ANALYSING THE EUROPEAN COMMISSION'S FINAL DECISIONS ON APPLE, STARBUCKS, AMAZON AND FIAT FINANCE & TRADE

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ABSTRACT[238]

This article addresses the issues which stem from the State aid investigations opened by the European Commission ("EC") against Luxembourg, Ireland and the Netherlands, concerning aid granted in the form of tax base reduction to certain undertakings, namely Apple Inc., Amazon, Starbucks and Fiat Finance and Trade ("FFT"). Furthermore, this article analysis the EC's main line of argument in the aforementioned State aid investigations that is, acceptance by the Netherlands, Ireland and Luxembourg, of the proposed calculation of the taxable base of these MNEs which do not reflect normal market conditions, may result in State aid, in that it will offer a more favourable treatment to the MNE compared to the treatment other undertakings would normally receive under the Member States' 'normal' tax system. In arriving at what would constitute normal market conditions, the EC uses two benchmarks namely, the internationally accepted standard, the Arm's Length Principle ("ALP") and the Prudent Independent Market Operator ("PIMO"), which makes its first appearance in these investigations. This article demonstrates the relationship between the two and whether both can be used as a benchmark for the purposes of the State aid rules as laid down under Art. 107(1) of the Treaty on the Functioning of the European Union ("TFEU").

KEYWORDS: FISCAL – STATE AID – EUROPEAN COMMISSION

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1. Introduction

The European Commission (Hereinafter referred to as 'EC') opened three in-depth investigations to examine whether decisions by tax authorities in Ireland, the Netherlands and Luxembourg with regard to the corporate income tax to be paid by Apple,[240] Starbucks,[241] Amazon,[242] and Fiat Finance & Trade,[243] comply with the European Union (Hereinafter referred to as 'EU') rules on State aid. More recently, the EC opened a formal investigation into Luxembourg's tax treatment of McDonald's.[244] On the 21st of October 2015, the EC decided that both Luxembourg and the Netherlands had granted selective tax advantages to Fiat Finance and Trade and Starbucks respectively through tax rulings.[245] Finally, on the 30th of August 2016, the EC issued a press release whereby it concluded that Ireland granted undue tax benefits of up to €13 billion to Apple.[246] Tax rulings as such are not problematic as they are comfort letters by tax authorities giving a specific company legal certainty on how its corporate tax will be calculated or on the use of special tax provisions. However, tax rulings may involve state aid within the meaning of EU rules if they are used to provide selective advantages to a specific company or group of companies.[247]

According to Article 107(1) of the TFEU, State aid which affects trade between Member States and threatens to distort competition by favouring certain

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240 *Alleged Aid to Apple* SA.38373 C(2014) 3606 final [2014].

241 *Alleged aid to Starbucks* SA.38374 C(2014) 3626 final [2014].

242 *Alleged aid to Amazon by way of a tax ruling* SA.38944 C(2014) 7156 [2014].

243 *Alleged aid to FFT* SA.38375 C(2014) 3627 final [2014].

244 European Commission, 'State aid: Commission opens formal investigationinto Luxembourg's tax treatment of McDonalds' (*European Commission: Press*, 11 November 2015) <http://europa.eu/rapid/press-release_IP-15-6221_en.htm> accessed 10 March 2015.

245 European Commission, 'Commission decides selective tax advantages for Fiat in Luxembourg and Starbucks in the Netherlands are illegal under EU state aid rules' (*European Commission: Press Release*, 21 October 2015) <http://europa.eu/rapid/press-release_IP-15-5880_en.htm> accessed 10 March 2015.

246 European Commission: Press Release, 30 August 2016. The non-confidential version of the decisions will be made available under the case number SA.38373 in the State aid register on the DG Competition website once any confidentiality issues have been resolved

247 *Alleged aid to FFT* SA.38375 C(2014) 3627 final [2014].

undertakings is in principle incompatible with the EU Single Market. Tax rulings are used in particular to confirm transfer pricing arrangements through a form of tax ruling known as Advanced Pricing Arrangement (Hereinafter referred to as 'APA'). If tax authorities, when accepting the calculation of the taxable basis proposed by a company, insist on a remuneration of a subsidiary or a branch on market terms, reflecting normal conditions of competition, this would exclude the presence of state aid. However, if the calculation is not based on remuneration on market terms, it could imply a more favourable treatment of the company compared to the treatment other taxpayers would normally receive under the Member States' tax rules. This may constitute state aid.

Normally, the Arm's Length Principle (Hereinafter referred to as 'ALP') is the standard used to determine the correct transfer price. The EC acknowledges that market conditions may be arrived at through transfer pricing established through the ALP. However, the EC seems to be applying a standard which goes over and above the ALP to determine whether the transfer pricing calculations are at normal market conditions. This new standard is the Prudent Independent Market Operator (Hereinafter referred to as 'PIMO') standard which makes its appearance for the first time in the four cases.[248] As we shall see the PIMO has similarities, not only to the ALP but also to other tests and principles previously advocated by the EU courts.[249] Furthermore, in the Starbucks final decision the EC is applying the legal principle of equal tax treatment, which according to the EC is reflective of the ALP.

2. Transfer Pricing and The Arm's Length Principle (ALP): A General Note

Transfer pricing refers to the setting of the correct transfer price between associated enterprises forming part of a multinational enterprise (Hereinafter referred to as 'MNE') group.[250] Transfer pricing by itself does not necessarily involve tax avoidance. It is where the transfer pricing does not accord with applicable international norms that mispricing or incorrect pricing occurs, and where issues of tax avoidance and fraud may arise.[251]

[248] *Apple* recitals 53 and 54; *Starbucks* recitals 74 and 75; *Amazon* recitals 53, 54 and 64; *FFT* recitals 60 and 61.

[249] Case 124/10 *European Commission v Électricité de France (EDF)* [2012] (GC), paras 59, 60 and 80; the Prudent Private Investor Test and the Market Economy Agent Test.

[250] Organisation for Economic Cooperation and Development Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD, 1995) para 12.

[251] United Nations, 'Practical Manual on Trnasfer Pricing for Developing Countries' (ST/ESA/347, United Nations 2013) <http://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf> accessed 8 March 2015.

In order to ensure the determination of the correct transfer pricing between associated enterprises, OECD Member States have chosen to treat each entity in the MNE as a separate entity. This separate entity approach is the most reasonable means for achieving equitable results and minimising the risk of unrelieved double taxation. In order to apply the separate entity approach to intra-group transactions, individual group members must be taxed on the basis that they act at arm's length in their transactions with each other. However, the relationship amongst the members of the MNEs may permit that they establish special conditions between themselves, which do not reflect and/or differ from normal market conditions between independent enterprises. To ensure the correct application of the separate entity approach, OECD member countries adopted the ALP, under which the effect of special conditions on the levels of profits should be eliminated.[252]

2.1 *Interpretation and Application of the ALP*

The general rule is that, 'profits derived by an enterprise of a contracting State are taxable only by the contracting State in which the enterprise has its residence'.[253] Article 9(1) in the OECD Model Convention, allows the State to depart from these general rules by adjusting profits accruing to a domestic enterprise, which is associated with a foreign enterprise, to the extent that the business profits concerned were affected by terms and conditions differing from normal market conditions between independent enterprises.[254] Article 9 concerns the question of whether an element of profit, which has been subjected to tax in the foreign contracting State, may nevertheless be attributed to, and taxed in the hands of a domestic enterprise. Consequently, Article 9 is designed to avoid economic double taxation.[255] Article 9 allows such a rewriting of accounts, that is, reallocation of profits to be made only according to the ALP. Whether or not that contracting State may avail itself of this treaty authorization, depends on its own domestic law.

According to Vogel,[256] Article 9 does not create any legal basis for such a rewriting of accounts. Like any other article of a tax treaty, its effects are to restrict domestic law to the extent that the latter provides for profit adjustments between associated enterprises beyond those permissible under the ALP.

