
[182] C-555/07, *Kücükdeveci v. Swedex* (2010) ECR I-00365 para 23 and see also Paul Craig and Gráinne de Búrca, *EU Law: Text, Cases and Materials* (6th ed. Oxford University Press, Oxford 2015) p. 195 f

treatment or State aid. The Commission seem content with relying on the *Belgian Coordination Centres* case law as justification of its choice of method but this assumption is very much open to criticism.

5.7 Is the Arm's Length Principle a Good Indicator of State Aid?

Even if the Commission's use of the arm's length principle is accepted by the courts it is not necessarily a good litmus test for State aid. While transfer pricing laws may be *prima facie* selective the logic in previous State aid cases that a finding of selectivity is enough for a presumption of advantage and imputability does not necessarily hold true. The primary problem is that transfer pricing is far from an exact science. Even if the Commission arrives at an exact EU definition of the principle there are still questions to be raised in the context of the scope of the State aid assessment. Art. 107 is only relevant in regards to the situation within the Member State concerned. It follows from the requirement of imputability that a Member State cannot be held responsible for the actions of another state. In addition by that fact and the nature of the selectivity criterion only advantageous treatment in relation to the domestic market of a Member State is relevant for the State aid analysis. In instances where we are faced with the taxation of MNE:s these limitations presents potential difficulties the Commission has to address in these cases.

Since the comparison being drawn is between independent companies and groups in light of the general corporate tax system the difference in treatment being scrutinized concern the size of the tax base. This is so because transfer pricing rules is ultimately about the allocation of taxable income within a group of companies and in the case of MNE:s this by effect means allocation of taxation rights between jurisdictions. In other words the concern regarding a misapplication of transfer pricing rules should be that MNE:s end up not paying taxes on the same profits as domestic undertakings in the relevant country. In regards to non-residents the correct tax base would be reflective of all profits derived from the host state. Meanwhile residents should be taxed on its full worldwide income. The arm's length principle in this instance would be a tool for the Commission –just as is the case for national authorities– to determine the correct tax base for an integrated company. This logic is consistent with the single country approach of Art. 107 as a Member State's refusal to tax the same income for both kind of undertakings could be characterised as a derogation from the general tax regime. By this logic it would not matter whether the same income was taxed or not in another State after the fact; the only question is how much the state that may have granted the aid has taxed the undertaking. If the tax base for an MNE after an application of transfer pricing rules (in accordance with an APA or otherwise) does not accurately reflect its income

from that state it would be held to constitute an advantage awarded through state resources.[183]

The alternative to this logic –which it regrettably would appear that the Commission has chosen– is the argument that there is a positive obligation on Member States to apply an EU arm's length principle. A failure to do so would then automatically be in violation of Art. 107. This would mean that Member States would effectively be required to impose market conditions on MNE:s in order to put them and independent enterprises on equal footing. This is not in line with Art. 107 since a different approach to transfer pricing rules in and of itself is not enough to prove the existence of an advantage or which state's resources has been used.

The *Apple* case exemplifies this very well. The Irish authorities based the profit allocations in the APA on the mere fact that the head offices of the Apple companies were not located in Ireland without determining where they were actually located. As the companies were not considered resident in either Ireland or the US for tax purposes any income not attributable to the Irish branches were stateless. The assumption of the Irish authorities that a majority of the profits stemmed from the Apple IP is not questioned by the Commission. The conclusion that is contested by the Commission is that this IP is located outside of Ireland for the purposes of the transfer pricing analysis.[184] According to the Commission the fact that the head offices had no capacity to manage the IP means it had to be located in the Irish branch.[185] However as argued by the Irish authorities this is not reflective of economic reality either as the Irish branches cannot be reasonably considered to possess the capability to generate these relatively enormous profits themselves. In reality the profit attributable to the Apple IP should likely be allocated to the Apple group's headquarters in the US (Apple, Inc.).[186] The Commission correctly points out that these profits should be dealt with through the CSA between the Irish branches and Apple, Inc. which is not at issue in the current proceedings.[187]

In other words there should likely be an upward adjustment in the CSA if the payments prescribed there is not in line with market conditions. This should arguably matter for the question of whether State aid has been granted or not though. It would seem that if the payments of the Irish branches through the CSA had been higher and corresponded to the profits allocated to the head office the Commission would not have an issue with

