
TAX REVIEW

No. 336

EU STATE AID DEBATE:

Who's wrong between the US/EU multinationals, EU Member States, the EU Commission, EU law, OECD arm's length principle and the U.S. Treasury?

Michel Collet

March 13, 2017

© Michel Collet

In the new world/international fiscal order, non-mobile income went through increased tax pressure. Politicians also had no choice but to go after mobile income, international structuring and multinationals for the tax increase to become acceptable or at least fair to the public opinion. That's the beginning of the new age of a fiscally super active G20 with an empowered OECD, finally happy with a long-expected political push on proposed technical materials (transparency, anti-abuse etc.). Taxpayers and tax practitioners are now navigating through a BEPS universe of proposals, copied and pasted domestic law and EU BEPS hard law effective in the euro zone.

Within the framework of the current transparency trends, international taxation and tax planning hit the headline. State aid investigations on taxation and in particular private tax rulings practices from EU Member States to MNEs is one illustration among others.

Since 2015, these investigations have been relentlessly focusing the attention of the media and have aroused tensions between, on the one side, the States involved and the U.S. Treasury and, on the other side, the European Commission.

For EU tax practitioners, the potential risk that tax rulings could fall within the scope of the EU State aid legislation could not have been totally ignored since the mid - 1990s. Nonetheless, the fact that the European Commission relies on transfer pricing analysis, and more particularly on an arm's length principle which have been presented as possibly deviating from the OECD guidelines, may seem more surprising. However, the European Commission seems to reserve such possibility in very limited circumstances.

In this article, we will revisit the background of the current Commission's state aid investigations (I.) before going through the current several state aids investigations in order to discuss the position held by the U.S. Treaty in the White Paper (II).

I. STATE AID RULES & BACKGROUND

A. Current investigations

The EU is a single market where goods, workers, services and capital should freely move or circulate with no barriers or obstacles. Also, one should be able to establish oneself in another Member State in the same conditions as a local resident. These fundamental freedoms governing the single market should not be restricted unless the restriction may be justified by overriding reasons of public interest (e.g. the preservation of the allocation of the power to tax between Member States, risk of tax avoidance, danger that losses would be used twice¹, the coherence of the tax system, etc.). The extent of the acceptable restriction should not be beyond what is necessary to achieve the objective of the overriding reason of public interest at stake (according to the proportionality principle).

On the combination of EU law and domestic law, the principle of subsidiarity and the principle of proportionality govern the exercise of the EU's competences. In areas in which the European Union ("EU") does not have exclusive competence (such as direct taxation), the principle of subsidiarity seeks to safeguard the ability of Member States to make decisions and take action as well as authorize intervention by the EU when the objectives of an action cannot be sufficiently achieved by Member States on a stand-alone basis "*by reason of the scale and effects of the proposed action*".

The principle of subsidiarity regulates the exercise of the EU's non-exclusive powers. It rules out the Union's intervention when an issue can be dealt with effectively by Member States at central, regional or local level. The EU action is not legitimate unless Member States prove unable to achieve satisfactorily the objectives of a proposed action.

¹ These three justifications have, for example, been forward successfully in the following case: CJEU, 13 December 2005, Marks & Spencer

When it comes to direct taxation, the European Court of Justice's ("ECJ") ruled that although "*direct taxation does not as such fall within the purview of the [Union], the powers retained by the Member States must nevertheless be exercised consistently with [European Union law]*"². Therefore, Member States shall not enact tax regimes hindering fundamental freedoms or being discriminating between tax residents and non-residents. This is the reason why many national anti-abuse tax regimes (CFC, earning stripping, etc.) – by essence targeting cross border situations - were struck down for instance.

Also, direct taxation regimes of Member States may also be affected by other EU mechanisms such as competition law. The fair competition between Member States and their operators is one of the primary objectives of the EU. Hence, pursuant to Article 107 of the Treaty on the Functioning of the European Union ("TFUE"), Member States shall not grant any State aid without the prior consent of the European Commission.

Pursuant to Article 108 of the TFUE, the European Commission, and more particularly the "*DG Competition*", is in charge of determining whether a specific State aid is compatible (or not) with the EU's "*internal market*". Also, it should investigate if any national measure, including fiscal measures³, may constitute an illegal State aid.

Therefore, one should have in mind that State aid investigations launched by the European Commission on tax rulings primarily deal with competition law rather than tax law and should thus be read through that competition distortion angle rather than tax abuse *per se* or aggressive tax planning.

² CJEU, 14 February 1995, C-279/93, Finanzamt Köln-Altstadt v Roland Schumacker n° 21

³ CJEU, 20 November 2003, C-126/01, SA GEMO

1. Ongoing European Commission's investigations

Since June 2013, the European Commission has been investigating under State aid rules, the tax ruling practice of seven Member States (**Cyprus, Ireland, Luxembourg, Malta, the Netherlands, the UK and Belgium** as regards certain specific tax rulings). Then, the European Commission extended its investigations to tax ruling practices in all Member States of the EU as in December 2014. The Commissioner in charge of competition policy, Margrethe Vestager, said

*"We need a full picture of the tax rulings practices in the EU to identify if and where competition in the Single Market is being distorted through selective tax advantages. We will use the information received in today's enquiry as well as the knowledge gained from our ongoing investigations to combat tax avoidance and fight for fair tax competition"*⁴.

Based on the information gathered, the European Commission decided to launch the following formal investigation procedures:

1. formal investigation procedure launched in June and October 2014 as regards tax rulings, consisting in advance pricing agreements ("APA"), concluded by Amazon (**Luxembourg**)⁵, Apple (**Ireland**)⁶, Fiat Finance and Trade (**Luxembourg**)⁷ and Starbucks (**Netherlands**)⁸;
2. the formal investigation procedure launched in February 2015 as regards the **Belgian** "Excess Profit" tax scheme which is based on tax rulings granted to at least 35 multinationals mainly from the EU⁹;

⁴ European Commission - Press release – December 17, 2014

⁵ SA.38944 - Alleged aid to Amazon – Luxembourg

⁶ SA.38373 - Alleged aid to Apple

⁷ SA.38375 State aid which Luxembourg granted to Fiat

⁸ SA.38374 State aid implemented by the Netherlands to Starbucks

⁹ SA.37667 Excess Profit exemption in Belgium – Art. 185§2 b) CIR92

3. the formal investigation procedure launched on December 2015 and September 2016 as regards tax rulings granted by the **Luxembourg** tax authorities to the Luxembourg affiliates of the Mc Donald's¹⁰ and GDF Suez groups¹¹.

To date, the formal investigation procedures against Amazon/Luxembourg, Mc Donald's/ Luxembourg and GDF-Suez/Luxembourg are still in progress. As regards the other procedures, the Commission determined:

1. on October 21, 2015, that **Luxembourg** and the **Netherlands** had granted illegal State aids to respectively **Fiat Finance** and **Starbucks**. The amounts to recover from each taxpayer by those States are €20 - €30 million;
2. on January 11, 2016, the **Belgian "Excess Profit"** tax ruling was considered as an illegal State aid. The Commission determined that €700 million should be recovered from the 35 multinational companies which had benefited from this regime;
3. on August 30, 2016, **Ireland** had granted illegal State aids to **Apple**. The amount to recover from Apple is up to €13 billion. Such amount could nonetheless be reduced if other countries were to require Apple to pay more taxes on the profits recorded by its Irish subsidiaries, Apple Sales International and Apple Operations Europe, for the period covered by the procedure.

¹⁰ SA.38945 Alleged aid to Mc Donald's – Luxembourg

¹¹ SA.44888 Potential aid to GDF Suez

2. Tensions between the European Commission and the US Treasury

As of late 2015, members of the U.S. Senate Finance Committee expressed their concern as regards the State aid investigations launched by the European Commission against European subsidiaries of U.S. group companies and requested the U.S. Treasury to react.

On February 11, 2016, in a letter to the President of the European Commission, the U.S. Treasury Secretary, Jacob Lew, “*urged*” the European Commission to reconsider its position as he considered that the ongoing State aid procedures:

1. characterized the Commission's intention to apply retroactive penalties on the basis of a new and extensive interpretation of the concept of State aid;
2. appeared to be targeting U.S. companies disproportionately;
3. would give to EU Member States the right to impose income that is not attributable to them under international tax standards;
4. undermined the application of the tax treaties concluded between the United States and various EU Member States.