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252 *Alleged aid to FFT* SA.38375 C(2014) 3627 final [2014] preface, para 6.

253 OECD Model Tax Convention on Income and on Capital (2014), art 7.

254 Klaus Vogel, *Klaus Vogel on Double Taxation Conventions* (4th edn, Wolters Kluwer 2015) 555.

255 ibid. See also Lioubov Pogorelova, 'Transfer Pricing and Anti-Abuse Rules' (2009) 37 Intertax 683, 683-693.

256 Klaus Vogel, *Klaus Vogel on Double Taxation Conventions* (4th edn, Wolters Kluwer 2015) 517.

Therefore, a State may not rely solely on Article 9 of a tax treaty concluded with another State to enforce the ALP but it needs to implement the ALP in its domestic law. This is important to keep in mind for the Irish investigation concerning Apple Inc., whereby there were no transfer pricing rules implemented within the Irish domestic tax law. When considering the treaty rules corresponding to Article 9, it should again be noted that the tax treaty merely restricts, rather than generates, domestic law. The only legal basis for profit adjustments between associated enterprises are therefore, the rules of domestic law.

The ALP provides that, the conditions made or imposed between associated enterprises must be compared with those which would be agreed between independent enterprises, thus a comparability analysis taking into account functions performed, assets used and risks assumed, must be performed. There is above all a concrete possibility to make a comparison whenever a market price exists and can be ascertained, at a certain point in time and in a specific market for the, *inter alia,* goods and services received. If there is no such possibility to make a comparison, an attempt must be made to estimate by other means what would have been agreed between third parties that are independent of each other in the absence of any influence under company law. This comparison is necessarily a hypothetical one.[257] What must be taken in consideration is that the price is founded on certain market situations independent of the association of the two enterprises. Another point to be observed in the comparability analysis is the function, which the dependent enterprise has within the group as a whole.[258] For providing concrete basis for comparisons, certain standard methods have been developed for establishing the Arm's Length price.[259]

3. Fiscal State Aid

One of the main objectives of the EU is market integration, that is, it is a union 'where capital, labour, technology and enterprises should move unhindered between participating countries'.[260] State aid provisions, as part of the TFEU, should be regarded as having as a final objective market integration. They aim to promote and ensure, undistorted competition in a free market, thereby strengthening the internal market. State aid rules ensure this by controlling State interventions aimed to provide economic assistance to undertakings on a selective basis.

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257 ibid 527.

258 ibid 528.

259 For a detailed reading of the methods advocated by the OECD, see Chapter II of the TPG and US I.R.C. Sec 482. See also Klaus Vogel, *Klaus Vogel on Double Taxation Conventions* (4th edn, Wolters Kluwer 2015) 530-535.

260 Ali M. El-Agraa, *The European Union: Economics and Politics* (7th edn, Prentice Hall 2004) 2.

According to settled case-law of the Court of Justice of the European Union (Hereinafter referred to as 'CJEU'), within the EU, direct taxation has been left within the competence of the Member States. However, Member States must exercise such taxing powers within the parameters set by the supremacy of EU law.[261] In order to achieve this, it is necessary that two main sets of primary EU law rules are adhered to, namely, the rules protecting the fundamental freedoms and those that prohibit state aid set out in Articles 107-108 TFEU.[262] Both sets of rules aim to avoid distortion of competition with the EU internal market. State aid rules provide for an immediate prohibition of direct and indirect use of public resources for promoting national goods and undertakings, based on prudent estimation of the effect that a measure of this type may have on the functioning of the internal market.[263] Moreover, the ground for expansion of state aid control in the tax area was defined by the 1998 Commission's Notice,[264] however, the Court had long before recognised this from the very beginning of its case law when it held that the concept of State aid should be interpreted broadly encompassing fiscal measures.[265] Thus, in principle, State aid distorts competition, and fiscal aid is one form of state aid.

3.1 *The EC's Competence in State Aid Cases*

The EC is the supervising authority in charge of reviewing the compatibility of aids within the internal market, however, the EC is not the only protagonist in State aid review procedures. According to Article 108(2) TFEU, the Council has also the opportunity to decide the compatibility of an aid. The compatibility decision should be voted unanimously at a Member State's request. It is a derogatory regime which departs from the normal procedure, thus it can only arise under exceptional circumstances. In tax matters this has been used in the ***Belgian Coordination Centres*** case.[266] Moreover, apart from the Council, the CJEU plays a decisive role by reviewing the EC's decisions. Even though the EC is

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261 In the context of free movement provisions e.g. Case C-307/97 *Compagnie de Saint-Gobain, Zweigniedelassung Deautschland vs. Finanzamt Aachen-Innenstadt* [1999] ECR I-6181 para 57; Case C-446/03 *Marks & Spencer vs. David Halsey (Her Majesty's Inspector of Taxes)* [2006] ECR I-10837 para 29; Case C-196/04 *Cadbury Schweppes and Cadbury Schweppes Overseas vs. Commissioners of Inland Revenue* [2006] ECR I-07995 para 40.

262 "Pasquale Pistone, 'Smart Tax Competition and the Geographical, Boundaries of Taxing Jurisdictions: Countering, Selective Advantages Amidst Disparities' (2012) 40 Intertax 85.

263 Claire Micheau, *State Aid, Subsidy and Tax Incentives under EU and WTO Law* (Kluwer Law International 2014) 36-39.

264 Commission Notice of 10 December 1998 on the application of state aid rules to measures relating to direct business taxation [1998] OJ C384.

265 Case 30/59 *De Gezamenlijke Steenkolenmijenen in Limburg vs. High Authority of the European Coal and Steel Community* [1961] ECR 1 para 19; Case C-387/92 *Banco de Credito Industrial SA vs. Ayuntamiento de Valencia* [1994] ECR I-00877 paras 13-14; Case C-241/94 *French Republic vs. Commission of the European Communities* [1996] ECR I-4551 para 34.

266 Commission Decision of 17 February 2003 on the aid scheme implemented by Belgium for coordination centres established in Belgium [2003] OJ L282.

vested with exclusive jurisdiction to review the compatibility of the measure with the internal market, the CJEU overseas the EC's review to ensure that the procedural rules have been respected, the reasoning was sufficient, the facts were exact and there was no manifest error of assessment or misuse of power.[267] Naturally, the CJEU also has the competence to interpret authoritatively the concept of State aid under Article 107(1).

3.2 *The Measures of Tax Settlements and Rulings for State Aid Purposes*

All of the four cases deal with a tax ruling or APA which confirms a particular transaction or structure and through this validation by the Member State an aid is conferred. In its final decision, the EC noted that the tax rulings under investigation endorsed artificial and complex methods to establish taxable profits for the companies which did not reflect economic reality. According to Keyln Bacon, 'an aid to an individual undertaking is obviously selective'.[268] One of the main advantages of tax rulings and APAs is the legal certainty they provide to all parties involved and this is also acknowledged by the OECD Transfer Pricing Guidelines (Hereinafter referred to as 'TPG'). Therefore, one may question how such an instrument can fall within the provisions of the State aid rules. On this point, paragraph 22 of the EC 1998 Notice clarifies that, as far as administrative rulings merely contain an interpretation of general rules, they do not give rise to the presumption of aid.

Furthermore, the 1998 Notice provides that 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. This has also been repeated in the EC Draft Notice[269] and subsequently finalised on the 19 May 2016 whereby the EC published its final notice.[270]The EC Final Notice acknowledged that the use of rulings was used in determining arm's length profits for related party transactions where the uncertainty may justify an advance ruling practice designed to ascertain whether certain controlled transactions are conducted at arm's length. The EC Final Notice outlines that tax rulings should only aim to provide legal certainty to the fiscal treatment of certain transactions and should

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267 Hofmann H. Morini A, 'Judicial Review of Commission decision in State Aid' in Erika Szyszczak (ed), *Research Handbook on European State Aid Law* (Edward Edgar 2011) 354-389; Edoardo Gambaro, 'The Judicial Phase' in Alberto Santa Maria (ed), *Competition and State Aid* (Kluwer Law International 2007) 221-262.

