

2016

# State Aid in the EU through Tax Rulings and Transfer Pricing

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## Recommended Citation

Jone, Elizabeth A., "State Aid in the EU through Tax Rulings and Transfer Pricing" (2016). *Law School Student Scholarship*. 911.  
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## State Aid in the EU through Tax Rulings and Transfer Pricing

Article 107 of the Treaty on the Functioning of the European Union prohibits Member States from engaging in anything that qualifies as what they term State aid.<sup>1</sup> This is when a Member State of the European Union provides a selective advantage to a business entity through state resources, affecting competition in the internal market, and it is illegal.<sup>2</sup> The European Commission is empowered to investigate and remedy infractions,<sup>3</sup> such as certain tax arrangements, among which are tax rulings.<sup>4</sup> In 2014, the European Commission opened investigations into a handful of specific cases, then broadened their inquiry to include the tax ruling practices of a majority of the Member States.<sup>5</sup> The Commission found illegal State aid in the first two decisions released October 21, 2015,<sup>6</sup> and also in the case of Belgium's excess profits regime, release January 11, 2016.<sup>7</sup> These findings and the use of the State aid prohibitions to reach deeper into corporate pockets are controversial, however, and the Union may be better served pursuing fair corporate tax revenues through other means.

Tax Rulings are a process by which companies can receive prior government approval for certain tax arrangements and structures before filing, and they have become an essential element of doing business for many in today's global economy. Certainty is important in financial planning,

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<sup>1</sup> Consolidated Version of the Treaty on the Functioning of the European Union art. 107(1), 2012 O.J. C 326/62, at 121 [hereinafter TFEU].

<sup>2</sup> *Id.*

<sup>3</sup> *Id.* art. 108, at 122.

<sup>4</sup> Commission Notice on the Application of the State Aid Rules to Measures Relating to Direct Business Taxation, 1998 O.J. C 384/3 (hereinafter Notice on Direct Business Taxation).

<sup>5</sup> James Kanter, *E.U. Orders 2 Nations to Recover Taxes from Starbucks and Fiat*, N.Y. TIMES, Oct. 21, 2015, <http://nyti.ms/1W4SYJR>.

<sup>6</sup> *Id.*

<sup>7</sup> Mindy Herzfeld, *News Analysis: Belgian Excess Profits: The Commission Strikes Again*, 81 TAX NOTES INT'L 291, (Jan. 25, 2016).

and moreover, corporate boards would be neglecting their duty if they did not lay these plans so as to maximize profit and benefit while minimizing costs. But in those efforts to minimize cost, some companies may go beyond corporate responsibility into tax avoidance, which, when aggressive enough, may prompt action from authorities seeking fair contribution to State coffers.<sup>8</sup>

Transfer pricing is one area in particular for which businesses seek tax rulings. These advance pricing arrangements (APAs) have recently drawn scrutiny.<sup>9</sup> APAs determine how value is set on transactions between related companies, such as when a subsidiary supplier sells parts to a parent manufacturing company. Economic necessity as well as a gauntlet of national requirements mandate responsible transfer pricing practices. This mandate is encapsulated in the OECD's arm's length principle, which says that these transactions must be valued as they would be between similarly situated but independent companies.<sup>10</sup> This can be straightforward, or it can be exceedingly complex, and for the MNEs that must engage in it, application of the transfer pricing rules is costly and time consuming. However, the arm's length principle is flexible enough to put them in the unique position of being able to creatively locate profits and losses.

This creative process combined with Member States' misapplication of their own transfer pricing rules and guidelines seems to comprise the bulk of the Commission's theory.<sup>11</sup> For instance, one area of concern is the use of intellectual property holding companies in low or no tax jurisdictions to which subsidiaries pay large royalties for use, possibly shifting profits into a more

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<sup>8</sup> Toby Sterling, *EU Targets Apple and Starbucks for Fishy Tax Strategies*, INC.COM, Jun. 11, 2014, <http://www.inc.com/associated-press/apple-starbucks-fiat-under-eu-investigation.html>.

<sup>9</sup> Richard Lyal, *Transfer Pricing Rules and State Aid*, 38 FORDHAM INT'L L.J. 1017, 1017-18 (2015).

<sup>10</sup> See generally OECD (2010), "The Arm's Length Principle", in *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010*, OECD Publishing. <http://dx.doi.org/10.1787/tpg-2010-4-en>.

<sup>11</sup> Kanter, *supra* note 5.

favorable tax jurisdiction.<sup>12</sup> The breadth of similar tax rulings which have been granted creates a problem for this theory however which may cast doubt on the required selective advantage of an illegal State aid measure.<sup>13</sup> More importantly, the area of tax is one in which Member States enjoy and jealously guard their sovereignty, with unanimous votes required on any tax measures in the Council.<sup>14</sup> The ability of a jurisdiction to set its own tax policy is a key aspect of international competitiveness and growth, but the European Union's stated goal of harmonizing the internal market is seen by some as requiring, if not complete harmonization, at least a narrowing of the gaps between Member States' tax systems.<sup>15</sup> Finally, as stated above, businesses depend greatly on the reliability of these tax rulings, so if the Commission is applying State aid prohibitions in a way that will make corporate taxes unpredictable, that could have a highly negative economic impact.

Ultimately, the question which must be answered is this: how much competition is the European Union prepared to tolerate between Member States as regards their tax regimes? For individuals, this is a much simpler issue. The vast majority of humanity will live, work, purchase, sell, and die in one place, although ease of movement has increased dramatically in the last century or so. The question of where they will pay their taxes and how much is not often too difficult. Of far greater concern is the activity of multinational entities (MNEs), many of which generate revenue on par with small countries, and make creative use of the numerous jurisdictions and legal structures now available to them in order to maximize profits and minimize tax burdens. On one

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<sup>12</sup> Commission Press Release, IP/14/309 (Mar. 24, 2014).