On February 29, 2016, European Commissioner for Competition, Margrethe Vestager, replied that State aid control procedures (i) were consistent with the current OECD BEPS project in which the U.S. are involved, (ii) did not specifically target US groups, and (iii) related only to the taxation of income generated in the EU which (iv) must be determined based on the arm's length principle.

On May 23, 2016, some members of the US Senate, dissatisfied with this answer, addressed a letter to Jacob Lew asking him to continue to pressurize the European Commission and proposed to consider the application of the retaliatory measures provided by Section 891 of the Internal Revenue Code which authorized to double the U.S. tax rates applicable to citizens and companies from the EU¹².

On August 24, 2016, the U.S. Treasury issued a White Paper¹³ in which it challenged the Commission's analysis notably based on ECJ's case law and past decisions from the Commission. On the whole, the U.S. Treasury considered that the Commission approach (i) departed from past decisions and ECJ case law, (ii) should in any case be limited to prospective relief, (iii) and would undermine the international tax system.

B. State aid rules

Although the concept of State exists since the creation of the European Union, it has been subject of continuous questions and debates, particularly in the field of taxation.

It is notably to provide answers to those questions that the European Commission updated its 1998 notice on the notion of State aid on May 19, 2016 ("Guidelines")¹⁴.

¹² Section 891 of the Internal Revenue Code provides that “Whenever the President finds that, under the laws of any foreign country, citizens or corporations of the United States are being subjected to discriminatory or extraterritorial taxes, the President shall so proclaim and the rates of tax imposed by sections 1, 3, 11, 801, 831, 852, 871, and 881 shall, for the taxable year during which such proclamation is made and for each taxable year thereafter, be doubled in the case of each citizen and corporation of such foreign country”.

¹³ U.S. Treasury White Paper, “The European Commission’s recent State Aid Investigations of Transfer Pricing Rulings” (Aug. 24, 2016).

¹⁴ 2016/C262/01. Please note that a draft Commission Notice on the notion of State has been published in 2014.

1. Notion of State aid

State aid is defined under Article 107 (1) of the TFUE as *"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 [...], in so far as it affects trade between Member States"*.

State aids are, as a matter of principle, prohibited, but some are or may be permitted in limited circumstances which are not addressed in this paper.

A measure qualifies as a State aid, within the meaning of Article 107 (1) of the TFEU, where such measure (i) is granted by the State and financed through State resources, (ii) has an effect on trade (iii) which distorts or tends to distort the competition between Member States (iv) by favouring certain undertakings through an economic advantage (v) which is selective.

The ECJ may merge some of these criteria. As regards tax measures, the three first criteria are generally met but the distinction between the economic advantage test and the selectivity may give rise to discussions even by the ECJ (see below as regards the analysis of the White Paper arguments).

1. **the measure is granted by the State and is financed through State resources¹⁵**: the granting of an advantage directly or indirectly through State resources and the imputability of such an advantage to the State are two separate and cumulative conditions for State aid to exist¹⁶. The fact that the provision is granted by the State is generally met as regards tax provisions since they almost always derive from the law or regulations.

¹⁵ Including national, regional or local authorities, public banks and foundations, private or public intermediate body appointed by the State etc.

¹⁶ See, for instance, CJEU, 16 May 2002, C-482/99, *France v Commission (Stardust)*, n° 23; General Court, 5 April 2006, T-351/02, *Deutsche Bahn AG v Commission*, n° 103

The analysis or the application of a provision made by the tax authorities is in principle considered as a State's decision since it impacts its budget.

Moreover, as regards the use of State resources, the ECJ ruled that any “*renunciation by a Member State of tax revenue which it would normally have received*”¹⁷ and even any measure “*allowing certain undertakings [...] to postpone payment of tax normally due*”¹⁸ is considered as financing a State aid;

2. **the measure has an effect on trade which distorts or tends to distort competition between the Member States:** the effect on trade and the distortion of competition are also two separate and cumulative conditions for State aid to exist. These two criteria are in principle automatically met where the undertaking carries on an economic activity involving trade between Member States (and even if that undertaking carries on its own activity in one Member State only)¹⁹.
3. **an economic advantage** is qualified where the beneficiary benefits from a treatment that he would not have received in the normal course of business (i.e. without the State intervention);
4. **selectivity:** the measure grants an advantage in a selective way to certain undertakings or categories of undertakings or to certain industries. Moreover, general measures which *prima facie* apply to all undertakings but are limited by the discretionary power of the public administration are selective²⁰.

¹⁷ CJEU, 16 May 2000, C-83/98 P, France v Ladbroke Racing Ltd and Commission, n° 48 to 51

¹⁸ CJEU, 10 January 2006, C-222/04 Cassa di Risparmio di Firenze and Others n° 132

¹⁹ CJEU, 14 January 2015, C-518/13, Eventech v The Parking Adjudicator, n° 67; CJEU, 8 May 2013, Joined Cases C-197/11 and C-203/11, Libert and others, n° 78; CJEU, 14 September 1994, C-278/92 and C-280/92, Spain vs Commission, n° 40

²⁰ See CJEU, 29 June 1999, C-256/97, DMTransport, n° 27.

This is the case where meeting the given criteria does not automatically result in an entitlement to the measure.

2. Focus on “selectivity”

The debate on the qualification of a tax measures as State aid relates almost exclusively to the selectivity criterion. Where States adopt exemption measures applicable to all undertakings fulfilling certain conditions, the criterion of selectivity of the measures should normally be assessed through of a three-step analysis:

1. Identification of the reference system / reference framework (“benchmark”):

“the reference system constitutes the benchmark against which the selectivity of a measure is assessed.

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.

In the case of taxes, the reference system is based on such elements as the tax base, the taxable persons, the taxable event and the tax rates. For example, a reference system could be identified with regard to the corporate income tax system²¹, the VAT system, or the general system of taxation of insurance. The same applies to special-purpose (stand-alone) levies, such as levies on certain products or activities having a negative impact on the environment or health, which do not really form part of a wider taxation system. As a result, and subject to special cases illustrated in paragraphs 129 to 131 above, the reference system is, in principle, the levy itself”²².

In practice, the Commission and ECJ generally adopts a very broad reference system which corresponds to the entire scope of the tax at stake.

²¹ See Judgment of the Court of Justice of 8 September 2011, Paint Graphos and others, Joined Cases C-78/08 to C-80/08, paragraph 50.

²² Guidelines, n° 132

2. Second, it should be determined whether a given measure constitutes derogation from that reference system. It may be the case where the measure leads to a difference between economic operators (which may or may not be in its scope), which in light of the objectives inherent to the reference system, are in a comparable factual and legal situation.
3. Then, if the measure is *prima facie* selective, it needs to be established, in the third step of the test, whether the derogation is justified by the nature or the general structuring of the reference system.

In other words, selectivity may not be addressed through a restraint reference system of certain categories of operators. Selectivity should be assessed in light of a whole and general reference system as being scope of corporate income tax

A debatable decision from the General Court (“Lower EU Court”) seemed to challenge such analysis. This decision may lead to consider that a fourth step would have to be met to demonstrate selectivity. Such a fourth step would consist in identifying a particular category of undertakings, which are exclusively favoured by the measure at stake and which can be distinguished by reason of specific features, common to them and characteristic of them²³.

In *Autogrill / World Duty Free Group*, the measure at stake was the ability under Spanish tax law to depreciate the goodwill attached to substantial shareholdings in foreign companies held by Spanish companies.

²³ General Court, T-219/10, *Autogrill España (World Duty Free Group) v Commission*, n° 41, 45, 67 et 68 ; General Court, T-399/11, *Banco Santander and Santusa v Commission*, n° 45, 49, 71 et 72

The Lower EU Court considered that the selectivity test should be assessed between undertakings having acquired foreign shareholdings only excluding undertakings holding stock in domestic companies. The Lower EU Court considered that no State aid was qualified since there was no selectivity between companies with foreign subsidiaries.

This example substantiates the White Paper which considered (i) that differences between MNEs and domestic companies should lead to analyze the selectivity only between MNEs and (ii) through that angle the selectivity test should not be met since all MNEs were in position request the tax rulings at stake.

However, last December, the Grand Chamber²⁴ of the CJEU overturned the judgment of the Lower EU Court in *Autogrill / World Duty Free Group*:

“the appropriate criterion for establishing the selectivity of the measure at issue consists in determining whether that measure introduces, between operators that are, in the light of the objective pursued by the general tax system concerned, in a comparable factual and legal situation, a distinction that is not justified by the nature and general structure of that system. [...]