[183] For the same line of reasoning see: Werner Haslehner, "Double Taxation Relief, Transfer Pricing and State Aid", in editor: Isabelle Richelle, Wolfgang Schön, Edoardo Traversa, *State Aid Law and Business Taxation* (Springer-Verlag Berlin Heidelberg 2016) p. 150 ff
[184] Commission Decision SA.38373 *Apple* (30.08.2016), para 266-275
[185] Commission Decision SA.38373 *Apple* (30.08.2016), para 276-307
[186] This same conclusion is reached in Peter Wattel, "Stateless Income, State Aid and the (which?) Arm's Length Principle", (2016) vol 44:11, *Intertax*, p. 791, 798 ff
[187] Commission Decision SA.38373 *Apple* (30.08.2016), para 310-315

the arrangement, at least not on the same grounds as in this decision.[188] It is questionable whether the Apple companies in Ireland have actually received any advantage from Ireland if these profits could actually be allocated to entities in the US anyway. In that scenario it is the US rather than Ireland which would have granted the aid by failing to tax these profits. The Commission's approach is overly technical and fails to address the fact that the Irish companies relatively small size clearly indicates they cannot be solely responsible for the profits posted. This is not resolved by the fact that Ireland in their recovery may reduce Apple's tax burden if part of that amount is found to be attributable to other States by for instance retroactive changes to the CSA.[189] The purpose of the procedure is to establish whether illegal aid has been granted by Ireland and this assessment should not be affected by the tax interests or actions of other countries.

The Commission's application of the arm's length principle in this case is not capable of clearly demonstrating that Apple has actually been granted an advantage in relation to other Irish undertakings. Since the Apple companies are not residents for tax purposes in Ireland they should not have to pay tax on income attributable elsewhere. This follows *a contrario* from the *British Aggregates* case law. Anything else would mean that undertakings in a competitive relationship with Apple would be granted a selective advantage instead (since the effective tax rate would be too high on Apple's Irish income). As a result it is not enough to show that Ireland has misapplied the arm's length principle in regards to a particular transaction, the Commission must show that the total tax levied on the Apple companies is actually too small if it is to prove the existence of an advantage. This is a direct result of the Commission choosing the general corporate tax system as its frame of reference, it is not possible to prove an advantage relative to that system without first calculating the correct tax base. The Commission's simplistic approach may have been reasonable if the subject of the proceedings were a generally applicable scheme, but since it concerns an individual decision addressed to specific persons it is completely justified to require the Commission to also take into account whether the remuneration provided for in the CSA is too low.

In conclusion the assertion that a failure to abide by the arm's length principle in an individual decision or transaction is by itself enough to presume the existence of an advantage imputable to the State is faulty. In order to arrive at a conclusion in that regard a broader view must be taken in regards to the total tax liability of the undertaking in question.

5.8 Belgian Excess Profit – A General Scheme

This is reminiscent of the Belgian *Excess Profit* case[190]. This case concerned a Belgian scheme whereby companies resident in Belgium were allowed to

[188] As indicated in Commission Decision SA.38373 *Apple* (30.08.2016), para 450
[189] Commission Decision SA.38373 *Apple* (30.08.2016), para 448-450
[190] Commission Decision SA.37667 *Excess Profit* (2016) O.J. L/260/2016

apply for participation in a scheme where so called residual profit were deducted from the tax base of group entities. Belgium would calculate the profit a hypothetical average independent company would make in the same circumstances as the group entity and the tax base could effectively not exceed this average. This was justified in the view of Belgium by the fact that group entities benefits from intragroup synergies, economies of scale and other factors not available to an independent entity. In order to determine the average for comparison the TNMM were used. From this method the authorities would arrive at an adjusted arm's length profit which would be converted to a percentage representing the portion of profit the group undertaking could exempt from taxation. This estimate was supposed to be tested after three years where it could be adjusted retroactively, but such a readjustment never actually took place during the lifetime of the measure.[191] Belgium argued that the scheme served to avoid double taxation and is in line with the logic of the arm's length principle since the excess profits cannot be attributed to Belgium. If this excess profit is not taxed anywhere else –the argument goes– then that is not due to any fault of Belgium's.[192]