268 Kelyn Bacon, *European Union Law of State Aid* (2nd edn, OUP 2013).

269 Commission, 'Draft Commission Notice on the notion of State aid pursuant to Article 107(1) TFEU' (Communication).

270 Commission Notice of 19 July 2016 on the notion of State aid as referred to in Article 107(1) of the Treaty on the Functioning of the European Union [2016] OJ C262.

not have the effect of granting the undertakings concerned lower taxation that other undertakings in a similar legal and factual situation *but which were not granted such rulings*. From this paragraph we infer that the EC wants to suggest that the comparison test is not between two undertakings obtaining a tax ruling but between an undertaking which obtains a tax ruling, and one which doesn't. The EC Final Notice goes on to say that rulings are selective in particular where, the tax authorities have discretion in granting administrative rulings, the rulings are not available to undertakings in a similar legal and factual situation, the administration appears to apply a more favourable discretionary tax treatment compared with other taxpayers in a similar factual and legal situation and the ruling has been issued in contradiction to the applicable tax provisions and resulted in a lower amount of tax.[271] In the ***Starbucks*** final decision, the EC clarifies that group companies and stand-alone companies are to be treated similarly in order to avoid any selective advantage which may constitute State aid.

The first case involving administrative discretion was ***France vs. Commission.***[272] The EC first noted that, as a result of the agreement concluded between the State (Hereinafter referred to as 'FNE') and Kimberly Clark, the FNE undertook to fund part of the cost of the social plan to the extent of FF 27.25 million. The EC considered that the FNE intervention constituted State aid, since such agreements are negotiated with undertakings encountering employment problems and the FNE contribution, which is financed out of the State budget, is determined case by case by reference to the financial situation of the undertaking and the latter's own efforts.

AG Jacobs in his opinion states that it is clear that the state's discretion enables it to benefit 'certain' undertakings by agreeing or refusing to enter into agreements, by modifying the level of its contribution or by dispensing the undertaking from its financial participation.[273] He goes on to say that by virtue of the existence of and degree of discretion, the contributions are not in fact necessarily available to all undertakings on an equal footing.[274] He agrees with the EC and argues that the existence and degree of discretion in the administration of the FNE scheme takes it outside the definition of a general measure; any specific implementation may therefore constitute aid. He takes the view that the specific intervention in favour of Kimberly Clark, the subject of the decision being challenged, has the character of aid. The Court also agrees with

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271 ibid paras 169–174.

272 Case C-241/94 *French Republic vs. Commission of the European Communities* [1996] ECR I-4551.

273 ibid Opinion of Advocate General Jacobs.

274 ibid para 57.

the EC in that the FNE enjoys a degree of latitude which enables it to adjust its financial assistance having regard to a number of considerations such as, in particular, the choice of beneficiaries, the amount of the financial assistance and the conditions under which it is provided.[275]

Following ***Kimberly Clark***, the Court has endorsed this principle in various other judgments. In ***Ecotrade***,[276] the Court held that having regard to the class of undertakings covered by the legislation in issue and the scope of the discretion enjoyed by the minister when authorising, in particular, an insolvent undertaking under special administration to continue trading, that legislation meets the condition that it relates to a specific undertaking and is therefore selective, selectivity being one of the elements of State aid as defined in Article107(1).[277] In ***Rinaldo Piaggio***,[278] the Court confirmed the same exact principle as in ***Ecotrade***. In ***DMT***,[279] the Court outlined that general measures which do not favour only certain undertakings or the production of only certain goods do not fall within that provision. By contrast, where the body granting financial assistance enjoys a degree of latitude which enables it to choose the beneficiaries or the conditions under which the financial assistance is provided, that assistance cannot be considered to be general in nature. Furthermore in ***Lenzing***,[280] the court pointed out that case-law has already established that even assistance which at first sight is applicable to undertakings in general may present a certain selectivity and, accordingly, be regarded as a measure intended to favour certain undertakings or certain products. That is the case, in particular, where the administration called upon to apply the general rule has discretion when applying the measure. More recently, the Court gave further clarification on the degree of latitude or discretion in ***P Oy***.[281]

In terms of the above, it can thus be concluded that individual rulings by tax authorities do not constitute State aid if they are no more than interpretations and practical applications of general tax rules through administrative discretion on the basis of objective criteria.[282] Treating taxpayers on a discretionary basis may mean that a general measure becomes selective, particularly where the exercise of the discretionary power goes beyond the simple management of tax

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275 ibid paras 23-24.
276 Case C-200/97 *Ecotrade Srl vs. Altiforni e Ferriere di Servola SpA (AFS)* [1998] ECR I-7907.
277 ibid para 40.
278 Case C-295/97 *Industrie aeronautiche e Meccaniche Rinaldo Piaggio SpA vs. International Factors Italia SpA (Ifitalia)* [1996] ECR I-3735 para. 39.
279 Case C-256/97 *Déménagements-Manutention Transport SA (DMT)* [1999] ECR I-3919, para 27.
280 Case T-36/99 *Lenzing AG vs. Commission of the European Communities* [2004] ECR II-3609.
281 Case C-6/12 *P Oy* [2013] ECR I-525, paras 22-30.
282 Ben J. M. Terra, *European Tax law* (6th edn, Kluwer Law International 2012)156.

revenue by reference to an objective system of reference.[283] According to Claire Micheau, the fact that national administrations enjoy discretion is a strong indication of the selectivity of the measure.[284] Tax authorities have discretionary power in applying a measure, in particular, where the criteria for granting the aid are formulated in a very general or vague manner that necessarily involves a margin of discretion in the assessment. If the competent tax authorities have a broad discretion to determine the beneficiaries or the conditions under which the tax advantage is granted on the basis of criteria unrelated to the tax system, the exercise of that discretion hints at favouring 'certain undertakings or the production of certain goods'.[285] Decisions by the administration that depart from the general tax rules and benefit individual undertakings lead in principle to a presumption of State aid and must be analysed in detail.[286]

3.3 *Transfer Pricing Decisions by the EC in the Light of the State Aid Rules*

The selectivity test has been difficult to apply in cases dealing with transfer pricing schemes.[287] The TPG establish that to arrive at the correct arm's length transfer price one may use five alternative methods or else any other method, which is compatible with the ALP. To appraise the advantage in cases involving transfer pricing methods, the EC has taken as guidance the TPG, as it does again in the pending cases. It has expressly stated that 'in the area of transfer pricing the internationally agreed standard is the arm's length principle as set out in Article 9 OECD Model.'[288] We have noted that almost all EC decisions on State aid concerning transfer pricing, dealt with the special scheme concerning coordination centres which has been implemented in various Member States. The scheme provides that the taxable income is calculated by using the 'Cost Plus' method, which is a method recommended by the OECD TPG. The EC's 2004

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283 Case C-241/94 *French Republic vs. Commission of the European Communities* [1996] ECR I-4551, paras 23-24.

284 Claire Micheau, *State Aid, Subsidy and Tax Incentives under EU and WTO Law* (Kluwer Law International, 2014) 233.

285 Case C-6/12 *P Oy* [2013] ECR I-525, para 27.

286 Raymond H.C. Luja, '(Re)shaping Fiscal State Aid: Selected Recent Cases and Their Impact' (2012) 40 Intertax 120.

287 *Aid scheme implemented by Germany for control and coordination centres* Commission Decision 2003/512/EC [2003] OJ L177/17; Case C-48/2001; *Coordination Centres — implemented by Luxembourg* (Case C-49/2001) Commission Decision 2003/501/EC [2003] OJ L170/20; *Luxembourg – Finance Companies* (Case C-50/2001) Commission Decision 2003/438/EC [2002] OJ L153/40; *Belgium – Coordination Centres* (Case C-15/2002) Invitation to submit comments pursuant to Article 88(2) of the EC Treaty [2003] OJ L282/25; *Spain – Vizcaya coordination centres* Commission Decision 2003/81/EC [2003] OJ L131/26.