It is sufficient, in order to establish the selectivity of a measure that derogates from an ordinary tax system, to demonstrate that that measure benefits certain operators and not others, although all those operators are in an objectively comparable situation in the light of the objective pursued by the ordinary tax system. [...]

Contrary to what was held by the General Court in the judgments under appeal, neither can it be required of the Commission, in order to establish the selectivity of such a measure, that it should identify certain specific features that are characteristic of and common to the undertakings that are the recipients of the tax advantage, by which they can be distinguished from those undertakings that are excluded from the advantage.

²⁴ the ECJ sits in a Grand Chamber where a Member State or an institution which is a party to the proceedings so requests, and in particularly complex or important cases.

All that matters in that regard is the fact that the measure, irrespective of its form or the legislative means used, should have the effect of placing the recipient undertakings in a position that is more favourable than that of other undertakings, although all those undertakings are in a comparable factual and legal situation in the light of the objective pursued by the tax system concerned.”²⁵.

The ECJ considered that such analysis was consistent with its precedents. For instance, case-law relating to aid for exports determined that aids specifically granted to exporters, and which were not granted to wholly domestic comparable sellers, should be regarded as State aid granted to a limited defined groups. The selectivity test was then met²⁶.

3. Recovery in case of illegal State aid

Members States wishing to introduce or amend measures characterizing new State aid must notify the Commission of the proposed State aid so that it can be authorized if it constitutes one of the exceptions to the prohibitions provided for in the TFEU. In the absence of such notification, the State aid is illegal and must be reimbursed (plus interest) by the undertaking to the State which granted it.

This system of recovery is designed to re-establish a competitive situation similar to the one that would have existed in the absence of the unlawful aid. It does not aim at penalizing the Member State which granted the illegal State aid. Consequently, the undertakings (victims) cannot hold the “wrongdoing” State responsible unless there is evidence of damage distinct from the reimbursement of the aid²⁷. However, if the State aid was granted more than ten years ago, the recipient company must not reimburse it since the “statute of limitations” might be opposed as the aid is not considered as “new” anymore.

²⁵ CJEU, 21 December 2016, C-20/15 P - Commission v World Duty Free Group n° 60 and 76 to 79

²⁶See CJEU, 21 December 2016, C-20/15 P - Commission v World Duty Free Group n° 115 referring to decision of 10 December 1969, *Commission v France* (6/69 and 11/69, EU:C:1969:68), decision of 7 June 1988, *Greece v Commission* (57/86), and decision of 15 July 2004, *Spain v Commission* (C-501/00),

²⁷ For an example in France: Conseil d’Etat, 22 July 2015, n° 367567, Halliburton Manufacturing and Services France

C. State aids and tax rulings

1. Back to the 1990s: Anti-harmful tax measures policy

Tax rulings are administrative decisions describing how specific transactions shall be treated for tax purposes. Thus, in a more and more complex tax environment due to the stacking up of new regulations, rulings (i) are a source of legal certainty for taxpayers as well as for the tax authorities and (ii), in principle, should not constitute a state aid.

As of the mid-1990s, and well before the current BEPS works, the European Commission was already urging Member States to fight "*against harmful tax competition*" as a distortion of the single market and already considered that some rulings might constitute State aid influencing the location of the business or presence.

To this end, a Code of Conduct on Business Taxation was published on December 1st, 1997 ("CoC"). The CoC is merely soft law but Member States were firmly committed to apply it in abolishing tax measures designated as harmful tax competition.

The CoC identified criteria to qualify harmful tax measures:

"B. Within the scope specified in paragraph A, tax measures which provide for a significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in the Member State in question are to be regarded as potentially harmful and therefore covered by this code.

Such a level of taxation may operate by virtue of the nominal tax rate, the tax base or any other relevant factor.

When assessing whether such measures are harmful, account should be taken of, inter alia:

- 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 tax 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 relaxed at administrative level in a non-transparent way”.

Then, based on these criteria, the Code of Conduct Group (i.e., the authors of the CoC) identified tax measures/practices which affected, or might affect, in a significant way, the location of business in the single market and thus could be considered as harmful. In a report published in 2000²⁸ (“CoC Group’s Report”), 66 measures were considered as harmful tax practices and were, for most of them, accordingly repealed by the relevant Member States. Were notably identified as harmful tax practices:

1. Several **Dutch** tax ruling practices such as the “Cost plus ruling”, the “Resale minus ruling”, the royalty rulings or the Finance Branch rulings. Most of these tax rulings dealt with the assessment of the arm’s length principle with respect to intragroup transactions;

2. The “*Finance Branches **Luxembourg***” tax ruling practice:

“Fully taxable Luxembourg companies, whose principal activity is carried out by a foreign permanent establishment, can request a confirmation from the tax authorities regarding the division of profits proposed between the head office and the permanent establishment as the Luxembourg administration considers that a proportion of the profits realised through the permanent establishment should be attributed to the head office. One condition required by the administration is that both the head office and the permanent establishment have sufficient economic substance”.

3. Other tax ruling practices in **Belgium**.

²⁸ Report of the Code of Conduct group on business taxation (established further to the ECOFIN conclusions of 1 December 1997 on the so-called “tax-package”) as submitted to the ECOFIN COUNCIL on 29 November 1999 : http://www.consilium.europa.eu/lt/uedocs/cms_data/docs/pressdata/en/misc/acf150c.html.

According to The CoC Group's Report, tax ruling practices were also scrutinized and the question of their compliance with the OECD arm's length principle was already raised:

"41. The Group considered a number of measures relating to the transfer pricing of intra group services. The internationally accepted standard for transfer pricing is the arm's length principle, as set out in the OECD's Transfer Pricing Guidelines of 1995.

To prevent a multinational enterprise from shifting profits between countries by under or overvaluing transfer prices, the arm's length principle envisages that taxable profits on cross-border transactions between associated enterprises should be computed as if the transaction had been between parties acting at arm's length.

42. The generally preferred method in the OECD Guidelines for determining arm's length profits is the so-called comparable uncontrolled price method. This involves comparing the price charged for services transferred in a controlled transaction to the price charged for services transferred in a comparable uncontrolled transaction. But, as there may not always be comparable transactions, the Guidelines also recognise the use of the so-called cost plus and resale minus methods. These involve looking at whether the mark up or margin on a transaction is an arm's length one.

*43. Most of the intra group service measures that were considered by the (Code of Conduct) Group provided for the use of the cost plus and resale minus methods. **In evaluating the potentially harmful intra-group service measures, the Group paid close regard to whether the measures conformed to the OECD Guidelines.** In the case of cost plus and resale minus measures, the Group took particular account in its evaluation of whether some or all of the following features are present:*

- they are used in circumstances where a comparable uncontrolled price might reasonably be obtained*
- it is not clear that there is always an individual examination of the underlying facts of the particular case or that the mark-up or margin is reviewed regularly against normal commercial criteria*

- there is a requirement for the company concerned to be part of an international group

- there is a reduction in the expense base taken into account for the purposes of determining taxable income.

44. The Group gave a positive evaluation to 13 measures²⁹.

Preparatory works also confirm that the Code of Conduct group analyzed the tax rulings granted as regards transfer pricing / allocation of profits as potential State aids. It seems that the group relied on the arm's length principle deriving from the OECD transfer pricing guidelines and not on any other specific arm's length principle deriving from the EU law:

«Luxembourg

Finance Branches

*It has been acknowledged that these double taxation provisions are outdated and inappropriate. **Given the formulaic split of profits**, such a measure may significantly affect the location of business and we would conclude that this should receive a positive evaluation like the similar measure already considered (and indeed any measure of a similar nature).*

[...]

United Kingdom

(Informal) cost-plus rulings

A number of the members of the Group indicated yesterday that if the UK practices ensure a proper and consistent application of the OECD transfer pricing rules (case by case analysis, no formulaic approach, regular review) then they had no further concerns about this measure. On this basis, we are inclined to conclude the measure is not likely to significantly affect the location of business and it should receive a negative evaluation.

Comparison of cost-plus arrangements

²⁹ Extract from the above-mentioned report of the Code of Conduct.

(If necessary) we would distinguish those measures that, at one end of the scale, strictly apply elements of the OECD transfer pricing guidelines from those that provide formulaic safe harbours and those that, at the other end of the scale, also exclude some of the relevant costs »³⁰.