Once again the Commission argues for the general corporate income tax as the system of reference. The reasoning here is the same as previously as the system seek to tax all resident companies actual profits. Since the transfer pricing rules aims to put MNE:s on equal footing as other companies a unilateral downward adjustment to the tax base cannot be considered part of that system. In an interesting additional line of argumentation the Commission note that only large MNE:s with significant economies of scale and synergy advantages would be able to find benefit from the scheme.[193]

The approach chosen by Belgium is not in line with the arm's length principle as any residual profit as a rule should be granted to the party assuming the more complex tasks. Since the Belgian scheme considered the Belgian side of the transaction the "central entrepreneur" it does not make sense under that principle to not allocate the residual benefits to that undertaking.[194] The scheme is inconsistent in that it considers the beneficiaries of the scheme the more complex party when testing the actual transfer pricing profits and then treat it as the tested party in the second step when the amount of residual profit is determined. The Commission then went on to dismiss the claim that the measure were justified in order to avoid double taxation, as it should in that case be necessary for the beneficiaries to prove that the residual profits has been taxed somewhere else before they are exempted.[195]

[191] Commission Decision SA.37667 *Excess Profit* (2016) O.J. L/260/2016, para 21
[192] Commission Decision SA.37667 *Excess Profit* (2016) O.J. L/260/2016, para 78-84
[193] Commission Decision SA.37667 *Excess Profit* (2016) O.J. L/260/2016, 138-140
[194] Commission Decision SA.37667 *Excess Profit* (2016) O.J. L/260/2016, 156
[195] Commission Decision SA.37667 *Excess Profit* (2016) O.J. L/260/2016, para 181

This case is noteworthy as it regards first of all a clearly defined generally applicable measure being overruled by the Commission due to a failure to abide by the arm's length principle. The scheme made use of the fact that MNE:s inherently enjoy competitive boons independent companies does not. These kind of advantages are the very reason companies integrate in the first place and is not part of transactions between independent companies. The OECD has observed this and have proposed that these kinds of synergies should be split between the members of the group in relation to their respective contribution to their existence.[196] The problem from the perspective of the arm's length principle is that Belgium appear to simply conclude that said synergies does not belong to the Belgian company without any further analysis, giving rise to double non-taxation of those profits in instances where they end up being attributed to other members of the group in an overstated manner.[197]

As pointed to by Haslehner the way the Commission makes use of the arm's length principle is consistent with its earlier approach. Rather than focusing on rules reflecting the economic reality that groups can often be more efficient than independent undertakings; the Commission is more concerned with putting these two kinds of companies on an equal playing field from a competition perspective.[198] However if the point of comparison is independent companies should profits that is not available to those companies (outside of the arm's length margin) be taxed from a *State aid* perspective? If the purpose of the Commission's arm's length principle is to treat these two types of companies the same should this not work both ways? In other words downwards adjustments like this should be possible assuming that a proper analysis is carried out in determining to what extent these profits is attributable to the company being taxed. Even if this leads to a situation of double non-taxation the arm's length principle should not be an obstacle to a rule such as this. It is however important to note that the measure also contained features encouraging companies to move additional business to Belgium in order to enjoy benefits. Along with the lack of proper analysis on the part of the Belgian authorities this limits the case's usefulness in determining any legal doctrine laid down in the decision in this regard.[199]

Similar to the Apple case the Commission is not able to prove in this case that the profits being excluded is definitely attributable to the Belgian

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[196] OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10: Final Reports*, (2015) OECD Publishing, p. 47 ff
[197] Raymond Luja, "State Aid Benchmarking and Tax Rulings: Can We Keep it Simple?", in editor: Isabelle Richelle, Wolfgang Schön, Edoardo Traversa, *State Aid Law and Business Taxation* (Springer-Verlag Berlin Heidelberg 2016) p. 123 f
[198] Werner Haslehner, "Double Taxation Relief, Transfer Pricing and State Aid", in editor: Isabelle Richelle, Wolfgang Schön, Edoardo Traversa, *State Aid Law and Business Taxation* (Springer-Verlag Berlin Heidelberg 2016), p. 157
[199] See Commission Decision SA.37667 *Excess Profit* (2016) O.J. L/260/2016, para 115

companies. However the distinction between a general scheme and individual decisions is important in this regard. Belgium cannot viably claim it has demonstrated that the profits are not attributable to the Belgian undertakings either nor can it be excluded that the scheme allows for profits that should be allocated to the Belgian companies end up being untaxed. Thus even if a scheme similar to the one at hand may be justified the Belgian implementation of it is at the very least not proportional to the goal pursued.