288 *Aid scheme implemented by Germany for control and coordination centres* Commission Decision 2003/512/EC [2003] OJ L177/17.

Report[289] clarifies that although this method as such is not caught by the State aid provisions *per se*, it can give rise to an advantage where the tax arrangements applied do not take proper account of the economic reality (or normal market conditions) of the transactions and thereby result in a lower rate of taxation than if the standard tax method had been applied. In this respect we will see if this departure from the standard tax method may mean a departure from the ALP thus reflecting the issue in the pending State aid cases. For the purposes of this part we shall look at the decisions concerning France, Luxembourg, Spain and Belgium. Belgium brought an action for annulment of the EC decision in front of the Courts, that is, the ***Belgium and Forum 187*** case, which we have mentioned already, and which we shall look at more closely from a transfer pricing point of view. We also note that all the schemes in question were implemented into national law and that specific legal regime derogated from the general tax system.

In the scheme adopted by France for headquarters and logistics centres,[290] the scheme makes it possible to determine profits subject to corporation tax in an alternative manner, using the cost-plus method as opposed to the ordinary manner to calculate the taxable profits. The EC found that the scheme is selective on three grounds, namely, firstly, the measure is limited to supplies of services which correspond to the functions of management, administration, coordination or control and to activities preparatory or ancillary to productive or commercial functions performed in the context of an international group. Only the former activities are therefore capable of benefiting from the advantages identified. Secondly, the benefit of the scheme is limited exclusively to headquarters and logistics centres which provide their services predominantly to associated companies situated outside France. The EC noted that entities which do not provide their services predominantly to associated companies located outside France are excluded from the benefit of the measure. Thus, entities established in France but not satisfying the predominance condition cannot benefit from the advantages of the scheme despite the fact that in their transactions with associated companies or branches situated abroad they must face the same difficulties as headquarters and logistics centres in determining their taxable profits. Thirdly, the fact that logistics centres constituting a department attached to an industrial or commercial branch of activity of an existing enterprise or to a holding company are excluded from the scheme strengthens the selectivity of the measure.[291] The same reasoning was advocated in the scheme adopted by

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289 Commission, Report on the Implementation of the Commission Notice on the Application of the State Aid Rules to Measures Relating to Direct Business Taxation (C(2004)434).

290 *French headquarters and logistic centres* Commission Decision [2003] OJ L23/1.

291 ibid paras 65-67.

Luxembourg regarding coordination centres,[292] and similarly another Luxembourg scheme concerning finance companies,[293] together with the Spanish scheme concerning coordination centres in ***Vizcaya***,[294] In the decision against Luxembourg the EC examined whether the method of determining the mark-up rate, the exclusion of certain expenditure from the calculation of the tax base and the exercise of possible discretionary power by the administration might confer an advantage on coordination centres. Similarly, in the decision against Spain, the EC considered that the exclusion of financial costs from the calculation of profits under the cost plus method could confer an advantage on coordination centres.

The EC concluded that coordination centres and the groups to which they belong were able to derive an advantage by reason of the fact that, in practice, Luxembourg systematically granted the minimum rate of 5% without checking whether it corresponded to the economic reality of the underlying services. It transpires that the Luxembourg authorities failed, at least in some cases, to ensure that coordination centres were subject to taxation comparable to that which generally applied to enterprises liable for tax in Luxembourg, that is, those which do not fall under the scheme for coordination centres. Similarly, to the pending cases, most particularly Starbucks, the EC questions the economic rationale of the scheme. Moreover, such a fixed rate could have derogated (derogation test) from the reference system when compared to other enterprises which would not have been eligible for the scheme (comparability test).[295]

On selectivity, given that the tax provisions in question concerned only coordination centres belonging to multinational groups present in at least two countries other than Luxembourg and having their headquarters outside Luxembourg, only some enterprises had access to the advantages described above. Moreover, some tax advantages are on occasion restricted to certain functions, such as intra-group services. This also holds for the Luxembourg scheme for coordination centres. The criterion of selectivity is thus met.

In Luxembourg's view, there is no precedent for applying the State aid rules to the choice of methods for calculating the tax base. Applying them in this way would involve a radical and unforeseeable extension of the current scope of Article 107 of the Treaty.[296] The EC reiterated that such precedent is not

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[292] *Coordination Centres — implemented by Luxembourg* (Case C-49/2001) Commission Decision 2003/501/EC [2003] OJ L170/20.

[293] *Luxembourg – Finance Companies* (Case C-50/2001) Commission Decision 2003/438/EC [2002] OJ L153/40.

[294] *Spain – Vizcaya coordination centres* Commission Decision 2003/81/EC [2003] OJ L131/26.

[295] ibid paras 46-50.

[296] ibid para 38.

necessary (and this is also applicable for the pending cases). When it comes to reconciling the principle of legal certainty with that of full competition and providing taxpayers with a point of reference, there is nothing to prevent tax administrations from opting for the cost-plus pricing formula. The Commission is not criticising the use of that system as a means of facilitating the determination of transfer prices for transactions between associated entities. Nevertheless, in the case at issue, the systematic application of the 5% minimum rate must be regarded as a derogation from the correct use of the cost-plus pricing method which is liable to have conferred an advantage on some enterprises without being justified by the nature or general scheme of the system.[297] We therefore infer that the cost plus method is the reference framework in this case and that a fixed rate or 'safe harbour' is a derogation from it.

Finally, the ***Belgian Coordination Ventres*** decision,[298] which reached the Courts in ***Belgium and Forum 187***,[299] sheds more light on the interpretation of transfer pricing within EU. In this case, the Belgian authorities recommended that, in the absence of any objective criteria for determining the percentage of profits to be taken into account, a mark-up of 8% should be used, whatever the type of service provided and without any checks being made as to whether this corresponded to economic reality. First, the court points out that a centre's taxable income is determined at a standard rate according to the cost-plus method. It represents a percentage of the total operating expenses and costs, from which staff costs, financial charges and corporation tax are excluded. This constitutes a derogation from the ordinary Belgian tax system. In this point, the EC took the flat-rate assessment of income under the cost-plus method constitutes an economic advantage. Under the regime in question, taxable profits are set at a flat-rate amount which represents a percentage of the full amount of operating costs and expenses, from which staff costs and financial charges are excluded.[300]

In order to decide whether a method of assessment of taxable income such as that laid down under the regime for coordination centres confers an advantage on them, it is necessary, to compare that regime with the ordinary tax system, based on the difference between profits and outgoings of an undertaking carrying on its activities in conditions of free competition.[301]

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297 ibid para 57.

298 *Belgium – Coordination Centres* (Case C-15/2002) Invitation to submit comments pursuant to Article 88(2) of the EC Treaty [2003] OJ L282/25.

299 *Belgian Coordination Centres* Commission Decision 2003/755/EC [2003] OJ L282, 55, recitals 89 – 95; Joined Cases C-182/03 and C-217/03 *Belgium and Forum 187 vs. Commission* [2006] ECR I-5479.

300 *Belgium – Coordination Centres* (Case C-15/2002) Invitation to submit comments pursuant to Article 88(2) of the EC Treaty [2003] OJ L282/25.

301 ibid para 95.

With respect to selectivity and as regards the method of determining taxable income, while ***Forum 187*** argues that the regime in question applies to those companies for which it was specifically designed,[302] so that the risk of double taxation may be avoided, it is a matter of agreement that the regime applies only to international groups having subsidiaries which are established in at least four different countries, which have capital and reserves of at least BEF 1000 million, and have an annual consolidated turnover of at least BEF 10,000 million. It follows that the regime in question is also selective in that regard.[303] Ultimately the Court annulled the EC decision but not on grounds that the measure did not constitute aid.