The Code of Conduct published in 1997 already stated that some of the harmful tax practices covered (i) might fall within the scope of the provisions on State aid and that (ii) the Commission committed to publish guidelines on the application of the State aid rules to measures relating to direct business taxation by mid-1998, after submitting the draft guidelines to experts from Member States at a multilateral meeting. The Code of Conduct stated that (iii) the Commission committed to the strict application of the aid rules concerned, taking into account, inter alia, the negative effects of aids that are brought into light in the application of this Code and (iv) that the Commission intended to examine or re-examine existing tax arrangements and proposed new legislation by Member States on a case by case basis, thus ensuring that the rules and objectives of the Treaty are applied consistently and equally to all³¹.

Therefore, as requested within the frame of the Code of Conduct, the Commission published a “*notice on the application of the State aid rules to measures relating to direct business taxation*” in 1998 which specifically pointed out tax rulings as practices which might characterize a State aid:

³⁰ Extract from the “doc 2-Follow up to the study of admin practices - Final evaluation. (<https://circabc.europa.eu/sd/a/11516eb9-420a-4983-a75f-7b8516e13ba8/doc%202-Follow%20up%20to%20the%20study%20of%20admin%20practices%20-%20Final%20evaluation.pdf>)

To see the works of the Code of Conduct Group, notably as regards tax rulings - particularly in the sections from 1998 to 2000: <https://circabc.europa.eu/faces/jsp/extension/wai/navigation/container.jsp> (Section “Taxation and Customs Union” / “Information on the work of the CoC Group” / “Library”). However, most of the documents have been made available to the public on this website as from 2016 only.

³¹ Appendix J of the Code of Conduct published on 1st December 1997

“Discretionary administrative practice:

21. The discretionary practices of some tax authorities may also give rise to measures that are caught by Article 92. The Court of Justice acknowledges that treating economic agents on a discretionary basis may mean that the individual application of a general measure takes on the features of a selective measure, in particular where exercise of the discretionary power goes beyond the simple management of tax revenue by reference to objective criteria (Case C-241/94 France v. Commission (Kimberly Clark Sopalin) [1996] ECR I-4551).

22. If in daily practice tax rules need to be interpreted, they cannot leave room for a discretionary treatment of undertakings. Every decision of the administration that departs from the general tax rules to the benefit of individual undertakings in principle leads to a presumption of State aid and must be analysed in detail. As far as administrative rulings merely contain an interpretation of general rules, they do not give rise to a presumption of aid. However, the opacity of the decisions taken by the authorities and the room for manoeuvre which they sometimes enjoy support the presumption that such is at any rate their effect in some instances. This does not make Member States any less able to provide their taxpayers with legal certainty and predictability on the application of general tax rules”.

As a result, Member States repealed or amended before/right after the publication of the Code of Conduct most of the tax measures that had been identified as potentially harmful. Moreover, the European Commission launched a first wave of investigations as regards potential State aids in the field of taxation as of 2001 (notably as regards the coordination centers tax regimes in several member States).

Despite this sword of Damocles over them, some Member States continued issuing rulings that exceeded a mere interpretation of tax law that might be debatable in light of the arm’s length principle without seeking prior consent from the Commission.

It is in this context, the Commission initiated investigations on tax rulings concluded notably by European subsidiaries of U.S. groups with the tax authorities of their respective State of tax residence in June 2013 (C).

Also, the Commission updated its Guidelines on the notion of State aids³² and issued a working paper on State aid and tax rulings³³(B).

2. Clarifications recently provided by the Commission

First and foremost, the Guidelines issued in 2016 stress with no surprise that the legality of tax rulings is subject to the State aid rules. Moreover, they try to define categories of tax rulings that could qualify as State aid:

“a) the ruling misapplies national tax law and this results in a lower amount of tax; [- or -]

b) the ruling is not available to undertakings in a similar legal and factual situation; [- or -]

c) the administration applies a more ‘favourable’ tax treatment compared with other taxpayers in a similar factual and legal situation. This could, for instance, be the case where the tax authority accepts a transfer pricing arrangement which is not at arm's length because the methodology endorsed by that ruling produces an outcome that departs from a reliable approximation of a market-based outcome. The same applies if the ruling allows its addressee to use alternative, more indirect methods for calculating taxable profits, for example the use of fixed margins for a cost-plus or resale-minus method for determining an appropriate transfer pricing, while more direct ones are available”³⁴.

The last categories refer specifically to transfer pricing arrangements and more particularly to the “*arm's length principle*”. As such, it seems in line with the mentioned works of the Code of Conduct group. However, while the Code of Conduct group analyzed the tax rulings strictly in the light of the OECD arm's length principles, the Guidelines and the recent State aid decisions may be viewed as departing from the OECD guidelines.

³² A draft notice has been published in 2014 and the final version has been released on 19 May 2016

³³ DG Competition working paper on state aid and tax rulings dated 3 June 2016

³⁴ Guidelines, n° 174.

In its State aid decisions as regards transfer pricing arrangements (see for example, paragraph 264 of the *Starbucks / Netherlands* decision or paragraph 228 of the *Fiat / Luxembourg* decision), the Commission states that

“the arm’s length principle that the Commission applies in its State aid assessment is not that derived from Article 9 of the OECD Model Tax Convention, which is a non-binding instrument, but is a general principle of equal treatment in taxation falling within the application of Article 107(1) of the Treaty, which binds the Member States and from whose scope the national tax rules are not excluded”.

One might be tempted to conclude that some OECD compliant tax rulings could be qualified as State aid³⁵ since the “*EU arm's length principle*” seeks to ensure equality of treatment within the EU (which might not be exactly the aim of the OECD guidelines). However, the Commission moderates this approach by stating in its working paper that it would reserve in limited circumstances in “*cases where there is a manifest breach of the arm's length principle*”³⁶. Such reasoning seems similar to the one mentioned in the initial BEPS works which advocated for an adaptation or even a derogation from the arm's length principle in case of “*high risk*” transactions³⁷. We’ll get back to this issue in Section II. B. 5. hereinafter.

³⁵ By a reading *a contrario* of the paragraph n° 173 of the Guidelines: “*if a transfer pricing arrangement complies with the guidance provided by the OECD Transfer Pricing Guidelines, including the guidance on the choice of the most appropriate method and leading to a reliable approximation of a market based outcome, a tax ruling endorsing that arrangement is unlikely to give rise to State aid*”.

³⁶ DG Competition working paper on state aid and tax rulings dated 3 June 2016, n° 23

³⁷ OECD (2013), Action Plan on Base Erosion and Profit Shifting, OECD Publishing

II. STATE AID AND THE WHITE PAPER

A. The ongoing State aid procedures (summary for the sake of discussion).

The aim of this section is to sum up briefly the several ongoing State aid cases so as to assess the arguments raised by the U.S. Treasury in the White Paper.

Two sets of procedures are to be distinguished: (i) the allegedly state aids based on *“transfer prices/profits allocation which do not reflect the economic reality”* (Starbucks/Netherlands, Fiat/Luxembourg, Apple/Ireland, Amazon/Luxembourg and Belgium “Excess Profit” tax scheme) (ii) and the allegedly state aids based on an *“inconsistent application of national law, giving rise to a discretionary double non-taxation”* (Mc Donald’s and GDF Suez/Engie both with Luxembourg).

1. Starbucks / Netherlands

Starbuck’s Manufacturing EMEA BV, which is the only coffee roasting company of the Starbucks group in Europe, paid royalties to a Starbuck’s U.K. partnership (for the use of the technology and know-how of Starbucks to produce and sell roasted coffee) and purchased coffee beans from a Swiss subsidiary. In 2008, Starbuck’s Manufacturing EMEA BV concluded an APA with the Dutch tax authorities to validate the amounts of (i) the deductible royalties paid to the U.K. partnership and (ii) the purchase price of the coffee beans paid to a Swiss affiliate.

The Commission issued a decision to initiate the formal investigation procedure on 11 June 2014 in which it challenged the transfer pricing methodology that had been validated by the Dutch tax authorities. The Commission considered that the royalties amount and the price of the coffee beans were too high / not at arm’s length.

Moreover, the European Commission pointed out that the royalties were not taxable in the U.K. due to the tax treatment of partnerships.

The non-taxation feature seems to have been considered while it should have been in principle disregarded.