<sup>13</sup> Lyal, *supra* note 8, at 1042.

<sup>14</sup> TFEU, *supra* note 1, arts. 113, 115, 2012 O.J. C 326/62, at 125, 127.

<sup>15</sup> Agnès Bénassy-Quéré, Alain Trannoy & Guntram Wolff, *Tax Harmonisation in Europe: Moving Forward*, Vox, Jul. 22, 2014, <http://www.voxeu.org/article/partial-corporate-tax-harmonisation-eu>.

hand, this is simply responsible business management, but States have a legitimate concern that wealth which is generated within their borders might never end up contributing in any substantial way to their own revenues.

This essay will begin with an overview of the primary concepts at issue, those being State aid, tax rulings, and transfer pricing. The second part will lay out the application of the State aid prohibition to tax rulings for transfer pricing structures, especially as pertains to five high profile current cases. Finally, part three will analyze the usefulness of this policy for achieving the desired ends.

### Part I

#### State Aid:

State aid is the provision by a State of financial assistance to a business entity in a way which distorts competition in the internal market.<sup>16</sup> It is defined and prohibited by Article 107 of the Treaty on the Functioning of the European Union, which states in part that:

“any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favoring certain undertakings or the production of certain goods shall be incompatible with the common market, in so far as it affects trade between Member States.”<sup>17</sup>

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<sup>16</sup> TFEU, *supra* note 1, art. 107(1), 2012 O.J. C 326/62, at 121.

<sup>17</sup> *Id.*

Article 107 along with Articles 108 and 109 of the same treaty, with several implementing measures, embody the laws against State aid. Article 108 sets out the procedure for assessing and either approving or disapproving potential State aid measures,<sup>18</sup> while Article 109 empowers the Council to make appropriate regulations and determine the application of exemptions.<sup>19</sup> State aid is illegal unless submitted to and approved by the Commission, or falling within an exempt category.<sup>20</sup>

It has been read to be comprised of four necessary elements. First, the potential aid must confer an advantage to an undertaking or a group of such.<sup>21</sup> Second, that advantage must be materially selective.<sup>22</sup> This element is the crucial issue in State aid. The Commission must show that a business (or a group of businesses) is being given an advantage not available to other, similarly situated entities.<sup>23</sup> Third, that selective advantage must be attributable to the Member State in question, meaning it is provided from the governmental resources of that Member State.<sup>24</sup> So a tax ruling is checked only against the national tax system in question, and not against that of any other State.<sup>25</sup> If the advantage is due to jurisdictional differences, it should not be enough to support a finding of illegal State aid.<sup>26</sup> Fourth and finally, the State specific selective advantage must have at least a potential impact on competition and on trade between Member States.<sup>27</sup>

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<sup>18</sup> *Id.* art. 108, at 122-23.

<sup>19</sup> *Id.* art. 109, at 123.

<sup>20</sup> *Id.* arts. 107-08, at 121-23.

<sup>21</sup> Lyal, *supra* note 8, at 1028 (“Undertaking” is simply another word for business).

<sup>22</sup> *Id.*

<sup>23</sup> Raymond Lujá, *EU State Aid Rules and Their Limits*, 76 *Tax Notes Int’l* 353 (Oct. 27, 2014).

<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

<sup>26</sup> *Id.*

<sup>27</sup> Lyal, *supra* note 8, at 1028.

### Advance Tax Rulings:

Advance tax rulings are written statements from tax authorities which taxpayers seek in order to obtain clarification of future tax burdens.<sup>28</sup> For instance, a tax ruling may be sought prior to finalizing a large, cross border transaction because an adverse ruling would make the transaction untenable. They can be made between a taxpayer and a single government, or they can be more broad, composed of rulings obtained from all jurisdictions potentially involved in the transactions.<sup>29</sup> In addition, the Commission in their most recent State aid inquiry asks for “any communication or other instrument or action of similar effect, given by or on behalf of a Member State, regarding the interpretation or application of its tax laws.”<sup>30</sup> This expansion of the definition is intended to include less formal agreements or understandings as well, and not simply written documents. In theory, these rulings should simply be a confirmation of the normal application of tax laws to a company’s particular situation. However, it seems they have been used to set a limit on what will be assessed to the applying companies, fixing a certain profit or loss margin, or debt-to-equity ratio, or to allow improper profit and loss transfers. This should not be the case, but it seems likely that Member States have allowed such arrangements for the companies under investigation.<sup>31</sup>

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<sup>28</sup> Council Directive 2015/2376/EU amending Directive 2011/16/EU as regards Mandatory Automatic Exchange of Information in the Field of Taxation, 2015 O.J. L 332/1 [hereinafter the Directive on Automatic Exchange of Information].

<sup>29</sup> HM Revenue & Customs, Unilateral, Bilateral or Multilateral Agreement, <http://www.hmrc.gov.uk/manuals/intmanual/INTM422030.htm> (last visited February 19, 2016).

<sup>30</sup> Commission Press Release, MEMO/15/4609 (Mar. 18, 2015).

<sup>31</sup> Kelly Carr & Leslie Wayne, *‘Lux Leaks’ Revelations Bring Swift Response Around World*, THE INTERNATIONAL CONSORTIUM OF INVESTIGATIVE JOURNALISTS, Nov. 6, 2014, <http://www.icij.org/project/luxembourg-leaks/lux-leaks-revelations-bring-swift-response-around-world> (hereinafter Carr & Wayne).