By way of conclusion to this part and for the purposes of the pending cases, the EC's 2004 Report clarified that to determine whether a tax scheme derogating from the normal system may constitute State aid, it must be established whether the resulting tax burden is lower than that which would have resulted from the application of the relevant Member's States normal taxation method. We therefore infer that in derogating from the normal tax method (which may also be the cost plus method without the use of fixed margins as demonstrated in the EC decisional practice above) one must compare the tax burden of undertakings calculated by the normal tax method and the tax burden of undertakings calculated by the alternative method. The normal tax system in the EC's TP decisional practice seems to be the correct application of the cost plus method without the use of fixed margins. On various occasions the EC referred to the ALP in its decision. Thus, for example, in the French decision the EC acknowledged that the arm's length principle is the international standard agreed by OECD member countries to determine transfer prices for tax purposes with a view to avoiding, firstly, double taxation of taxable income and, secondly, tax evasion involving the same income. The EC also acknowledges that the French tax system did in fact comply with the ALP as regards the determination of taxable profits in international transactions between controlled enterprises, both at the level of domestic law, under Article 57 of the General Tax Code, and at that of the bilateral double taxation treaties concluded by France with its partner countries.[304]We also note in the Belgian decision that the advantage here derives from the fact that the tax administration refrains explicitly from monitoring the 'at arm's length' nature of operations between FSC and affiliated companies once the minimum mark-up is reached. This approach, together with a small mark-up, reduces the level of corporation tax compared with the conventional method for

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302 Joined Cases C-182/03 and C-217/03 *Belgium and Forum 187 vs. Commission* [2006] ECR I-5479.

303 Case C-15/2002 *Belgium – Coordination Centres* [2003] OJ L 282/25 paras. 119-121.

304 *Belgium – Coordination Centres* (Case C-15/2002) Invitation to submit comments pursuant to Article 88(2) of the EC Treaty [2003] OJ L282/25, para 45.

determining taxable income.[305] From this we conclude that even though not specifically mentioned in the decisions outlined above, the EC acknowledges the ALP as the correct standard to be used between related party transactions and may be used as a benchmark. We infer that the application of fixed margins and the exclusion of certain costs to which the margins are applied deviates from the correct application of the ALP as interpreted by the OECD TPG. In this respect, we may also infer that such decisions may be used as precedents for the pending State aid cases.

4. The Prudent Independent Market Operator (PIMO)

4.1 *Understanding the PIMO in the State Aid Cases*

In the four State aid cases, on several occasions, reference is made by the EC to a relatively new principle (this however does not seem to transpire in the EC's final Starbucks decision); the Prudent Independent Market Operator, in particular the phrases 'transactions between prudent market operators' and 'conditions prevailing between prudent market operators'. The EC states that,

> Tax authorities, by accepting that multinational companies *depart from market conditions* in setting the commercial conditions of intra-group transactions through a discretionary practice of tax rulings, may renounce taxable revenues in their jurisdiction and thereby forego State resources, in particular when accepting commercial conditions which *depart from conditions prevailing between prudent independent operators*.[306]

Moreover,

> Thus, where a ruling concerns transfer pricing arrangements between related companies within a corporate group, that arrangement should not depart from the arrangement or remuneration that *a prudent independent operator acting under normal market conditions would have accepted*.[307]

Furthermore,

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305 ibid para 12.

306 *Alleged Aid to Apple* SA.38373 C(2014) 3606 final [2014] recitals 53 and 54; *Alleged aid to Starbucks* SA.38374 C(2014) 3626 final [2014] recitals 74 and 75; *Alleged aid to Amazon by way of a tax ruling* SA.38944 C(2014) 7156 [2014] recitals 53, 54 and 64; *Alleged aid to FFT* SA.38375 C(2014) 3627 final [2014] recitals 60 and 61.

307 *Alleged Aid to Apple* SA.38373 C(2014) 3606 final [2014] recitals 53 and 54; *Alleged aid to Starbucks* SA.38374 C(2014) 3626 final [2014] recitals 74 and 75; *Alleged aid to Amazon by way of a tax ruling* SA.38944 C(2014) 7156 [2014] recitals 53, 54 and 64; *Alleged aid to FFT* SA.38375 C(2014) 3627 final [2014] recitals 60 and 61.

> when accepting a calculation method of the taxable basis proposed by the taxpayer, the *tax authorities should compare that method to the prudent behaviour of a hypothetical market operator,* which would require a market conform remuneration of a subsidiary or a branch, which reflect normal conditions of competition. For example, *a market operator* would not accept that its revenues are based on a method which achieves the lowest possible outcome if the facts and circumstances of the case could justify the use of other, more appropriate methods.[308]

Finally, in Amazon the EC states that,

> although, as the Luxembourgish authorities rightly argue, the OECD Guidelines provide some flexibility with respect to the application of the arm's length principle, that flexibility is limited by the *principle that the remuneration arrived at should reflect what a prudent independent operator acting under normal market conditions* would have accepted.[309]

When looking closely at the last citation, it seems that the EC is invoking a principle which goes beyond the ALP, that is, a stricter or higher standard. Furthermore, this last citation further suggests that the EC seems to be replacing the ALP, which is the internationally accepted standard, which would normally govern a related party transaction, with the PIMO standard. However, in the Apple press release and the Starbucks final decision, there is no reference to the PIMO and the emphasis is being done on the fact the rulings approve transactions which are artificial and do not reflect economic reality

We highlight that the PIMO is practically unknown. There is no guidance by the EC on this standard and no EU court has ever opined or deliberated on the PIMO, moreover, the literature on the PIMO is also very limited hence it will be very difficult to properly define it and correctly understand how the EC is trying to use this standard. Nevertheless, it seems that the EC seems to be applying a variant of the Market Economy Operator (Hereinafter referred to as MEO) test which arises from the EC Final Notice.

We conclude that the MEO is applied onto the public authorities to measure their behaviour in comparable normal market conditions to assess whether economic transactions carried out by public authorities confer an advantage whereas the EC is applying the PIMO, either in aggregation, by way of reinforcement of the

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[308] *Alleged Aid to Apple* SA.38373 C(2014) 3606 final [2014] recitals 56 and 57; *Alleged aid to Starbucks* SA.38374 C(2014) 3626 final [2014] recitals 77 and 78.

[309] *Alleged aid to Amazon by way of a tax ruling* SA.38944 C(2014) 7156 [2014]recital 61.

ALP or in replacement of the ALP, between related private undertakings in a similar fashion to the ALP. We also conclude that it would be not correct to replace an internationally accepted standard such as the ALP with an unknown one to determine what would constitute 'normal' market conditions. In relation to the pending State aid cases, it seems that the EC is using the PIMO to determine whether the transfer pricing arrangements between subsidiaries within the same corporate group depart from arrangements that a prudent independent operator acting under normal market conditions would have accepted. In this context, market conditions refer to transfer pricing established at arm's length. Thus the PIMO cannot be synonymous to the MEO test outlined in the EC Final notice as the latter's application addresses a different tester.

5. The Final State Aid Decisions: Apple, Starbucks, Amazon and Fiat Finance and Trade ("FFT")

5.1 *The EC's Main Arguments, Interpretation and Reasoning*

In all the four cases the EC was of the opinion that the contested tax rulings or APAs do not comply with the ALP. If proven that the tax rulings do not adhere to the ALP, this would mean that the tax rulings lowered the undertakings' tax liability, thereby granting an advantage to the undertakings.[310] Accordingly, the EC is of the opinion that through those tax rulings the tax authorities confer an advantage. Moreover, that advantage is obtained every year and on-going, when the annual tax liability is agreed upon by the tax authority in view of the ruling. The EC emphasises that rulings should not have the effect of granting the undertakings concerned lower taxation than other undertakings in a similar legal and factual situation. Tax authorities, by accepting that multinational companies depart from market conditions in setting the commercial conditions of intra-group transactions through a discretionary practice of tax rulings, may renounce taxable revenues in their jurisdiction and thereby forego State resources, in particular when accepting commercial conditions which depart from conditions prevailing between prudent independent operators.[311]

The EC argues that treating taxpayers on a discretionary basis through tax rulings may mean that the individual application of a general measure takes on

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310 *Alleged Aid to Apple* SA.38373 C(2014) 3606 final [2014] recital 48; *Alleged aid to Starbucks* SA.38374 C(2014) 3626 final [2014] recital 69; *Alleged aid to Amazon by way of a tax ruling* SA.38944 C(2014) 7156 [2014] recital 48; *Alleged aid to FFT* SA.38375 C(2014) 3627 final [2014] recital 54.