In its 21 October 2015 decision³⁸, the Commission concluded that the rulings constituted an illegal State aid and requested the Netherlands to recover the unpaid taxes for € 20 to € 30 million from Starbucks.

In its decision, the Commission pointed out for the first time that the arm's length principle applied by the Commission in its State aid assessment may not be OECD's but rather a general principle of equal treatment in taxation falling within the application of Article 107(1) of the Treaty³⁹.

The Netherlands and Starbucks challenged this decision before the Lower EU Court⁴⁰. In particular, the two countries argued that (i) the Commission had relied on a wrongful reference system, (ii) that there was no specific EU arm's length principle and (iii) that the latter was not part of the State aid assessment.

³⁸ SA.38374

³⁹ N° 264

⁴⁰ Cases T-760-15 ; T-636/16 and T-877/16



2. Fiat Finance and Trade / Luxembourg

Fiat Finance and Trade, based in Luxembourg, had provided financial services, such as related party loans. The European Commission considered that Fiat Finance and Trade's taxable profits could be determined as for a bank, based on a calculation of return on capital.

The European Commission compared the application of such calculation with the one resulting from the APA. The Commission considered that the methodology used in the APA departed from market conditions. Indeed, the Commission considered that the tax ruling: *"artificially lowers taxes paid by Fiat Finance and Trade in two ways:*

- *Due to a number of economically unjustifiable assumptions and down-ward adjustments, the capital base approximated by the tax ruling is much lower than the company's actual capital.*
- *The estimated remuneration applied to this already much lower capital for tax purposes is also much lower compared to market rates".*

Therefore, in its 21 October 2015 decision ⁴¹, the Commission determined that the ruling constituted an illegal State aid and requested Luxembourg to recover the unpaid taxes for € 20 to € 30 million from Fiat Finance and Trade. This decision is currently challenged in the Lower EU Court⁴².



3. Apple / Ireland

Under Irish tax law, companies incorporated in Ireland are, in principle, liable to corporate income tax in Ireland even if they are managed and controlled outside Ireland. However, prior to amendments introduced in 2013 and 2014, Irish law provided for two exceptions allowing a non-resident status for corporate income tax purposes even though they were carrying out trade and business in Ireland. Apple took benefit of one of these exceptions whereby the Irish company is non-resident and is ultimately controlled by a non-resident (established in the EU or in country with which Ireland had signed a tax treaty). This exception allowed Apple to claim a non-residency status without having to demonstrate an actual tax residence in another country.

⁴¹ SA.38375

⁴² T-759/15 and T-755/15

Apple Sales International (“ASI”) and Apple Operations Europe (“AOE”), two Irish incorporated companies, were both ultimately controlled by Apple Inc. which is resident in the U.S. ASI and AOE were managed and controlled from the U.S.. The two companies carried out a trading activity in Ireland through their respective branches. Therefore, ASI and AOE could claim the former non-resident exception and were not liable to Irish CIT on their whole profits. ASI and AOE concluded tax rulings with the Irish Revenue which provided that most of their profits should be allocated to their head office which was located in the U.S.. The Irish authorities confirmed that the Irish allocation rule disregarded the actual tax treatment of the revenue in the other country. Here, ASI and AOE were not liable to CIT in the U.S. on the U.S. allocated revenue by the Irish authorities and only very limited profits were actually allocated to the Irish branches. As a result of the allocation method endorsed in the tax rulings, Apple was taxed on the profits of ASI at an effective corporate tax rate that declined from 1% in 2003 to 0.005% in 2014 according to the Commission..

The Commission wrote that ASI and AOE did not have any taxable presence in any other tax jurisdiction besides Ireland during the time that the rulings were in force. Moreover, ASI’s and AOE’s U.S. head offices had no employees and were not located in an identifiable jurisdiction.

ASI and AOE’s tax ruling granted by Ireland in 1991, was renewed in 2007⁴³.

The Commission considered that

“such tax rulings issued by Ireland endorsed an artificial internal allocation of profits within ASI and AOE, which has no factual or economic justification. As a result of the tax rulings, most sales profits of ASI were allocated to its "head office" when this "head office" had no operating capacity to handle and manage the distribution business, or any other substantive business for that matter. Only the Irish branch of Apple Sales International had the capacity to generate any income from trading, i.e. from the distribution of Apple products.

⁴³ This tax ruling was terminated when Apple Sales International and Apple Operations Europe changed their structures in 2015

Therefore, the sales profits of Apple Sales International should have been recorded with the Irish branch and taxed there". The Commission took the same reasoning with respect to AOE.

In its 30 August 2016 decision ⁴⁴, the Commission determined that the ruling constituted an illegal State aid and estimated the amount of unpaid taxes to be recovered to € 13 billion (late payment interest excluded). In principle, those taxes should be recovered by Ireland from ASI and AOE. However, the Commission decision stated that the amount of unpaid taxes to be recovered by the Irish authorities should be reduced if other countries (EU Member States and the U.S.) were to require ASI and AOE to pay more taxes on the profits locally for the period covered by the decision.

This decision is currently challenged in the EU Lower court⁴⁵. Ireland denied the Commission's analysis on several grounds and particularly on an allegedly misunderstanding of Irish law and of the relevant facts. Moreover, other arguments are quite similar to those raised by the Netherlands in the Starbuck's case (wrongful reference framework, critic of the existence of an arm's length principle deriving from EU law, infringement of the principles of legal certainty and legitimate expectations by invoking alleged rules of EU law which had never been previously identified).

⁴⁴ SA.38373

⁴⁵ T-778/16 and T-892/16



4. Amazon / Luxembourg

Amazon's Luxembourg subsidiary, Amazon EU Sàrl, reached an APA with the Luxembourg tax authorities as regards a tax deductible royalty paid by Amazon EU Sàrl to a limited liability partnership established in Luxembourg (Lux SCS). Besides, the tax ruling also provided that Lux SCS would not be regarded as operating through a permanent establishment in Luxembourg, nor will the partners in Lux SCS be regarded as having a permanent establishment in Luxembourg. Therefore, the royalty was tax deductible at the level of Amazon EU Sàrl with no corresponding pick-up through Lux SCS.

At this stage, the Commission considers that the amount of this royalty, which lowered the taxable profits of Amazon EU Sàrl each year, may not be in line with market conditions.⁴⁶

The Commission has not issued its final decision yet: it is still investigating to confirm (or not) an illegal State aid.

⁴⁶ SA.38944 - Alleged aid to Amazon – Luxembourg

5. Belgian “Excess Profit” regime

Under the Belgian “Excess Profit” rulings, the actual profits attributed to a Belgian affiliate of a multinational group was compared with the theoretical average profits derived by a stand-alone company in a comparable situation. Should the theoretical stand-alone profit be lower than the profits attributed to the Belgian affiliate, the difference would not be taxable as the ruling confirmed (“Excess Profit”). The tax ruling is valid for four years and could be renewed.

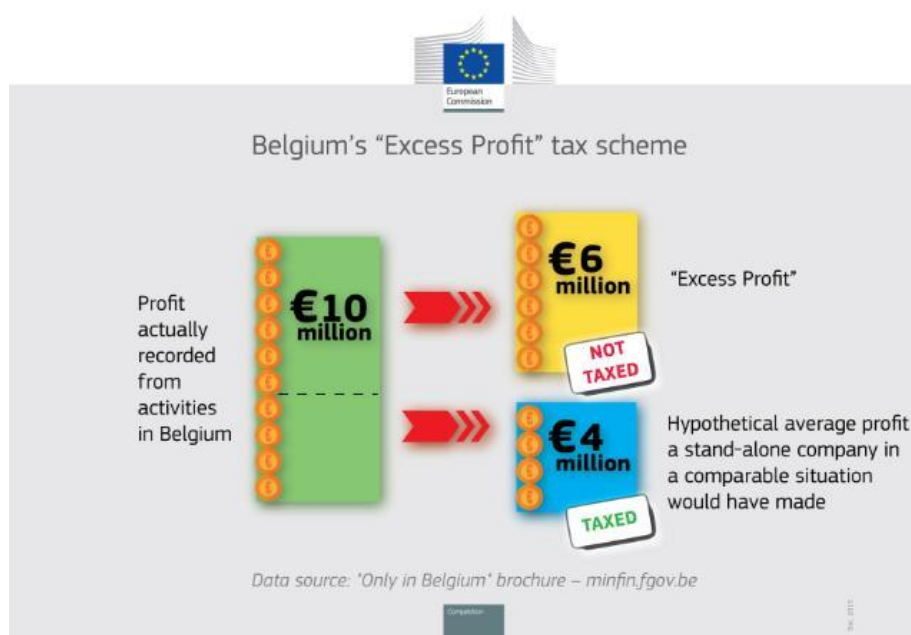
It is therefore assumed that a stand-alone company would have incurred additional expenses compared to an affiliate of a multinational group which then realized economies of scales, synergies etc. As a consequence, the Belgian affiliate was considered as showing an “Excess Profit” it would have not recognized had it been a stand-alone company. The multinational companies claiming the “Excess Profit” ruling are mainly European companies.