Recall that TFEU Article 107 requires a selective advantage to a business and an effect on competition in the internal market in order for an action to be State aid. The Court of Justice has stated that “the effect [can be] that the transfer prices do not resemble those which would be charged in conditions of free competition. It follows that such an exclusion confers an economic advantage.”<sup>32</sup> So these advance tax rulings can constitute State aid, per TFEU Article 107(1), if they provide businesses with an advantage by departing “from conditions which would have been set between independent market operators (the arm’s length principle).”<sup>33</sup> So if the Commission finds that the content of the ruling reaches a tax conclusion which does not accord with day to day application of that Member State’s tax rules, then the ruling will be found to be illegal State aid. In most jurisdictions, the rulings and their contents are secret, which makes investigation difficult. Regulation 734/2013 aids in this process, clarifying that the Commission may ask Member States and undertakings for relevant information directly once a formal investigation has begun.<sup>34</sup>

#### Transfer Pricing:

Many advance tax rulings have to do with transfer pricing, which is the basis of the recent investigations and perceived problems.<sup>35</sup> For companies which are comprised of more than one single legal entity, transfer pricing is the method by which value is set on internal transactions.<sup>36</sup> This matters for tax purposes because multinational corporations which control separate legal

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<sup>32</sup> Belgium v. Commission, Joined Cases 182/03 & 217/03, [2006] E.C.R. I-5479.

<sup>33</sup> *Id.* ¶¶ 96-97.

<sup>34</sup> Council Regulation 734/2013/EU amending Regulation 659/1999/EC Laying Down Detailed Rules for the Application of Article 93 of the EC Treaty, 2013 O.J. L 204/15.

<sup>35</sup> Lyal, *supra* note 8, at 1017.

<sup>36</sup> *Id.* at 1020-23.

entities in multiple jurisdictions are taxed under the distinct tax laws of each such jurisdiction.<sup>37</sup>

What they are taxed on exactly and how much depends on how their profits are allocated between the jurisdictions, and this is determined in significant part through transfer pricing.

The Organization for Economic Cooperation and Development (the OECD) is a group of more than 100 countries “working together to promote economic growth, prosperity, and sustainable development.”<sup>38</sup> In response to numerous difficulties encountered in the taxation of MNEs, the participating states adopted a theory of entity taxation.<sup>39</sup> This allows the state in which an entity is located to tax profits generated by that entity. The goal is to avoid double taxing when multiple states claim the right to tax, but because different jurisdictions have different tax rates, it creates a strong incentive for the multinationals to get creative with their transfer pricing so that their subsidiaries in higher tax jurisdictions turn a lesser profit, if they profit at all.

The OECD sets international standards on a range of subjects, including transfer pricing.<sup>40</sup> Their Transfer Pricing Guidelines center on application of the arm’s length principle to related company transactions,<sup>41</sup> and the Commission asserts that this principle is part of State aid law on the basis of case law.<sup>42</sup> In essence, this principle posits that transactions between related companies must be valued as nearly as possible to how they would be between two similarly situated, but

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<sup>37</sup> PriceWaterhouseCoopers, INTERNATIONAL TRANSFER PRICING 2015/16, 4 (2015), <http://www.pwc.com/internationaltp>.

<sup>38</sup> What is the OECD, <http://usoecd.usmission.gov/mission/overview.html> (last visited Feb. 21, 2016).

<sup>39</sup> OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, [http://www.oecd-ilibrary.org/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations\\_20769717](http://www.oecd-ilibrary.org/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations_20769717) (last visited Feb. 21, 2016) [hereinafter OECD Guidelines].

<sup>40</sup> About the OECD, <http://www.oecd.org/about/> (last visited Feb. 21, 2016).

<sup>41</sup> OECD Guidelines, *supra* note 39.

<sup>42</sup> Commission Notice, 2014 O.J. C 460/03 [hereinafter Netherlands] (The present investigations, discussed later, assert that Member States failed to correctly apply the OECD Transfer Pricing Guidelines, resulting in tax advantages).

independent companies. In the long run, this is a smart business practice regardless of outside mandates, because a company cannot assess the true state of corporate affairs without using accurate, market based numbers.

Regardless, with ever present economic pressures, there is a temptation to alter those numbers for the tax authorities and shift profits into a more favorable jurisdiction if possible. One popular method to accomplish this is the use of intellectual property holding companies established in low tax jurisdictions.<sup>43</sup> Less favorably situated companies pay royalties to these holding companies for use of the IP, and in some arrangements, those royalties line up closely with what would otherwise have been taxable profit. Another example of controversial transfer pricing arrangements is found in the transfer of goods between related companies. For instance, Starbucks is accused of having its Dutch company pay too much for coffee beans from its Swiss company.<sup>44</sup>

Presently, it is the task of each individual state to assess these arrangements, either when they are presented in advance for a tax ruling or when they are ultimately filed with the relevant tax authority. The current Commission cases are probably the most extensive third party review of the appropriateness of these tax rulings in relation to transfer pricing practices which has yet taken place. Some propose that a more permanent system of review and periodic monitoring may be necessary to address concerns of abuse.<sup>45</sup> This would also greatly reduce the enforcement load on the Commission. In response, the Council adopted a directive in December 2015, becoming effective in January 2017, requiring Member States to automatically exchange information on

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<sup>43</sup> Jesse Drucker, *EU Tax Deals Put Haven Nations on Divergent Paths*, BLOOMBERG BNA DAILY TAX REPORT, Oct. 22, 2015.

<sup>44</sup> Kanter, *supra* note 5.

<sup>45</sup> Luja, *supra* note 23.

cross-border tax rulings and APAs.<sup>46</sup> This should greatly improve the States' communication and efficiency on this matter, should they wish to address it.

#### Remedies Available:

If a ruling is found to constitute illegal State aid, then it will be declared void and unenforceable from its effective date,<sup>47</sup> with the caveat that OECD Guidelines and TFEU Articles only apply from the time the Member State in question adopted them.<sup>48</sup> So if a ruling has been in place for ten years, but the state only joined the EU six years previous, then only those most recent six years will be invalidated. The Commission can order the offending Member States to recover up to ten years of tax benefits from the affected companies, plus interest, or the Commission may conduct its own assessment.<sup>49</sup> If the States refuse to enforce the ruling or the companies do not pay the assessment voluntarily, then the Commission can refer the matter directly to the Court of Justice.<sup>50</sup> A beneficiary company may challenge a finding of State aid through European courts, but this is costly, time consuming, and does not automatically suspend the decision in the interim.<sup>51</sup>

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<sup>46</sup> Council Press Release, IP/905/15 (Dec. 8, 2015).