311 *Alleged Aid to Apple* SA.38373 C(2014) 3606 final [2014] recital 53; *Alleged aid to Starbucks* SA.38374 C(2014) 3626 final [2014] recitals 74; *Alleged aid to Amazon by way of a tax ruling* SA.38944 C(2014) 7156 [2014] recital 56; *Alleged aid to FFT* SA.38375 C(2014) 3627 final [2014] recital 59.

the features of a selective measure, particularly where the exercise of the discretionary power goes beyond the simple management of tax revenue by reference to objective criteria. If, instead of issuing a ruling, the tax administration simply accepted a method of taxation based on prices which departs from conditions prevailing between prudent independent operators, there would also be State aid. The main problem is not the ruling as such, but the acceptance of a method of taxation which does not reflect market principles.[312] The EC considered that the imputability and State resources conditions were satisfied as the rulings were issued by the tax authorities, which are part of the State. Those rulings gave rise to a loss of State resources since any reduction of tax for the undertakings, resulted in a loss of revenue for the State.[313] The EC further considered that all the undertakings are globally active firms, operating in various Member States, so that any aid in their favour distorts or threatens to distort competition and has potential to affect intra-EU trade.[314]

The EC goes on to say that, in the context of a related party transaction (that is a transaction between undertakings within the same group of companies), market conditions can be arrived at through transfer pricing established at arm's length.[315] The EC further acknowledges that the OECD TPG is the appropriate reference document for the approximation of an arm's length pricing outcome. It further states that the document has been previously used in the previous EC decisions.[316]

The EC concluded that the ALP requirement was not met by providing different reasons in each case accordingly as follows. In ***Apple***, the EC stated that the taxable basis in the 1991 ruling was negotiated rather than substantiated by reference to comparable transactions. The Irish Revenue accepted the calculation of profit attributable to the branch on the basis of actual costs without this choice being reasoned in any way. The fact that the methods used to

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312 ibid.

313 *Alleged Aid to Apple* SA.38373 C(2014) 3606 final [2014] recital 49; *Alleged aid to Starbucks* SA.38374 C(2014) 3626 final [2014] recitals 70; *Alleged aid to Amazon by way of a tax ruling* SA.38944 C(2014) 7156 [2014] recital 49; *Alleged aid to FFT* SA.38375 C(2014) 3627 final [2014] recital 55.

314 *Alleged Aid to Apple* SA.38373 C(2014) 3606 final [2014] recital 50; *Alleged aid to Starbucks* SA.38374 C(2014) 3626 final [2014] recitals 71; *Alleged aid to Amazon by way of a tax ruling* SA.38944 C(2014) 7156 [2014] recital 50; *Alleged aid to FFT* SA.38375 C(2014) 3627 final [2014] recital 56.

315 *Alleged Aid to Apple* SA.38373 C(2014) 3606 final [2014] recital 55; *Alleged aid to Starbucks* SA.38374 C(2014) 3626 final [2014] recitals 76; *Alleged aid to Amazon by way of a tax ruling* SA.38944 C(2014) 7156 [2014] recital 54; *Alleged aid to FFT* SA.38375 C(2014) 3627 final [2014] recital 61.

316 *Alleged Aid to Apple* SA.38373 C(2014) 3606 final [2014] recital 56; *Alleged aid to Starbucks* SA.38374 C(2014) 3626 final [2014] recitals 77; *Alleged aid to Amazon by way of a tax ruling* SA.38944 C(2014) 7156 [2014] recital 55; *Alleged aid to FFT* SA.38375 C(2014) 3627 final [2014] recital 62.

determine profit allocation result from a negotiation rather than a pricing methodology, reinforces the idea that the outcome of the agreed method is not arm's length and that a prudent independent market operator would not have accepted the remuneration allocated to the branches in the same situation. No transfer pricing report was included in the documents provided by the Irish authorities to support the calculation of taxable profits as confirmed in that ruling, which is a common manner by which a transfer pricing proposal is made to tax authorities.[317] The EC had also doubts as to the appropriateness of the transfer pricing method chosen as the choice of that particular net profit indicator is neither explained by the tax advisor nor by Irish Revenue.[318]

The EC further outlines that the mark-up of 65% of the costs attributable to the Irish branch appear to be reverse engineered so as to arrive at a taxable income of around USD [28-38] million, although according the figure of USD [28-38] million does not have any economic substance.[319] Moreover, it is important to mention that as regarding the duration of the 1991 ruling, this ruling was applied by Apple for fifteen years without revision. This raised doubts as to the appropriateness of the method agreed between Irish Revenue and Apple to arrive to that allocation in the latter years of the ruling's application, given the possible changes to the economic environment and required remuneration levels. The EC notes, in particular, that that duration is much longer than the length of APAs concluded by other Member States.[320]

In ***Starbucks***, the EC's first set of doubts relates to the fact that the arm's length remuneration accepted in the APA depends on Starbucks Manufacturing BV being classified as a low-risk toll manufacturer, despite evidence pointing to the contrary.[321] The EC TP argument mostly concerned this classification. It then went on to outline another issue concerning adjustments made to the Starbuck's cost base. The EC had doubts on the appropriateness of those adjustments and gave very detailed reasons in this respect.[322] Finally, with respect to the royalty payment and choice of profit level indicator, the EC outlined that the fact that the royalties due by Starbucks Manufacturing BV to Alki LP are dependent on the difference between the remuneration established in the APA and the accounting pre-tax profit before the payment of the royalty, leads to a situation in which that royalty payment is calculated as profit in excess of the SMBV agreement and does not reflect the value of the IP.[323] Accordingly, the EC is of the opinion that by

317 *Alleged Aid to Apple* SA.38373 C(2014) 3606 final [2014] recital 56.
318 ibid recital 60.
319 ibid recital 62.
320 ibid recital 65.
321 *Alleged aid to Starbucks* SA.38374 C(2014) 3626 final [2014] recitals 79-96.
322 ibid recitals 97-114.
323 ibid recital 115.

accepting Starbucks Manufacturing BV's use of the SMBV APAs as regards the calculation of royalties in its profit and loss statement, in so far as the level of those royalties could be overestimated in view of the value of the IP in question, the Dutch tax authorities conferred an advantage on that undertaking.[324]

In ***Amazon***, (same as in ***Apple***) the EC noted firstly that Luxembourg did not submit to the EC any transfer pricing report prepared by Amazon in support of the transfer pricing arrangement in the ruling.[325] Furthermore, the EC expressed doubts as to whether the Luxembourgish tax authorities properly confirmed by the contested tax ruling that the transfer pricing arrangement presented in Amazon's ruling request reflected what a prudent independent operator acting under normal market conditions would have accepted. The EC further notes that the ruling request by Amazon was assessed within eleven working days from the receipt of the first letter constituting the ruling request, which is a very short period of time had a transfer pricing report been submitted and assessed in this case.[326] Secondly, (same as in ***Starbucks***) the EC doubted the choice of transfer pricing method. The method proposed by Amazon's tax advisor in the ruling request and accepted by the Luxembourgish tax authorities in the contested tax ruling does not seem to correspond to any of the methods listed in the OECD TPG. While those methods are not exhaustive, the EC has doubts, particularly in the absence of a transfer pricing report, whether the Luxembourgish tax authorities properly confirmed that the transfer pricing arrangement presented in Amazon's ruling request was in line with market conditions.[327] The EC understood that the remuneration accepted in that ruling is still accepted as being at arm's length by the Luxembourgish tax authorities more than ten years later without any revision, thus this making the ruling not in line with normal market conditions.[328]

Finally in ***FFT***[329] the EC claims that by agreeing to a taxable basis which can vary only marginally, the Luxembourgish tax authorities disregard any significant increase or decrease in the activities of FFT.[330] It further criticises the choice of method and states that the transactional net margin method is one of two indirect methods for estimating the profit level according to the OECD

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324 ibid recital 123.