5.9 Transfer Pricing Rules as the Reference System

If the arm's length standard is not upheld by the courts there are two possibilities for finding State aid using the domestic transfer pricing rules as reference system; that the tax authorities has derogated from existing legal practice or that their discretion is too wide. As pertains to the former it is a question of finding comparable instances where the transfer pricing rules have been applied differently. The problem with this is first of all that the Commission needs to find comparable cases which in itself can be difficult. Intragroup transactions needs to be considered in their entirety and as such even slight differences can be valuable for the final decision whether to adjust the price. Second of all it needs to be determined which decision constitute the general system if the Commission is faced with only two differing ones, although in this case as previously mentioned the least beneficial one would likely be used as the "normal" tax. Thirdly there is the fact that these rules are often not consistently applied at all by tax authorities, a matter the Commission brings up repeatedly.[200] Finally APA:s are secret, meaning that cases based on comparisons between different APA:s are difficult to meaningfully discuss or analyse as case law.[201]

The Commission comes close in *Starbucks* where it notes that the guidelines provided by the tax authority explaining the Dutch transfer pricing system clearly states that the OECD rules are transposed into national law.[202] However the lack of clarity of the OECD guidelines previously described makes it difficult to assert that different interpretations of them constitutes derogations from the domestic law. When it comes to instances where the guidelines are not clear such as in regard to the choice of method or assessments of the facts of a case the Commission would still be required to find legal precedent in the national law to prove that a decision indeed derogates from this reference system. As such it is in my estimation not enough for the Commission to simply replace the Netherlands' interpretation of those guidelines with its own.

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[200] Commission Decision SA.38373 *Apple* (30.08.2016), para 371-377; Commission Decision SA.38375 *Fiat* (2015) O.J. L/351/2016, para 321-336

[201] See: Raymond Luja, "State Aid Benchmarking and Tax Rulings: Can We Keep it Simple?", in editor: Isabelle Richelle, Wolfgang Schön, Edoardo Traversa, *State Aid Law and Business Taxation* (Springer-Verlag Berlin Heidelberg 2016) p. 120 f

[202] Commission Decision SA.38374 *Starbucks* (2015) O.J. L/83/2017, para 411

Due to the difficulty of comparing different APA:s the question of the limits of tax authorities' discretion may be more interesting. In *Fiat*[203] and *Apple*[204] the Commission argues that it is not possible to meaningfully use the national transfer pricing rules as a reference system as these are too vaguely written and not consistently applied. This is directly related to the Commission's complaints regarding the choice of profit indicator in *Fiat*, the price increase of green beans in *Starbucks* and the allocation of the IP in *Apple* to name a few. In all of those cases the tax authorities fails to explain their reasoning as to why these parts are in line with the arm's length principle or any other method for profit allocation.

This can be scrutinized under the doctrine referred to in *P*. If the tax authority have a large area of discretion that is not limited by objective criteria (in line with the internal goals of the tax system) the decisions of that authority is liable to give rise to a selective advantage. In the realm of advanced tax rulings it would be reasonable that an application of transfer pricing rules in a system devoid of specific provisions guiding and limiting the tax authorities discretion falls afoul of Art. 107 on this basis. For example where it regards the choice of which method for calculation to use it is not satisfactory that a tax authority can choose freely between them when they may result in different outcomes. On the other hand the sheer complexity involved in the application of these rules requires a large degree of autonomy on the part of the tax authority. It seems to me however that this is the central issue, the fact that tax authorities are relatively free in handing out sweetheart deals under these rules. Particularly since the lack of transparency in the system means that there is no real consequence of the authorities using their discretion liberally as it will not be subject to public scrutiny or litigation from anyone not party to the APA.

In *P* however that discretion regards the application of an exception and thus the "normal" situation is easily identifiable.[205] A narrower reference system does not solve the fundamental issue of finding a suitable benchmark for comparison in transfer pricing cases. This may very well be the reason for the Commission's choice to use the corporate income tax systems as reference; it is very difficult to conclusively show that the tax authorities' rulings diverge from established national law. The exception to this is the *Excess Profit* case which is explicitly framed as an exception and appear to not be based on purely objective factors.