<sup>47</sup> Council Regulation 2015/1589/EU for the Application of Article 108, 2015 O.J. L 248/9 [hereinafter Article 108 Regulation].

<sup>48</sup> Luja, *supra* note 23.

<sup>49</sup> Article 108 Regulation, *supra* note 48, at 26.

<sup>50</sup> *Id.* at 24.

<sup>51</sup> *EU Investigates Tax Rulings for Breach of State Aid Rules*, SHEARMAN & STERLING ANTITRUST CLIENT PUBLICATION, Feb. 4, 2015, <http://www.shearman.com/~media/Files/NewsInsights/Publications/2015/02/EU-Investigates-Tax-Rulings-for-Breach-of-State-Aid-Rules-Antitrust-020415.pdf> (hereinafter Shearman & Sterling Antitrust).

## Part II

## Extant Case Law:

These recent cases are not an entirely new use of State aid law, and in fact, there are several lines of case law exploring the necessary elements of State aid as applied to tax measures and rulings.<sup>52</sup> The question of an effect on the internal market and competition has never been at issue, but as early as 1974, the Court of Justice took up the question of advantage in the case, *Italy v. Commission*.<sup>53</sup> There, they upheld a finding of State aid where Italy was granting a tax advantage to its own textile industry.<sup>54</sup> The Advocate General stated in his opinion that the phrasing, “in any form whatsoever,” in what is now Article 107(1) does in fact apply to “aid in any form.”<sup>55</sup> So the definition of an “advantage” is broad indeed, and a Member State can grant such an advantage in plentiful ways, from directly subsidizing an industry, to granting a too lenient tax ruling.<sup>56</sup> The question of an advantage is a primary point at issue in the present cases.<sup>57</sup>

As to the requirement that the advantage be given from State resources, the Commission released a series of decisions in 2003 finding issue with rulings in Belgium, Luxembourg, Germany, and France, very similar to those at issue today.<sup>58</sup> These cases emphasized how the advantage is given through State resources. The Court of Justice said that “any reduction of tax for

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<sup>52</sup> Lyal, *supra* note 8, at 1018-19.

<sup>53</sup> *Italy v. Commission*, Case 173/73, [1974] E.C.R. 709.

<sup>54</sup> *Id.*

<sup>55</sup> Opinion of Advocate General Warner, *Italy v. Commission*, Case 173/73, [1973] E.C.R. 709, 727.

<sup>56</sup> Notice on Direct Business Taxation, *supra* note 4 (An Advocate General’s opinion is the equivalent of US dicta).

<sup>57</sup> Lyal, *supra* note 8, at 1042.

<sup>58</sup> *Id.* at n.13.

[a company] results in a loss of tax revenue that otherwise would have been available to [the Member State],”<sup>59</sup> and so constitutes a loss of State resources.

However, the validity of this finding rests heavily on the selectivity of the aid in question. The view has been that simply because a tax is not being paid, it should not be considered a foregoing of potential State revenue if no other similarly situated businesses are paying that same tax. The Court held in the 2001 decision, *Adria Wien Pipeline*,<sup>60</sup> that the determination of selectivity should be made by comparing similarly situated businesses “in light of the objective pursued by the measure in question.”<sup>61</sup> So if all these businesses are receiving identical treatment, there is no selectivity. This reading does not harmonize well, however, with the Treaty’s prohibition on aid to categories of undertakings. A more recent case, *Paint Graphos*, came out just a little differently in 2011, stating that the determination should be “in the light of the objective pursued by the corporation tax regime, namely the taxation of company profits.”<sup>62</sup> One reading says it is indicative of the Court’s intent to broaden selectivity into a more abstract thing, viewing a measure or measures within the whole of a Member State’s tax regime, rather than only as compared to a limited group.<sup>63</sup> Such a reworking of this requirement would give the Union a much broader reach into Member States’ tax regimes in order to stamp out illegal State aid.

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<sup>59</sup> Commission Notice, 2014 O.J. C 369/22, ¶ 50.

<sup>60</sup> *Adria-Wien Pipeline GmbH and Wietersdorfer & Peggauer Zementwerke GmbH v. Finanzlandesdirektion für Kärnten*, Case C-143/99, [2001] E.C.R. I-08365.

<sup>61</sup> *Id.* at ¶ 41.

<sup>62</sup> *Ministero dell’Economia e delle Finanze, Agenzia delle Entrate v. Paint Graphos Soc. coop. arl*, Joined Cases C-78-80/08, [2011] E.C.R. I-07611.

<sup>63</sup> Roland Ismer, Sophia Piotrowski, *The Selectivity of Tax Measures: A Tale of Two Consistencies*, 43 *Intertax* 559 (2015).

Beyond the Treaty requirements, there is also a history of Union action in support of more consistency across their numerous tax jurisdictions. In the late 90's, growing concern with governmental facilitation of corporate tax avoidance led to Member States' agreement on the Code of Conduct for Business Taxation.<sup>64</sup> This was shortly followed by the Commission's Notice on State Aid, which, among other things, reaffirmed that tax measures are State aid if the Member State grants the recipient company a fiscal advantage that affects competition and trade in the internal market.<sup>65</sup>

#### Presently Pending Cases:

The EU recently began wide-scale investigations of many Member State tax rulings for State aid violations, focused primarily on possible transfer pricing problems. Formal investigations have been opened into rulings by Ireland for Apple, Luxembourg for Fiat, and the Netherlands for Starbucks and Amazon.<sup>66</sup> An inquiry into Belgium's excess profits regime, which requires MNEs to apply for a tax ruling if they believe they qualify, resulted in a decision finding illegal State aid on January 11, 2016.<sup>67</sup> A few months prior, in October 2015, the decisions were made regarding the Fiat and Starbucks rulings, so we will begin with those.<sup>68</sup>

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<sup>64</sup> Council Conclusions of the ECOFIN Council Meeting on 1 December 1997 Concerning Taxation Policy, 1998 O.J. C 2/01.