325 *Alleged aid to Amazon by way of a tax ruling* SA.38944 C(2014) 7156 [2014] recital 63.

326 ibid recital 64.

327 ibid recitals 65-71.

328 ibid recital 76.

329 This decision is being challenged before the General Court – T759/15, T-755/15. 'SA.38375 State aid which Luxembourg granted to Fiat' (*European Commission*, 21 February 2014) <http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_SA_38375> accessed 10 March 2015.

330 *Alleged aid to FFT* SA.38375 C(2014) 3627 final [2014] recital 64.

Guidelines. However, according to the case law[331] as well as those guidelines, the use of direct methods for setting an appropriate level of profits is preferred. In particular, it is acknowledged that, whenever possible, the comparable uncontrolled price method is best at approximating conditions prevailing between prudent independent operators.[332] The EC further questions the capital remunerated and on the method employed together with observing the level of remuneration in that that the Luxembourgish tax authorities accepted the comparables selected by the tax advisor for the determination of an appropriate beta in the transfer pricing report without making any effort to filter out names which might not be appropriate peers.[333]

5.2 *Analysis and Criticism of the EC's Reasoning*

5.2.1 *The ALP as a Benchmark*

We noted that to appraise the advantage in cases involving transfer pricing methods, the EC has taken as guidance the TPG, as it does again in the pending cases, particularly the EC uses the internationally accepted principle, the ALP as its point of departure. The question is whether these transfer pricing decisions may be used as a precedent by the EC and indeed whether the ALP may be used as a benchmark.

First of all, in the previous transfer pricing decisions, the ALP was embedded in the Member States' domestic 'normal' tax system, thus it may be safe to say that it can form part of the reference system of a Member State for the purposes of the first step in analysing selectivity. The EC pointed out in its final decisions concerning the Netherlands that the reference system consists of the general Dutch corporate income tax system regardless whether it is a group or a stand-alone company. The Luxembourg decision outlined that with reference to the need to prevent tax avoidance and to the principle of full competition (the ALP), the Luxembourg authorities pointed out that Article 164 of the Law of 4 December 1967 on income tax constitutes the legislative basis for transfer prices. It was in this context that Circular 119 was adopted to facilitate the taxation of certain types of activity. The status of coordination centres is governed by Circular LIR No. 119 of 12 June 1989. The Circular stated that, for corporation tax purposes, the provision of intra-group services must generate an appropriate trading profit in line with the normal behaviour of a prudent manager in his relations with independent third parties (the ALP). To that end, taxable profit is

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331 Joined Cases C-182/03 and C-217/03 *Belgium and Forum 187 vs. Commission* [2006] ECR I-5479, para 95.

332 ibid recital 65.

333 ibid recitals 66-77.

determined according to the cost-plus pricing method by applying a flat-rate mark-up.

Secondly, on numerous occasions of these decisions the EC made reference to the ALP and the OECD TPG as being the point of reference for inter-party transactions. By way of example, in the Luxembourgish decision the EC states that in the area of transfer prices, this international principle (the ALP) is set out in Article 9 of the OECD Model Tax Convention (and, in more detail, in the OECD TPG). Since an analysis requires individual facts and circumstances to be taken into account, the OECD TPG does not recommend the use of 'safe harbours' (such as fixed margins). Moreover, the EC pointed out that the systematic application of the 5% mark-up without checking if it corresponds to the economic reality of the underlying services, departs from the correct application of the ALP thus giving coordination centres an advantage when compared to enterprises not qualifying for the scheme. We have learnt that the EC did not criticise the use of the cost-plus method as laid down under the OECD TPG but rather this systematic application.[334] Similarly in the Belgian decision, the EC stated that the advantage here derives from the fact that the tax administration refrains explicitly from monitoring the 'at arm's length' nature of operations between FSC and affiliated companies once the minimum mark-up is reached. This approach, together with a small mark-up, reduces the level of corporation tax compared with the conventional method for determining taxable income amongst independent entities.

At this point we note that the ALP as implemented in the respective Member State's domestic tax system was the departing point for the EC and was used as the reference framework. We also note that a fixed rate or 'safe harbour' is the derogation from the ALP because it does not reflect correctly the economic reality between independent parties. The EC questions the economic reality of the transactions, that is, that they do not reflect normal market conditions. The EC reiterated that the cost-plus method together with a fixed mark-up may lead to the economic reality being underestimated and therefore to the payment of less tax. We understand that, what determines the economic reality of a transaction is the ALP. A fixed mark-up is not really reflective of the ALP especially when the tax authorities do not check whether such a mark-up corresponds to the economic reality of the underlying services.

Lastly, as we have mentioned above, in the pending State aid cases the EC quotes case law,[335] and the previous EC's decisional practice,[336] on transfer pricing to

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[334] ibid para 57.

[335] Joined Cases C-182/03 and C-217/03 *Belgium and Forum 187 vs. Commission* [2006] ECR I-5479, para 95.

reinforce its arguments and seems to be invoking a precedent that the ALP is the benchmark or at least part of the reference framework. The EC further emphasises that the principle which is being applied is a general European legal principle of equal tax treatment which is reflective of the ALP. The EC interprets the paragraph of the quoted case law as meaning that if the method of taxation for intra-group transfers does not comply with the ALP and leads to a taxable base inferior to the one which would result from a correct implementation of that principle, it provides a selective advantage to the company concerned.[337] The paragraph quoted is the following,

> In order to decide whether a method of assessment of taxable income such as that laid down under the regime for coordination centres confers an advantage on them, it is necessary, as the Commission suggests at point 95 of the contested decision, to compare that regime with the ordinary tax system, based on the difference between profits and outgoings of an undertaking carrying on its activities in conditions of free competition.

Even though we feel that in the light of the previous transfer pricing decisional practice the ALP may be used as a benchmark only when it forms part of the domestic tax system of Member State thus forming part of the reference system for the purposes of step 1 of the selectivity analysis, we find it very hard to agree with the EC's aforementioned interpretation of the case law. In our view the paragraph quoted by the EC does not necessarily state that any deviation from the ALP leads to a selective advantage but simply provides a comparability test, that is, that the scheme is compared with the ordinary tax system.

As pointed by Gunn and Lutz,[338] the EC does not appear to follow this three step approach, however, we argue that firstly, as we have seen above in *Gibraltar*, the EC need not follow this three step approach and need not expressly and specifically outline the reference system even though we feel that the identification of the ordinary tax system is a very important step. However, the EC mentions in paragraph 54 of its preliminary decision that the method of assessment of the taxable income needs to be compared to the ordinary tax

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336 Case C-45/2001 *French Headquarters and Logistics Centres* [2004] OJ L23 recitals 50 and 53; Case C-47/2001 *Germany - foreign companies coordination centres* [2001] OJ L177/17 recitals 46-47 and 50; Case C-48/2001 *Spain - Vizcaya coordination centres* [2003] OJ L31/26; Case C-49/2001 *Luxembourg - coordination centres* [2003] OJ L170/20; Case C-50/2001 *Luxembourg - Finance Companies* [2002]; Case C-15/2002 *Belgium - Coordination Centres* [2003] OJ L282/25 recitals 89-95; Joined Cases C-182/03 and C-217/03 *Belgium and Forum 187 vs. Commission* [2006] ECR I-5479, paras 96-97.