The Commission considered that such a scheme derogated from normal practice under Belgian tax rules since the Excess Profit ruling was not available to actual stand-alone companies. Moreover, the assessment of the “Excess profit” allocated to the company requesting the ruling would not reflect the economic reality since the entire Excess Profit would be discounted unilaterally from the Belgian taxable basis and not shared multilaterally between the other companies of the multinational group.

Therefore, in its 11 January 2016 decision ⁴⁷, the Commission concluded that the ruling constituted an illegal State aid and requested Belgium to recover the unpaid taxes for € 700 million from the companies which had benefited from this regime (mainly EU groups). This decision is currently challenged in the Lower EU Court ⁴⁸.

⁴⁷ SA.37667

⁴⁸ http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_SA_37667



6. Mc Donald's / Luxembourg

Based on the Commission's decision, Mc Donald's Europe Franchising's head office was located in Luxembourg and was in charge of the company's strategic decision-making. The company also had (i) a Swiss branch, which had a limited activity related to franchise rights, and (ii) a US branch, which did not have any actual activities.

Mc Donald's Europe Franchising was the beneficial owner of a number of franchise rights intangibles which gave rise to royalties from franchisees operating restaurants in European Member States and Russia for the right to use the McDonald's brand and associated services. Such royalties were attributed internally to the US branch of the company.

Mc Donald's Europe Franchising obtained two tax rulings from the Luxembourg authorities about the allocation of profits between its U.S. branch and its Luxembourg head office.

The first ruling confirmed that the U.S. branch qualified as a permanent establishment for the purpose of Luxembourg tax and that, based on the Luxembourg-US double tax treaty, the attributable profits to the U.S. branch was tax exempt in Luxembourg. This ruling required that Mc Donald's provided evidence that those profits had been declared and taxed in the U.S. every year. Such profits were not actually taxed in the U.S. as the activity of the U.S. branch was not considered as giving rise to an effectively connected trade and business in the U.S. Therefore, Mc Donald's Europe Franchising applied for a second ruling to clarify the situation and argued that the absence of taxation in the U.S. should not affect the tax treatment in Luxembourg.

The Luxembourg authorities then issued a second tax ruling which confirmed that McDonald's Europe's income was not subject to tax in Luxembourg even if not subject to tax in the US either.

The Commission has not issued its final decision yet: it is still investigating to determine whether Luxembourg authorities selectively derogated from the provisions of their domestic tax law and the Luxembourg-US Double Taxation Treaty and whether thereby the Luxembourg authorities had given McDonald's an advantage which was not available to other companies in a comparable factual and legal situation⁴⁹. It may be raised that the sole application of the tax treaty concluded between Luxembourg and the U.S., should have resulted in the same outcome. Indeed, it was in an effort to prevent such structuring like McDonald's Europe's in Luxembourg that the U.S. decided to amend their bilateral treaty in 2016.

⁴⁹ SA.38945



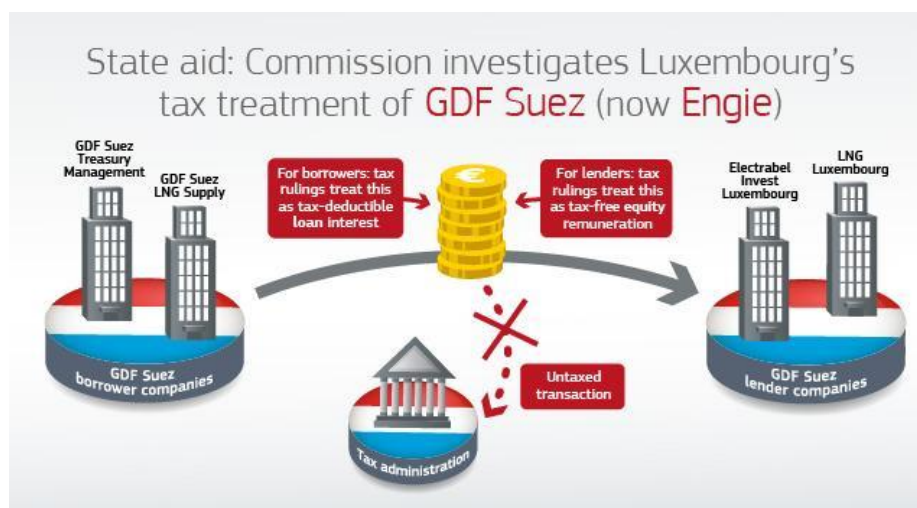
7. Engie / Luxembourg

Since September 2008, Luxembourg has issued several tax rulings concerning the tax treatment on two similar financial transactions between the same four companies of the French group GDF Suez group, all based in Luxembourg. These wholly domestic financial transactions are convertible loans which bear zero interest. One convertible loan was granted in 2009 by LNG Luxembourg (lender) to GDF Suez LNG Supply (borrower); the other in 2011 by Electrabel Invest Luxembourg (lender) to GDF Suez Treasury Management (borrower).

Subject to further investigations, the Commission considered that the tax rulings provided an inconsistent tax treatment of the same transaction resulting in a whole zero tax treatment⁵⁰. On the one hand, according to a first ruling, the transaction was considered as a loan and the borrowers could record deductible provisions for interest payments. On the other hand, according to another ruling granted to the lender, the income should be treated as exempt dividends since the financing was regarded as equity.

⁵⁰ SA.44888

The Commission considers that two tax rulings on the same transactions took conflicting positions and resulted in double non-taxation for both the financing and the financed parties on profits arising in Luxembourg. The Commission is investigating to determine whether an inconsistent application of domestic tax law endorsed in tax rulings, leading to double non-taxation, characterizes State aid.



B. The White Paper

The arguments put forward by the U.S. Treasury in the White Paper issued in August 2016 may appear narrower in scope compared to those developed in the letter sent by the U.S. Secretary to the European Commission on February 11, 2016.

Indeed, the fact that the investigations appeared to be targeting U.S. companies disproportionately is not elaborated. The White Paper however indicates that this concern will be more thoroughly addressed if the Commission continued to initiate disproportionately more investigations against U.S. companies. The acknowledgment of the increase of State aid investigations against European companies might explain that new approach⁵¹. Also, the new position of the Commission suggesting that other countries (EU Member States or the U.S.) may exercise the power to tax the untaxed Apple income (up to circa. €13 billion of taxes); instead of claiming a cash refund from Apple, may have been the reason why the U.S. Treasury lowered its position whereby the EU is targeting income that Members States have no right to tax.

1. The Commission's approach departs from prior EU case law

In the White Paper, the Treasury firstly argues that the Commission's approach is new and departs from prior EU case law. According the White Paper the Commission decisions merged the economic advantage and selectivity tests in one test which should normally be assessed distinctively. Taxpayers and Member States could therefore not foresee that the selectivity test would no longer be a meaningful precondition to a State aid if the economic advantage test is met.

⁵¹ Belgian Excess profit and GDF-Suez cases, on top of the Fiat case.

However, according past ECJ's case law, the difference between the economic advantage and the selectivity criteria is very thin with respect to tax measures. The ECJ therefore combines these two criteria as done in past decisions since 2006 :

“to determine whether the measure at issue is selective it is appropriate to examine whether, within the context of a particular legal system, that measure constitutes an advantage for certain undertakings in comparison with others which are in a comparable legal and factual situation. The determination of the reference framework has a particular importance in the case of tax measures, since the very existence of an advantage may be established only when compared with “normal” taxation”⁵².

The ECJ ruled that in case of an individual aid, the selectivity is deemed to be met where the economic advantage is proved:

“It must, however, be noted that the selectivity requirement differs depending on whether the measure in question is envisaged as a general scheme of aid or as individual aid. In the latter case, the identification of the economic advantage is, in principle, sufficient to support the presumption that it is selective”⁵³.