<sup>65</sup> Notice on Direct Business Taxation, *supra* note 4.

<sup>66</sup> Lyal, *supra* note 8, at 1017.

<sup>67</sup> Commission Press Release, IP/16/42 (Jan. 11, 2016).

<sup>68</sup> Commission Press Release, IP/15/5880 (Oct. 21, 2015).

## Netherlands and Starbucks

In 2008, Starbucks received a ruling from the Netherlands regarding the remuneration of its coffee roasting operations there.<sup>69</sup> The ruling fixes remuneration to “a fixed percentage of the relevant cost base,” and allows them to pay a tax deductible royalty to a company outside the Netherlands in the amount of any profits in excess of the amount agreed to.<sup>70</sup> Starbucks’ tax advisor submitted a transfer pricing report in the application process, which is an extensive document detailing how the company arrived at its figures. This is a standard practice of companies receiving these rulings.<sup>71</sup>

The Commission found that the ruling did grant a selective tax advantage.<sup>72</sup> The full text of the decision has not yet been released, but the announcement of the decision states that the ruling “endorsed artificial and complex methods to establish taxable profits that did not reflect economic reality [which] resulted in reporting of transfer pricing transactions which did not correspond to market conditions.”<sup>73</sup> The European Commissioner for Competition, Margrethe Vestager, has stated that Starbucks vastly overvalued IP rights for its coffee roasting process and recipe, and paid an inflated price for unroasted coffee beans to their Swiss company.<sup>74</sup>

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<sup>69</sup> Commission Notice, 2014 O.J. C 460/11 [hereinafter Starbucks].

<sup>70</sup> *Id.*

<sup>71</sup> OECD White Paper on Transfer Pricing Documentation (2013).

<sup>72</sup> Starbucks, *supra* note 72.

<sup>73</sup> *Id.*

<sup>74</sup> Kanter, *supra* note 5.

The Dutch have expressed surprise, and insist their transfer pricing laws comply with OECD guidelines and carefully implement the arm's length principle.<sup>75</sup> Starbucks also disagrees with the decision and plans to appeal.<sup>76</sup> According to Corey duBrowa, the senior vice president of communications at Starbucks, they comply with all OECD rules, guidelines and laws, support the tax reform process, and pay an average global effective tax rate 14.5% higher than that paid by other large US companies.<sup>77</sup>

### Luxembourg and Fiat/FFT

Fiat's Luxembourg based financing company, Fiat Finance and Trade (FFT), received a tax ruling from that State in 2012.<sup>78</sup> The Commission stated concerns that Luxembourg misapplied minimum capital requirements, and found in October 2015 that they had granted selective tax advantages to Fiat Finance and Trade.<sup>79</sup> Vestager says Fiat's taxable profits would have been twenty times higher if based on market conditions.<sup>80</sup>

Luxembourg says the Commission used unprecedented criteria to establish State aid which does not establish a selective advantage within the national legal framework.<sup>81</sup> Fiat says its financing unit has not received any State aid from Luxembourg.<sup>82</sup> Jean Schaffner, head of Allen

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<sup>75</sup> Press Release, Government of the Netherlands, Reaction of the Dutch Authorities to the Commission Decision on Starbucks (Oct. 21 2015) (<https://www.government.nl/latest/news/2015/10/21/reaction-of-the-dutch-authorities-to-the-commission-decision-on-starbucks>).

<sup>76</sup> Kanter, *supra* note 5.

<sup>77</sup> Kim Hjelmgaard, *EU: Starbucks, Fiat Profited from Illegal Tax Breaks*, USA TODAY, Oct. 21, 2015, <http://usat.ly/1LKyu6>.

<sup>78</sup> Commission Press Release, IP/15/5880 (Oct. 21, 2015) (hereinafter Fiat).

<sup>79</sup> *Id.*

<sup>80</sup> Kanter, *supra* note 5.

<sup>81</sup> Press Release, Luxembourg Minister of Finance, Luxembourg to Appeal the Commission's Fiat Decision (Dec. 4 2015) (<https://www.gouvernement.lu/5497651/04-luxembourg-fiat>).

<sup>82</sup> Kanter, *supra* note 5.

& Overy's Luxembourg tax practice, expressed agreement with Luxembourg that the decision most likely does not meet the selectivity requirement because numerous similarly situated companies in Luxembourg are using the same methods and getting the same settlements.<sup>83</sup> Schaffner also says the supposed problem would have resulted in Fiat group companies paying less in interest to the Luxembourg company, and thus enlarging their tax base in other Member States.<sup>84</sup>

### Ireland and Apple

At issue in Ireland are two 1991 tax rulings, both revised in 2007, validating transfer pricing methods determining the net profits of two Apple subsidiaries.<sup>85</sup> Three of the seven Apple companies incorporated in Ireland are not tax resident there:<sup>86</sup> Apple Operations International, its subsidiary Apple Operations Europe, and AOE's subsidiary, Apple Sales International. The latter two, AOE and ASI, are the companies whose tax rulings are at issue in this case.<sup>87</sup> AOE is primarily involved in manufacturing computers, but also provides some centralized payroll services, purchasing, and a call center for company operations in Europe, the Middle East, and Africa.<sup>88</sup> ASI is primarily involved in the procurement and sale of Apple finished goods, and related logistics operations.<sup>89</sup>

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<sup>83</sup> Shearman & Sterling Antitrust, *supra* note 53.