[203] Commission Decision SA.38375 *Fiat* (2015) O.J. L/351/2016, para 321-336
[204] Commission Decision SA.38373 *Apple* (30.08.2016), para 371-377
[205] See also: Joint Cases T-92/00 and T-103/00, *Territorio Histórico Álava and Others v. Commission* (2002) ECR II-01385

6. Analysis: The Expanding Scope of Art. 107

6.1 Is the Commission's Approach to Transfer Pricing Compatible with Art. 107?

As demonstrated throughout this analysis the Commission's approach in these cases raises a lot of questions. In my view the Commission is correct to argue that integrated and independent undertakings ought to be treated equally as this is the ostensive purpose of transfer pricing laws; to allow for corporate tax to be effectively levied on corporate groups. The problem lies with the implementation of the arm's length principle in these decisions. This principle alone is not capable to prove the existence of an advantage by virtue of state resources and find poor support in prior case law or other EU legal doctrine. However without this tool it is not likely the Commission would be able to carry out a proper test due to the difficulty to use the domestic transfer pricing systems as a reference framework. Even so I will now put forward the arguments for why I feel the courts should ultimately reject the Commission's proposed method in these cases. I will also explain how the ECJ's inconsistent application of the selectivity test in the case law led to these decisions, thus making the argument that the ECJ should take this opportunity to clarify and limit its previous case law.

6.2 From Negative to Positive Integration

These cases aptly illustrates the problems with the increasingly expansive interpretation of Art. 107 in current jurisprudence. Pursuant of the objectives of transfer pricing laws integrated and independent undertakings should be treated equally. The issue the Commission faces is how to find a workable reference framework.

There are two competing tests that can be divined from the case law. As indicated by *Santander* in the three-step test one demonstrates that there are a derogation from a general framework. However since the undertakings still need to be in comparable legal and factual situations for a selective advantage to be at hand this distinction is of academic importance. Rather the point is to identify two comparable undertakings facing differing treatment from which one can conclude selectivity regardless of the legal structure of the regime. In *Gibraltar* the ECJ opened the door to use a hypothetical reference system if national legislation did not provide for one naturally. The issue with this approach is that it presumes a "normal" state of affairs where undertakings are easily comparable independent of the tax system. This is particularly problematic when undertakings considered to be comparable can be as broad as every undertaking in a Member State, which is the necessary conclusion of using the general corporate income tax as the point of reference.

As we have seen in the cases concerning APA:s this require an autonomous definition of that "normal" state of an undertaking since transfer pricing rules are not conferrable onto independent undertakings. This was foreshadowed in the *Gibraltar* and *Sardinia Stopover Tax* cases as the ECJ simply conclude that certain undertakings are taxed less than their competitors without much significant analysis in regards to the other parts of the test. However when applied to a more complex system this is significantly more difficult to simply conclude. The Commission ends up having to define a methodology to use in order to determine at what point parity has been achieved between the tax bases of MNE:s and domestic undertakings. What results is a rigid and complex set of rules being *de facto* imposed on all Member States.

The simplistic assumption that an advantage by means of State resources can be presumed if a tax measure is shown to be selective is the primary cause of this. It absolves the Commission of the burden to prove that a measure is tantamount to a transfer from state to undertaking meaning that the Commission's (or ECJ's) definition of the "normal" state does not have to regard the domestic tax system at all. The Commission takes this to its natural conclusion with its insistence that its arm's length principle is mandatory for the Member States to apply. At this point the Commission is essentially implying that Member States have an obligation to ensure through tax law that independent and integrated companies compete on equal terms. In effect the Member States are now required to *implement* a measure in order to avoid falling afoul of Art. 107 even if it is foreign to their respective tax systems. This is unlike previous cases where Art. 107 would only *stop* measures resulting in State aid.

In other words one could say that the ECJ opened pandora's box when it introduced the concept of inherently discriminatory systems and hypothetical benchmarks into the case law. This gives the Commission a wide open space for interpreting what constitutes equivalent treatment. Examples of measures which could potentially be questioned under this doctrine could for instance be different environmental levies. If a Member State introduce separate regulatory taxes on activities doing different kinds of damage to the environment (say a water polluting activity and an air polluting one) it is not out of this world to wonder whether concerns about the competitiveness of the domestic market may enter into the decision-making process. Would the Commission then be entitled to enter its own quantification of the damage caused by the various activities as a benchmark? On its face this seem like an obvious policy matter within the sphere of competence of the Member States. But in a world where the *Gibraltar* case exist this is far from certain. After all it seems equally valid to claim that which methodology to use to calculate equitable tax bases for MNE:s and domestic actors is a matter of policy. In the same vein

Gibraltar's decision which factors of production to tax is most certainly a policy question.