Therefore, it appears that the issue of the combination between the two criteria was settled in 2006 depending upon “individual aid” was granted or an aid through a general measure.

2. Wrongful “reference framework”

The U.S. Treasury argues that the Commission did not take into account the relevant “*reference framework*” to qualify the selectivity of the advantage available to the pertaining companies.

⁵² CJEU, 6 September 2006, C-88/03, Portugal vs Commission, n° 56 and see also CJEU, 15 November 2011, C-106/09 and C-107/09, European Commission and Kingdom of Spain vs Government of Gibraltar and United Kingdom of Great Britain and Northern Ireland, n° 90

⁵³ CJEU, 4 June 2015, C-15/14 P - Commission v MOL, n° 60; CJEU, 30 June 2016, C-270/15 P - Belgium v Commission

The Treasury considered that the Commission should have compared the situations between MNEs only and not between MNEs and stand-alone domestic companies. To support its reasoning, the U.S. Treasury relied on certain ECJ cases and notably on *Autogrill Espana / World Duty Free Group* decision of the Lower EU Court⁵⁴.

However, in *Autogrill / World Duty Free Group* which addressed a Spanish CIT benefit (depreciation of the related goodwill) attached to the ownership of foreign substantial shareholdings, the last December ECJ's Grand Chamber⁵⁵ overruled the lower Court decision which considered that the selectivity test was not met since all the Spanish companies with foreign shareholdings were on an equal footing. The Grand Chamber recalled that:

“the appropriate criterion for establishing the selectivity of the measure at issue consists in determining whether that measure introduces, between operators that are, in the light of the objective pursued by the general tax system concerned, in a comparable factual and legal situation, a distinction that is not justified by the nature and general structure of that system. [...]

It is sufficient, in order to establish the selectivity of a measure that derogates from an ordinary tax system, to demonstrate that that measure benefits certain operators and not others, although all those operators are in an objectively comparable situation in the light of the objective pursued by the ordinary tax system. [...]

Contrary to what was held by the General Court in the judgments under appeal, neither can it be required of the Commission, in order to establish the selectivity of such a measure, that it should identify certain specific features that are characteristic of and common to the undertakings that are the recipients of the tax advantage, by which they can be distinguished from those undertakings that are excluded from the advantage.

⁵⁴ General Court, 7 November 2014, T-219/10, *Autogrill España (World Duty Free Group) v Commission*; General Court, 7 November 2014, T-399/11, *Banco Santander and Santusa v Commission*

⁵⁵ CJEU sits in a Grand Chamber when a Member State or an institution which is a party to the proceedings so requests, and in particularly complex or important cases.

All that matters in that regard is the fact that the measure, irrespective of its form or the legislative means used, should have the effect of placing the recipient undertakings in a position that is more favourable than that of other undertakings, although all those undertakings are in a comparable factual and legal situation in the light of the objective pursued by the tax system concerned.”⁵⁶.

The ECJ considered that such analysis was consistent with its case law. For instance, the case relating to aid for exports determined that aids specifically granted to exporters, and which were not granted to wholly domestic comparable stakeholders, should be regarded as State aid granted to a limited defined groups of operators and therefore the selectivity test was deemed to be met⁵⁷. The White Paper might then appear outdated on that specific argument.

3. The grounds of the arm’s length principle were not foreseeable

The U.S. Treasury argues that the Commission used arm’s length principle on its own to analyze the substance of particular Member States’ rulings. The Treasury accordingly considered that such a new approach was not foreseeable to the involved companies and Member States. The U.S. Treasury therefore considers that the recovery of past allegedly unpaid tax would constitute an unlawful retroactive enforcement. More specifically, the U.S. Treasury pointed out that:

“with no indication of the Commission’s new approach, U.S. companies have been receiving transfer pricing rulings from EU Member States for decades and had no reason to doubt their legality. [...]

⁵⁶ CJEU, 21 December 2016, C-20/15 P - Commission v World Duty Free Group n° 60 and 76 to 79

⁵⁷See CJEU, 21 December 2016, C-20/15 P - Commission v World Duty Free Group n° 115 referring to decision of 10 December 1969, *Commission v France* (6/69 and 11/69, EU:C:1969:68), decision of 7 June 1988, *Greece v Commission* (57/86), and decision of 15 July 2004, *Spain v Commission* (C-501/00),

Moreover, it is our understanding that, until the Commission had started its inquiries and investigations, neither internal review nor third-party review and audit of the affected firms by tax and audit professionals gave rise to any determination that their tax treatment could potentially be subject to aid rules”.

It is true that in the light of the Code of Conduct works which were initiated as of 1997, it was expected that the Commission was to rely on the arm’s length principle as determined in the OECD guidelines (see Section I, C. 1.).

Also, in its State aid decisions as regards transfer pricing arrangements (see for example, paragraph 264 of the Starbucks / Netherlands decision or paragraph 228 of the Fiat / Luxembourg decision), the Commission stated that:

“the arm’s length principle that the Commission applies in its State aid assessment is not that derived from Article 9 of the OECD Model Tax Convention, which is a non-binding instrument, but is a general principle of equal treatment in taxation falling within the application of Article 107(1) of the Treaty, which binds the Member States and from whose scope the national tax rules are not excluded”.

Nevertheless, a fair reading of the position retained by the Commission leads to acknowledge that, in practice, the Commission actually relied on the arm’s length principle as defined by the OECD (even if their application is subject to discussion). For instance,

- in the Fiat/Luxembourg and Starbucks/Netherlands, the Commission based its position on a fair application of the OECD arm’s length principle so as to justify its analysis, notably in order to deny the arguments of the Luxembourg/Netherlands tax authorities according to which “transfer pricing is not an exact science”:

“Finally, in response to the argument of Luxembourg and FFT that, because transfer pricing is not an exact science, the assessment by the Commission of the transfer pricing arrangement agreed in the contested tax ruling should necessarily be limited, the Commission recalls that the approximation component of transfer pricing has to be viewed in the light of its objective.

While the OECD TP Guidelines do indeed acknowledge that transfer pricing is not an exact science in paragraph 1.13 thereof, that same point first explains that “[i]t is important not to lose sight of the objective to find a reasonable estimate of an arm’s length outcome based on reliable information”. The objective of the OECD TP Guidelines is to develop, for the benefit of tax administrations and multinational enterprises, the most appropriate methods for estimating arm’s length prices of cross-border transactions between associated enterprises for taxation purposes. The pursuit of that objective would be impossible if the approximate nature of the transfer pricing exercise could be used to disregard the consensus on appropriate transfer pricing methodologies which those guidelines represent. The approximate nature of the arm’s length principle can therefore not be invoked to justify a transfer pricing analysis that is either methodologically inconsistent or based on an inadequate comparables selection”.

In conclusion, if it can be shown that the methodology accepted by the Luxembourg tax administration by way of the contested ruling for the determination of FFT’s taxable profits in Luxembourg departs from a methodology that leads to a reliable approximation of a market-based outcome and thus from the arm’s length principle, that ruling will be found to confer a selective advantage on FFT for the purposes of Article 107(1) of the TFEU, in so far as it leads to a lowering of FFT’s tax liability under the general Luxembourg corporate income tax system as compared to nonintegrated companies whose tax base is determined by the profits they generate under market conditions”⁵⁸.

In that case, as in most of the cases, the States put forward the approximate nature of the transfer pricing exercise to justify that OECD principles are complied with. However, according to the Commission, the approximation should not lead to legitimate the non-satisfaction of the OECD arm’s length objectives, which is a fair allocation of tax base or income between related parties. It allegedly was the case with Fiat and Starbucks. In that sense, the Commission may appear to actually follow the OECD arm’s length principle in correcting approximations.

⁵⁸ Commission decision of 21.10.2015 on State aid SA.38375 (2014/c ex 2014/nn) which Luxembourg granted to Fiat, n° 230 and 231; See also Commission decision of 21.10.2015 on State aid SA.38374 (2014/c ex 2014/nn) implemented by the Netherlands to Starbucks, n° 266 and 267to

The Commission referred to the OECD principle to assess how suitable was the methodology retained by the companies in *Fiat/Luxembourg* and *Starbucks/Netherlands*.