<sup>84</sup> *Id.*

<sup>85</sup> Commission Notice, 2014 O.J. C 369/22 [hereinafter Apple].

<sup>86</sup> *Id.* at ¶ 19.

<sup>87</sup> *Id.* at ¶ 30.

<sup>88</sup> *Id.* at ¶ 25.

<sup>89</sup> *Id.* at ¶ 27.

The reason tax residency is a concern is because of the double Irish arrangement, in which a company claiming tax residency elsewhere can shift profits out of Ireland to that other jurisdiction.<sup>90</sup> However, it turns out that the profits are not taxed there either because the companies could make use of deductions for foreign profits because the profits “originated” in Ireland. Tax avoidance opponents strongly disfavor such an arrangement, and in fact, Ireland is phasing it out in favor of a special IP arrangement.<sup>91</sup> Moreover, an assessment of other Member States’ ruling practices reveals none which allow the rulings to remain in force for more than five years at the most,<sup>92</sup> so the sixteen year lifespan of these rulings prior to revision is concerning in itself. More concerning to the Commission is that Ireland did not provide any transfer pricing report or other documentation supporting the figures allowed by the rulings.<sup>93</sup> While not always required, this is a common practice of companies applying for such rulings.<sup>94</sup> The question, as with the other cases, is whether the rulings confer a selective advantage upon Apple by lowering their tax liability in Ireland. The decision on this case was said to be expected by Christmas 2015, but since then, the Commission has requested further information from Ireland. Due to this delay, the decision will likely not be released until well into 2016.<sup>95</sup>

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<sup>90</sup> Stephen Castle, Mark Scott, *Ireland to Phase Out ‘Double Irish’ Tax Break Used by Tech Giants*, N.Y. TIMES, Oct. 14, 2014, <http://nyti.ms/1rsFKRA>.

<sup>91</sup> *Id.*

<sup>92</sup> Apple, *supra* note 88, at ¶ 45.

<sup>93</sup> *Id.* at ¶¶ 40-41.

<sup>94</sup> *Id.* at ¶ 59.

<sup>95</sup> J.P. Finet, *New Information Request on Apple Rulings Raises Questions*, 80 TAX NOTES INT’L 741, Nov. 30, 2015.

## Luxembourg and Amazon

Amazon EU Sarl is incorporated in Luxembourg and functions as Amazon's head office in Europe, operating websites, managing the treasury, and holding all European subsidiaries.<sup>96</sup> They received a tax ruling from Luxembourg in 2003 for a transfer pricing arrangement which sets out the method to determine that company's taxable profit.<sup>97</sup> The ruling allows a tax deductible payment of an undefined IP royalty, and also sets out the remuneration for Amazon EU Sarl's services within the corporate structure.<sup>98</sup>

In its opening letter, the Commission stated that it considers the royalty to be too large, and the remuneration to be both too low for the services provided and inappropriately capped.<sup>99</sup> Additionally, it seems that the tax base calculation may not correspond with any OECD guideline methods. Although not required, the Commission finds this concerning.<sup>100</sup> The decision is not yet released but expected later this year.

## Belgium and Excess Profits

Belgium is a somewhat different case than the others because it is not a single ruling under investigation, but a part of their tax system. They put into law an "excess profit tax system," which allows MNEs to take deductions for excess profits.<sup>101</sup> At the time of the notice, some fifty distinct

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<sup>96</sup> Commission Notice, 2014 O.J. C 44/13 [hereinafter Amazon].

<sup>97</sup> *Id.*

<sup>98</sup> *Id.*

<sup>99</sup> *Id.*

<sup>100</sup> *Id.*

<sup>101</sup> Commission Notice, 2015 O.J. C 188/04 [hereinafter Belgium].

companies had taken advantage of that law.<sup>102</sup> Belgium suspended the program in February 2015 due to pending investigation, the results of which were released in January 2016.<sup>103</sup>

Belgium claims to have implemented a transposition of the arm's length principle. A company wishing to take advantage of the adjustment must file for a tax ruling and show that their profits would have been lower in an arm's length situation.<sup>104</sup> The system seems to be based in a theory that other jurisdictions will make upward adjustments to a company's taxable base to meet the arm's length principle, and accordingly lower their taxable base in Belgium.<sup>105</sup> However, the law does not remedy actual double taxation events, but proactively adjusts Belgian profits, regardless of outside taxation.<sup>106</sup> The Commission sees a State aid problem in that proactivity, and also a selectivity in that by its nature, the deduction is only available to MNEs.<sup>107</sup>

### Part III

Real World and Policy Implications: Is this where the EU wants to take State Aid?

If we assume that the Commission's most recent rulings as to Luxembourg and the Netherlands are ultimately upheld by the Court of Justice, and tax rulings in the European Union cease to be a consistent and reliable tool of multinational business, what then? As set out earlier in this essay, transfer pricing is an essential part of doing multinational business. The Member States are rightly concerned about the fences they thought were set up around their tax sovereignty, but

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<sup>102</sup> *Id.*

<sup>103</sup> Commission Press Release, IP/16/42 (Jan. 11, 2016) [hereinafter Belgium Press Release].

<sup>104</sup> Belgium, *supra* note 104.

<sup>105</sup> *Id.*

<sup>106</sup> *Id.*

<sup>107</sup> *Id.*

on the business side all that will likely change is the certainty available in the EU through tax rulings as to upcoming tax burdens. These are significant changes, however.

MNEs do not choose the jurisdictions in which they incorporate by throwing darts at a map. They are mobile, so there is a thriving competition among States to attract and keep them. A host of government policies are weighed, pro and con, then the location which seems most suited to the company's purpose(s) is selected. The Member States whose practices are condemned in these decisions now find themselves differently positioned for this weighing than they were prior. As the cases illustrate, the Commission does not look favorably on corporate locations being unfairly compensated, high or low, for the actual value they provide to the company as a whole.<sup>108</sup> However, the EU does not operate in a political vacuum, and its Member States are not the only ones competing for the business of big business.