The fact that the Commission may not go that far in its enforcement policy does not alter the fact that all but the most general of tax rules could potentially be subject to harmonization by unelected EU authorities. This cannot in my view be considered to be the intent of the State aid rules. There can be no mistaking however that the arm's length principle the Commission desire to implement is in effect a harmonization of the transfer pricing rules in the EU.

6.3 The Irrelevance of the Justification Criterion

This problem of a wide reaching definition of comparability would be mitigated by a more active use of the justifiability criterion. This would not stop the fact that significant parts of Member States autonomy in the area of taxation would be restrained. But it would allow for the ECJ to establish safe havens where for instance in the area of the environment the Member States would be allowed wider discretion. To distinguish the grounds of justification from the "general scheme of the system" criterion is particularly important where hypothetical or external reference systems are used. It is worth noting that in both *Gibraltar* and the transfer pricing cases the Member States are robbed of their ability to justify the measures under their own rules. Instead they need to argue in line with the reference system the Commission or the ECJ has chosen to apply. Indeed the cases looked at in this paper rather heavily imply that the only guiding principle the ECJ and the Commission recognizes is the one of equal treatment, which explains why this part seem to be constantly conflated with the comparability test.

The reason for treating MNE:s and independent companies separately is obvious considering the different parameters involved in assessing their tax liability. Thus the argument that the different treatment is necessary for the functioning of the system is strong. This is however bypassed by the State aid test focusing on the effect of a measure rather than its goals. The Commission consequently does not have to concern itself with the way the systems functions if it can show that the outcome is not equitable. Hence this entire point of assessment is completely without meaning if comparability is determined independent of national law.

6.4 Negative Integration does not bring Legal Certainty

That line of argument touches on the next reason why I think that the ECJ should ultimately reject the Commission's arguments in the transfer pricing cases; the aspect of legal certainty. This principle has a central role in the area of tax law. However negative integration through prohibitive rules in the TFEU is not capable of delivering this. All we can divine from the cases before us in regards to transfer pricing is how the Commission consider the rules apply to these specific cases' circumstances. In spite of this we are

also told that all group transactions is subject to a vague set of rules of what the Commission consider to be within arm's length. The Commission's caginess as to what degree it is applying the already imprecise OECD guidelines as opposed to a system of its own devise is naturally not helpful. This is once again echoing of *Gibraltar* and touched upon again in *Santander*. In the former it is not clear which specific points makes it an inherently discriminatory general system as opposed to a collection of special levies besides the fact that offshore companies happen to be comparatively better off. Similarly in *Santander* regardless of that case's ultimate outcome it is not clear when cross-border transactions will be considered to be comparable to their purely domestic counterparts and when that will not be the case.

The ECJ and the Commission seem to simultaneously want to avoid the problem of Member States making legislation that artificially get around the State aid prohibition the way the Gibraltar government attempted while still paying lipservice to the idea of Member State sovereignty in tax matters. The result is an unforgivable lack of clarity as to when a Member State is not in breach of Art. 107. Any undertaking with an APA now has no recourse to know with certainty whether the APA is actually allowed under the EU rules short of having the tax authorities give notice to the Commission under the procedure laid down in Art. 108. As regard other tax laws one can only speculate where the Commission finds the next legal principle expressing equal treatment allowing it to harmonize another area of law.

6.5 Specific Decisions versus Abstract Comparables

This leads us to the next point worthy of discussion: the Commission's decision to scrutinize individual decisions as opposed to the general rules themselves. This is a shortcut the Commission takes in order to get around the vacuousness and inconsistent application of domestic transfer pricing rules while still approximating the law of the Member States. It is evident the Commission's goal in these decisions are to impact how the Member States apply their transfer pricing regimes. However it leads to questionable consequences as in Apple where the Commission ends up with a conclusion not reflective of economic reality. Further in all of these cases it requires the Commission to make complex assessments of factual circumstances rather than abstract legal definitions. This puts the Commission in the position of an appeals court second-guessing the assessments of tax authorities. It seems doubtful the Commission ought to make a habit out of this as a decision by a tax authority is not whether to hand out aid but rather to determine the proper level of taxation for a taxpayer. We have already seen in *Starbucks* an instance where the Commission appear to endeavour to interpret Dutch national law by enforcing its own interpretation of what constitutes a transposition of the OECD guidelines, which is not part of the Commission's duties. The Commission is not an EU level tax authority and an incorrect application of national law is a domestic matter not a State aid

issue. The Commission ought to limit its purview in this area to where tax decisions result in manifest breaches of a Member State's law or legal practice; which has not been proven in the transfer pricing cases described here.