- Also, in the preliminary Amazon/Luxembourg decision, the Commission pointed out that the transfer pricing methodology presented by Amazon's counsel in the ruling request and accepted by the Luxembourg tax authorities in the challenged tax ruling did not seem to correspond to any of the methods listed in the OECD guidelines⁵⁹. Moreover, the Commission described the OECD guidelines to justify its preliminary analysis.
- The Commission also based its analysis on the OECD principles in the Belgian Excess Profit decision⁶⁰.
- In the Apple/Ireland decision, the Commission justified its analysis by (i) describing/analyzing the OECD transfer pricing principles⁶¹, and then by (i) stating that the Apple/Ireland methodology was not compliant with the “*authorized OECD approach for profit allocation to a permanent establishment*” nor with the “OECD TP guidelines” and pointed out that such approach was already available at the time the ruling was issued⁶².

The Commission moderated its approach as regards the possibility to depart from the OECD arm's length principle by stating that it would reserve it for "cases where there is a manifest breach of the arm's length principle"⁶³.

⁵⁹ See n° 64 of the Amazon decision

⁶⁰ See as from n° 158 of the Belgian Excess Profit decision

⁶¹ See Apple decision as from n° 79

⁶² See Apple decision as from n° 322

⁶³ DG Competition working paper on state aid and tax rulings dated 3 June 2016, n° 23

In any event, the Commission's approach may therefore be justified (i) by the fact that the objective of the State aid rules (equality of treatment within the EU) goes beyond the OECD arm's length principle (i.e. fair competition as opposed to allocation of tax base) and (ii) accordingly the Commission reserved the possibility to depart from the OECD guidelines only with respect to "cases where there is a manifest breach of the arm's length principle"⁶⁴.

4. The Commission should seek only prospective relief

According to the principle of protection of legitimate expectations with respect to the rule of law, as recognized by case law of the ECJ⁶⁵, actions of public bodies shall not interfere with vested rights and final legal situations unless it is absolutely necessary in light of overriding reason of public interest. In this context, EU law shall have no retroactive effect unless it clearly results from its terms and that such was the intention of the legislature. Also, the objective to be achieved should so demand and finally the legitimate expectations of those concerned should be duly respected. Legitimate expectations shall be duly taken into account where an administrative decision is cancelled or revoked.

The U.S. Treasury highlighted that the EU Commission had precedents whereby⁶⁶ retroactive effect of recognized State aids was not applied in order to respect the legitimate expectations of the involved Member States and companies⁶⁷.

⁶⁴ DG Competition working paper on state aid and tax rulings dated 3 June 2016, n° 23.

⁶⁵ CJEU, 13 July 1965, 111/63 Lemmerz-Werke v High Authority of the ECSC, where the concept of protection of legitimate expectations was first explicitly enunciated.

⁶⁶ German coordination centres Decision, 2003 O.J. L 177/17; See also Aid scheme implemented by France for headquarters and logistics centres, Commission Decision 2004/76/EC, 2004 O.J. L 23/1, 81-82; Aid scheme implemented by Belgium – Tax ruling system for United States foreign sales corporations, Commission Decision 2004/77/EC, 2004 O.J. L 23/14, 77-78; Luxembourg Coordination Centres Decision, 2003 O.J. L 170/20, 68-69; Luxembourg Finance Companies Decision, 2003 O.J. L 153/40, 63-64; see also Belgium and Forum 187 ABSL, C-182/03 & C-217/03, 147-67; Belgian Coordination Centres Decision, 2003 O.J. L 282/25, 117-20

However, the precedent is not relevant. It applied to tax measures which were submitted by Member States to the Commission for State aid review. The Commission validated the measure before taking the opposite position years later in determining that it was a State aid. That was the case with the former Belgian tax regime comparable to the excess profit⁶⁸. Indeed, the exceptions to retroactive recovery are in principle limited to:

“exceptional cases which show that the Commission manifestly failed to act and clearly breached its duty of diligence in the exercise of its supervisory powers”⁶⁹; or in case of

“precise assurances given by the Commission”⁷⁰ (the latter exception is not applicable to measures that have not been notified to the Commission before their entry in force).

Save these exceptional situations, the principle of legitimate expectations should not be an obstacle to the State aids proceeding and its retroactive effect. State aid recovery is designed to re-establish a competitive situation similar to the one that would have existed in the absence of the unlawful aid. Retroactivity is viewed as inherent to the State aid recovery system.

5. The Commission’s approach would undermine the international consensus on transfer pricing standards

The U.S. Treasury considers that the existence of an EU arm’s length principle which may deviate from the OECD’s one would undermine the international consensus on transfer pricing standards.

⁶⁷ See Aid scheme implemented by France for headquarters and logistics centres, Commission Decision 2004/76/EC, 2004 O.J. L 23/1, 81-82; Aid scheme implemented by Belgium – Tax ruling system for United States foreign sales corporations, Commission Decision 2004/77/EC, 2004 O.J. L 23/14, 77-78; Luxembourg Coordination Centres Decision, 2003 O.J. L 170/20, 68-69; Luxembourg Finance Companies Decision, 2003 O.J. L 153/40, 63-64; see also Belgium and Forum 187 ABSL, C-182/03 & C-217/03, 147-67; Belgian Coordination Centres Decision, 2003 O.J. L 282/25, 117-20

⁶⁸ This decision was not published.

⁶⁹ CJEU, 22 April 2008, C-408/04 P - Commission v Salzgitter n° 106 and 107

⁷⁰ CJEU, 22 June, C-182/03 and 271/03 - Belgique and Forum 187 ASBL v Commission, n° 147

However, the Commission practically refers to OECD standards unless in "cases where there is a manifest breach of the arm's length principle"⁷¹.

It could be considered that such approach is consistent with the initial BEPS works which advocated for adaptation or even derogation from the arm's length principle in case of "high risk" transactions⁷². Moreover, based on the Guidelines and recent decisions from the Commission, it seems that the Commission:

- should not challenge tax rulings that only provide legal certainty as regards the strict application of a general tax rule and should approve rulings which prove reliable in light of the OECD arm's length principle;
- should focus its attention on "aggressive" tax rulings resulting in significant tax benefits no obvious justification.

6. The Commission's approach would question the ability of Member States to honor bilateral tax treaties

The U.S. Treasury considers that the Commission's investigations may question the ability of Member States to honor bilateral tax treaties, and more particularly of treaty-based mutual agreement procedures ("MAP").

However, the State aid investigations are primarily dealing with competition law rather than with tax law. They should thus be read through a competition angle rather than a pure fiscal one.

⁷¹ DG Competition working paper on state aid and tax rulings dated 3 June 2016, n° 23.

⁷² OECD (2013), Action Plan on Base Erosion and Profit Shifting, OECD Publishing

The power of the EU as regards competition matters is not debatable: the objective of fair competition between Member States of the EU is inherent to the EU single market. Moreover, the State aid rules were agreed by Member States in signing the EU Treaty. The application of EU competition / State aid rules in the field of taxation is not new and does not constitute a decline in the sovereignty of EU Member States: Members States remain free to determine their domestic (direct) tax regimes as long as they respect the EU law.

Concluding Thoughts

Almost 20 years after the first warning given in the Code of Conduct group, the European Commission gave the first red cards. In an environment of global tax planning for MNEs and competition between States, it is tempting for some States to offer tax friendly regimes as a local incentive to do business or settlement. The favorable tax regimes offered by some Member States facilitated aggressive tax planning for new business models within the EU. The tax ruling jurisdictions could have often been a fiscal gateway to channel tax free the EU sourced profits out of the EU in also reducing drastically the tax burden in Member States where businesses were made. The new fiscal order revealed that current tax law, pre-BEPS was unable to tackle these structures. The EU competition debate might be an indirect manner to strike down these solutions from the past in challenging the tax friendly host Member States. The economic advantage of the ruling seems to be primarily a decrease of the tax basis in the jurisdiction of the ruling. However, looking twice, it may prove to be the path for shifting the low-taxed profit to another jurisdiction with no corresponding taxation (having – as the case may be- in the first place reduced drastically the tax burden in the Member States of operation).

That latter feature is not relevant to the State aid incrimination but the Commission could not have ignored it. Today “aggressive tax planning” may hardly derive from sophisticated legal arrangement and allocation of profits. Within the Single Market, it may mainly derive from more plain vanilla solutions such as establishing the businesses where the lowest tax rates apply. The functioning of the Single Market with no tariffs should facilitate that trend and interestingly enough foster the competition between Member States...

MC