In the EU, the Netherlands and Ireland should be somewhat more attractive than Luxembourg, post decisions, because they have the space and human capital to more feasibly offer a greater variety of business services than just an address.<sup>109</sup> The Netherlands also offers a patent box, and a non-tax realm.<sup>110</sup> As for Luxembourg, however, there is debate over whether the famously tiny State can accommodate a significant influx of substantive operations.<sup>111</sup> It does offer political and economic stability, a central location, excellent infrastructure, and a highly skilled workforce with extensive experience in transnational finance.<sup>112</sup> On the other hand, as discussed

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<sup>108</sup> Amazon, *supra* note 99; Apple, *supra* note 88; Fiat, *supra* note 81; Starbucks, *supra* note 72.

<sup>109</sup> Drucker, *supra* note 43.

<sup>110</sup> *Id.* (The non-tax realm refers to its port, airport, and financial sector).

<sup>111</sup> *Id.*

<sup>112</sup> *Id.*

above, Ireland plans to end its notorious double-Irish arrangements, and implement a low tax on patent innovation profits. The effect this action will have on their corporate shine is uncertain.

At the moment, the entire outcome remains uncertain since the decisions will likely be fought up to the Court of Justice, and this could take years.<sup>113</sup> Member States always have legal capacity to appeal, and normally beneficiaries of aid will as well.<sup>114</sup> The first appeal must go to the Court of First Instance, which can take on factual disputes.<sup>115</sup> The case could then continue up to the Court of Justice, but only on a point of law.<sup>116</sup> The parties can request that recovery of the aid be suspended, but it will not be automatic.<sup>117</sup> And after all of that, it may not come out the way the Member States and companies prefer.

However, the judgment is fairly insignificant when compared to Starbucks' and Fiat's reported profits.<sup>118</sup> Commissioner Vestager says the Apple and Amazon investigations are very different cases.<sup>119</sup> Larger judgments are expected against them. The findings could be viewed as a windfall for Member States harder hit by difficult economic times, but it may not be enough to offset drawbacks in the form of corporate disincentives, possibly even relocation.<sup>120</sup> Elisa Ferreira, Portugal's European Parliament member, says the cases show that tax competition among States to attract companies and profits is the norm, but the EU does need a way to exchange information

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<sup>113</sup> *Id.*

<sup>114</sup> Commission State Aid Manual of Procedures, Internal DG Competition Working Documents on Procedures for the Application of Articles 107 and 108 TFEU (2013), ¶ 24.

<sup>115</sup> *Id.* at ¶ 23.

<sup>116</sup> *Id.*

<sup>117</sup> *Id.* at ¶ 25.

<sup>118</sup> Drucker, *supra* note 43.

<sup>119</sup> Kanter, *supra* note 5.

<sup>120</sup> *Id.*

and deter over generous terms for companies.<sup>121</sup> The directive on the automatic exchange of information taking effect next year may help.<sup>122</sup> Something wider reaching, like changes in international transfer pricing rules, especially in the United States and the United Kingdom, would do more to bring about a significant and less regionally harmful effect.<sup>123</sup> The State aid prohibitions may simply not be the best weapon against this issue.

Transfer pricing and tax rulings are not something most would expect to find in the front page news. So what is it that has taken something which should be a benign, uninteresting back office function and made it into the burning hot center of a political and social firestorm? The tussle between the EU and its Member States over corporate tax is a long ongoing thing, but it has seen an intense renewal in recent years. The financial crisis of 2008 heightened public concern with aggressive tax planning by MNEs,<sup>124</sup> then in late 2014, a group of investigative journalists released what has come to be known as the LuxLeaks. That was a treasure trove of about 1,600 confidential tax rulings obtained by PricewaterhouseCoopers from Luxembourg for its clients.<sup>125</sup> Most of the rulings discussed above were already under investigation when the LuxLeaks scandal set off a fresh wave of public outrage over sweetheart tax deals for MNEs.<sup>126</sup> Calls for them to “pay their fair share” were accompanied by a decrease in State aid notifications following reforms, which freed resources for *ex officio* investigations by the Commission,<sup>127</sup> and investigate they did.

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<sup>121</sup> Kanter, *supra* note 5.

<sup>122</sup> Directive on the Automatic Exchange of Information, *supra* note 28.

<sup>123</sup> Drucker, *supra* note 43.

<sup>124</sup> Shearman & Sterling Antitrust, *supra* note 53.

<sup>125</sup> Wayne & Carr, *supra* note 31.

<sup>126</sup> *Id.*

<sup>127</sup> Shearman & Sterling Antitrust, *supra* note 53.

Recent years have seen a multi-continent crackdown on aggressive tax avoidance,<sup>128</sup> which may have emboldened EU politicians in their own efforts. Another government motivator is simply the perceived cost to those governments of successful tax avoidance. The OECD estimates the cost to affected countries may be up to \$240 billion annually.<sup>129</sup> There is definitely political frustration with tax competition in the Eurozone. Another contributing frustration is with the bailouts for some States with low corporate tax rates or their banks, although these States are not the ones presently under investigation,<sup>130</sup> with the notable exception of Ireland.<sup>131</sup> In response, current EU politicians have made a priority of fighting corporate tax avoidance.<sup>132</sup> With the widespread use of tax rulings for questionable purposes, the State aid rules have become an attractive potential tool in that fight.<sup>133</sup>

But in its zeal, the Commission should remember that the State aid prohibitions have never been about tax competition between States, but the integrity of national tax systems, standing alone.<sup>134</sup> Viewed through this lens, even something as polarizing as the LuxLeaks may not be so strong. Yes, it reveals that many of those more able to pay a heavier tax burden are not, in fact, doing so, but at the same time, the larger that group is, the less selective is the necessary advantage required to invalidate it, if an advantage remains at all. Indeed, a Member State could, if it made financial sense, eliminate their corporate tax burden entirely without doing anything illegal. Some

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<sup>128</sup> Drucker, *supra* note 43.