The exception is seen in the *Excess Profits* case. There the approach of comparing an abstract actor under the Belgian special regime and one subject to the ordinary tax rules is easily demonstrable as one only need to identify more preferential rules under the special measure. However in the case of decisions addressed to individuals the Commission cannot simply impose its own interpretation of what the outcome ought to be without first showing how the decision actually diverge from the Member State's law. If the issue under Art. 107 concern an individual decision then it should reasonably be compared to other decisions under the same law. If as in these cases the concern actually regards the law the decision were taken under, the Commission should test whether the law or the legal practice surrounding it are in breach of Art. 107 in order to ensure consistency.

6.6 Final Conclusion

This leads us to the point that the domestic laws are poorly written and the fact that some Member States may not be applying them in a sincere way (i.e they use them as a tool of tax competition). While one may be sympathetic to the goals the Commission is pursuing the State aid rules are not an appropriate tool for achieving them. We should recall the opinion of Advocate General Geelhoed that the State aid rules are a *lex specialis* to Art. 116 and 117. In scenarios where the Commission cannot show a transfer between state and undertaking these rules should take precedence.

To circle back to the beginning of this essay and the topic of harmful tax competition the State aid rules should not be the primary solution to this issue. Due deference should be left to the Member States in regards to taxation measures and they should be allowed to set their own internal goals for their legislation. Only in instances where it can be shown the Member States actually forego revenue that would have otherwise fallen to them by way of a derogation should State aid be a concern. The onus on proving this is on the Commission which should not have the power to design its own reference system to circumvent its own burden of proof. Thus the ECJ in my opinion must severely restrict the *Gibraltar* case law and limit the State aid test to use reference systems with foundations in the domestic law of the Member States.

7. Conclusions

This paper has investigated four recent decisions taken by the Commission in regards to transfer pricing rules and State aid. The conclusions reached are that these are part of a trend of a major expansion of the definition of State aid in the area of taxation. This stems from the Commission's use of its own interpretation of the OECD's arm's length principle as an external reference system. The reason for this choice is the lack of a proper reference system in the national laws due to vague and inconsistently applied rules. However this expansion has the effect of harmonizing transfer pricing rules to be in line with the Commission's interpretation of the arm's length principle.

This result follow from the inconsistent application of these rules in the ECJ's case law. Although the State aid definition ostensibly require an advantage through a grant of state resources in tax law it is often enough to merely prove that a competitive advantage exist. This is due to the supreme importance placed by the court on the comparability test. This reached its head in the *Gibraltar* case where the ECJ ruled that a collection of tax measures intended to replace a general corporate income tax was "inherently selective". This appears to open the door for finding tax measures selective purely on the basis of a discrimination test. This test is significantly more opaque and potentially more restrictive than that test carried out in other parts of EU law due to the narrow definition of the justifiability criterion.

In its transfer pricing decisions the Commission uses the arm's length principle as a litmus test for State aid. This is despite the fact that the basis for this principle in EU law is weak. Although the Commission is correct in holding that transfer pricing should put MNE:s in the same position as independent companies relative to the general corporate income tax, this does not mean that the Commission is at liberty to implement its own reference system. The way it has chosen to apply this principle however leads to outcomes which are neither reflective of economic reality nor is it capable of proving the existence of an advantage by way of state resources. However –due to the underlying rules' vagueness– if the Commission has to use domestic law as the reference system it is likely that it will not be possible to prove the existence of a selective advantage.

This paper nevertheless argues that such an outcome is preferable to the Commission's proposed method. The latter infringes too much on the tax sovereignty of the Member States. This approach is also problematic from the perspective of legal certainty and the autonomy of domestic authorities in their application of national law. The far reaching consequences of allowing the Commission to define equal treatment independent of the national legal systems leads this author to argue for the ECJ to take a more

restrictive approach in future case law.

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