337 Case C-45/2001 French Headquarters and Logistics Centres [2004] OJ L 23 recitals 50.

338 Anna Gunn, Joris Luts, 'Tax Rulings, APAs and State Aid: Legal Issue' (2015) 24 EC Tax Review 119, 119–125.

system based on the difference between profits and losses of an undertaking carrying on its activities under normal market conditions. Furthermore, the EC goes on to say that market conditions may be arrived at through transfer pricing established at arm's length. Therefore, we infer that the EC is using the ALP as the benchmark or reference 'normal' tax system, which is the first step to take of the three step approach. In the *Amazon* decision it is explained that Article 164 of the Luxembourg Tax Code, which constitutes the legislative basis for transfer pricing in Luxembourg, implements the arm's length principle laid down in Article 9 of the OECD MC.[339] Hence the ALP is part of the national tax system, which is the relevant reference framework in examining the selectivity of national fiscal measures under the State aid rules.

We have seen how far the purposes of selectivity, the courts have established a three step approach. As one of the steps one must identify the normal regime applicable in the Member State concerned. This means that the normal regime must be part of a State's domestic law. The EC clarified in its final decision concerning the Netherlands that the reference system consists of the general Dutch corporate income tax system which has the taxation of the profits of all firms that are subject to tax in the Netherlands as a goal. Whilst the ALP is embedded in the domestic law of Luxembourg,[340] and the Netherlands,[341] it is not the same for Ireland (up to 2010). Therefore, one may question the EC's reasoning and reliance on the ALP vis-à-vis Ireland when technically it did not form part of the Irish 'normal' tax regime. It may be problematic for the EC to ascertain whether the ALP forms part of the reference system of a Member State where no transfer pricing rules exist.

To this effect, it is logical to assume at this stage, that if a principle does not form part of the normal tax system in question, consequently there can be no derogation from it. We have seen how the ALP has achieved an internationally recognised status but can it be considered as forming part of the normal tax system of a Member State within the EU without actual transposition of the ALP in its domestic law? The answer to this question may be achieved if we assume that there is an international tax regime with principles (such as the ALP), which are inherent in every national tax system. However, there is hardly any agreement that such international tax regime exists and even more so that such principles are inherent in every national tax system. According to Reuven Avi-Jonah,[342] he argues repeatedly that a coherent international tax regime exists,

339 *Alleged aid to Amazon by way of a tax ruling* SA.38944 C(2014) 7156 [2014] recital 59.
340 ibid.
341 *Alleged aid to Starbucks* SA.38374 C(2014) 3626 final [2014] recital 31.
342 Reuven S. Avi-Jonah, *International Tax as International Law* (Cambridge University Press 2007) Chapter 1.

embodied both in the tax treaty network and in domestic laws, and that it forms a significant part of international law (both treaty-based,[343] and customary international law). This thesis is quite controversial. Several international tax academics and practitioners in the United States have advocated the view that there is no international tax regime and that countries are free to adopt any tax rules they believe will further their own interests.[344] Other tax academics and practitioners have supported the view advocated above.[345]

6. Conclusions

Firstly, a State may not rely solely on Article 9 of a tax treaty concluded with another State to enforce the ALP but it needs to implement the ALP in its domestic law. That being established, for the purposes of the State aid rules as laid down under Article 107 of the TFEU, if the ALP is not transposed within a State's domestic tax system, it cannot be considered that the ALP forms part of the reference system of 'normal' tax system of the State. Moreover, we also conclude that whilst it is acknowledged that the ALP is the internationally recognised standard for determining the correct transfer price between related parties, it does not have the status of customary international law which would make the ALP directly applicable without the need for traditional means of transposition within the national legal systems. The EC clarify in its Final Notice that the ALP necessarily forms part of the EC's assessment of tax measures granted to group companies under Article 107(1) of the Treaty, independently of whether a Member State has incorporated this principle into its national legal

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343 By way of reminder, we have seen in chapter 1 of this article that a tax treaty does not give tax rights in itself, and according to Vogel, a State may not rely on Article 9 of the OECD Model Tax Convention alone without implementing such within its domestic law.

344 Graetz, Michael J., 'Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies'(2001) 26 Brooklyn Journal of International Law 1357; David H. Rosenbloom, 'Cross-Border Arbitrage: The Good, The Bad and The Ugly' (2007) Taxes - The Tax Magazine; David H. Rosenbloom, 'International Tax Arbitrage and the 'International Tax System' (2000), 53 *Tax Law Review* 137; Julie Roin, 'Competition and Evasion: Another Perspective on International Tax Competition' (2001) 89 *Georgetown Law Journal* 543; Tsilly Dagan, 'The Tax Treaties Myth' (2000), 32 NYU Journal of International Law and Policy 939; Mitchell A. Kane, 'Strategy and Cooperation in National Responses to International Tax Arbitrage' (2005), 53 Emory Law Journal 89.

345 Luca dell'Anese, 'Tax Arbitrage and the Changing Structure of International Tax Law' (2006); Diane M. Ring, 'One Nation Among Many: Policy Implications of Cross-Border Tax Arbitrage (2005) 44 Boston *College Law Review* 79; Shay N. Menuchin, 'The Dilemma of International Tax Arbitrage: A Comparative Analysis using the cases of Hybrid Financial Instruments and Cross-border leasing' (PhD thesis, London School of Economics and Political Science 2005); Hugh J. Ault, 'The Importance of International Cooperation in Forging Tax Policy' (2001), 26 Brooklyn Journal of International Law 1693; Paul R. McDaniel, 'Trade and Taxation' (2001), 26 Brooklyn Journal of International Law 1621; Richard J. Vann, 'International Aspects of Income Tax' in Victor Thuronyi (ed.), *Tax Law Design and Drafting* (Volume 2, 2000) 18; Philip R. West, 'Foreign Law in U.S. International Taxation' (1996), 3 Florida Tax Review 147.

system and in what form. It is used to establish whether the taxable profit of a group company for corporate income tax purposes has been determined on the basis of a methodology that produces a reliable approximation of a market-based outcome.[346]

With respect to the EC's transfer pricing decisional practice, the EC's 2004 Report clarified that to determine whether a tax scheme derogating from the normal system may constitute State aid, it must be established whether the resulting tax burden is lower than that which would have resulted from the application of the relevant Members States' normal taxation method. We therefore infer that in derogating from the normal tax method one must compare the tax burden of undertakings calculated by the normal tax method and the tax burden of undertakings calculated by the alternative method e.g. a fixed margin. In this respect, the non-adherence to the ALP between related parties will result in a lower tax burden when compared to undertakings which adhere to the ALP i.e. independent parties.

Furthermore, we conclude that for the purposes of selectivity test as one of the conditions of the State aid rules, the comparables for the purposes of the comparison test, are various. The EC needs to clarify against which undertakings must the comparability test be applied. Indeed, this is the purpose for selecting a reference framework in order to determine those undertakings, which are in a similar legal and factual position. Moreover, as demonstrated by the EC's decisional practice if a ruling allows taxpayers to use alternative methods to calculate taxable profits, inter alia, fixed margins for a cost plus method for determining an appropriate transfer price, that ruling may involve State aid. We further conclude that, tax rulings are selective in particular where, the tax authorities have discretion in granting administrative rulings, the rulings are not available to undertakings in a similar legal and factual situation, the administration appears to apply a more favourable discretionary tax treatment compared with other taxpayers in a similar factual and legal situation and the ruling has been issued in contradiction to the applicable tax provisions and resulted in a lower amount of tax.

Finally, the normal tax system requires related party transactions to be in accordance with the ALP and such transactions can only be examined against the ALP and not any other standard. The ALP already permits that special conditions adopted between related parties are replaced by market conditions which reflect the economic reality between independent parties. Thus, the introduction of the

[346] Case C-241/94 *French Republic vs. Commission of the European Communities* [1996] ECR I-4551 para 172.

PIMO may be unnecessary and the ALP is sufficient to establish normal market conditions.