<sup>129</sup> *Taxing Multinational Enterprises – Base Erosion and Profit Shifting*, BEPS Update No. 3 (OECD Pol’y Brief), Oct. 2015.

<sup>130</sup> Shearman & Sterling Antitrust, *supra* note 53.

<sup>131</sup> Vox Editors, *The IMF’s Analysis of the Irish Bailout*, VoxEU, Nov. 17, 2015, <http://www.voxeu.org/article/imf-s-analysis-irish-bailout>.

<sup>132</sup> Luja, *supra* note 23.

<sup>133</sup> Pierpaolo Rossi-Maccanico, *Fiscal Aid, Tax Competition, and BEPS*, 75 TAX NOTES INT’L 857 (Sep. 8, 2014).

<sup>134</sup> Luja, *supra* note 23.

critics are uncomfortable with allowing areas of low or no taxation, viewing them as inconsistent with a generally applicable tax structure.<sup>135</sup> However, Member States' tax sovereignty means they are generally free to tax what they wish, in whatever way they wish. Maintaining this sovereignty is important so long as EU States are still in competition with the rest of the world for multinational citizens. So long as they are not subjectively applying their own laws in a way that excludes a significant part of what they are supposedly intended to include, there should be no problem.<sup>136</sup> To maintain the integrity of State aid law, violations should not be found unless a tax burden has only been lowered for a particular category of business.

There is a related argument to be made that cross border tax planning and these sorts of tax rulings are selective by nature as they are really only available to MNEs.<sup>137</sup> However, this advantage is an inherent part of such an entity. Most likely, there will always be an array of different tax jurisdictions in the world from which the more mobile among us may pick and choose. Others are not barred from this flexibility, but only lack the present ability to use it. The advantage of multiple tax systems is a natural outgrowth of different sovereignties, and not tied to any one State in particular. Since Article 107 requires the advantage to be attributable to a particular Member State, a legitimate State aid argument on this basis is lacking without a showing of selective treatment between different categories of businesses.<sup>138</sup>

Ultimately, there are a number of limits on this trending use of State aid which render it unsuitable for the purpose of tackling cross jurisdictional tax avoidance. For one, the State aid

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<sup>135</sup> Rossi-Maccanico, *supra* note 138.

<sup>136</sup> Luja, *supra* note 23.

<sup>137</sup> Rossi-Maccanico, *supra* note 138.

<sup>138</sup> Luja, *supra* note 23.

rules are meant to reign in Member States and keep them from favoring their own local businesses over those based elsewhere. In these cases, the effect is entirely opposite, with States allegedly favoring outside companies at the expense of their own. Maybe this is still something the Union wishes to dissuade, but under this approach, it is the companies which end up bearing the resulting burden, if there is one, and the States get increased revenues.<sup>139</sup> The dissuasive effect on them is difficult to gauge, and the precedent is an uncomfortable one if it is only being used for political purposes. The scope of State aid application is already very broad.<sup>140</sup>

Another limit is that the State aid rules are really only useful against some groups of companies and some types of internal tax competition. They are not suited to addressing large scale tax avoidance<sup>141</sup> because of the difficulty of enforcing such prohibitions across jurisdictions, especially outside of the EU.<sup>142</sup> The international tax framework is highly conducive to exploitation through the use of tax havens and the like, which renders State aid prohibitions much less useful, and possibly quite harmful on a large scale if used inappropriately.<sup>143</sup> The present cases, for instance, are less likely to stop the use of tax havens than to shift them to new, non-EU jurisdictions.<sup>144</sup> If a tax ruling is a proper application of the national law, there should be no State aid problem, and there can certainly be State aid problems in the absence of a ruling.<sup>145</sup> Advanced tax rulings are an important part of business planning, providing legal certainty businesses need in

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<sup>139</sup> Shearman & Sterling Antitrust, *supra* note 53.

<sup>140</sup> Luja, *supra* note 23.

<sup>141</sup> *Id.*

<sup>142</sup> Amanda Athanasiou, *TAXE Committee Studies Address BEPS and Ruling Practices*, 80 TAX NOTES INT'L 310 (Oct. 26, 2015).

<sup>143</sup> *Id.*

<sup>144</sup> Drucker, *supra* note 43.

<sup>145</sup> Luja, *supra* note 23.

order to act with confidence.<sup>146</sup> Eroding their trusted foundation could be harmful, putting EU States at a disadvantage against non-EU States in competing for business investment.<sup>147</sup>

### Conclusion

This essay concludes that Member State tax disparities which are not due to a conflict with internal national law but rather to a lack of Union tax law harmonization should be dealt with through other means than the Article 107 State aid prohibition. Such use is not what the EU founders intended or what the Member States agreed to, and will actually have more harmful effects within the EU than positive. If the Commission is only pursuing these cases out of a conviction that the businesses should bear a greater share of tax burdens than they do, that is a political fight, and one the Member States have reserved to themselves. Wielded as a political weapon, State aid is a powerful tool, and under recent interpretation, it is able to reach much farther into the sovereign sphere of national tax policy than was probably ever intended. Moreover, it may not even be necessary to use it as such. There is independent movement in the Union to simplify and solidify their disjointed tax laws, and in the meantime, the simple threat of investigation may be enough to ensure that States take more care before issuing rulings and companies do not take them for granted.<sup>148</sup> Such alternative approaches to the problem may be better able to achieve the desired results without opening the political can of worms that State aid investigations can become.

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<sup>146</sup> Shearman & Sterling Antitrust, *supra* note 53.

<sup>147</sup> Luja, *supra* note 23.

<sup>148</sup> Athanasiou, *supra* note 137.